

2 INTRODUCTION

2.1 The Strategic context

A sound corporate financial reporting system is the cornerstone of a well functioning market economy and the bedrock of a robust financial system.

In developing a strategy to enhance the quality of corporate financial reporting in Bosnia Herzegovina it is important to consider the “deterrents” and “incentives” which motivate the development of this strategy.

- Deterrent is considered in light of the financial crises and corporate scandals that have taken place in the late 1990s in developing markets and over the past few years in industrialized countries. High quality financial reporting helps to avert such scandals, which have enormous economic and social costs. For example:
- Financial system crises in South East Asia resulting from weak corporate financial reporting practices had significant macro-economic consequences on countries such as Thailand (minus 10% in Gross Domestic Product (GDP) in 1998), South Korea (minus 7% in GDP in 1998) and Indonesia (minus 13% in GDP in 1998). Importantly, these crises had a disproportional negative effect on the poor resulting in reversal in school enrolment, severe health implications, etc;
- Enron filed for bankruptcy in 2001 resulting in a loss of US\$67 billion in market capitalization. Consequently, thousands of employees worldwide lost their job and thousands of employees and retirees lost a significant portion of their pension benefits;
- Parmalat underreported loans by approximately US\$14 billion. As a consequence, 36,000 jobs in 65 countries were put at stake and 5,000 farmers are still owed US\$150 million, or US\$30,000 per farmer.

These scandals send a very clear picture of the negative effects of poor corporate financial reporting. In contrast good corporate financial reporting is conducive to financial sector development and private sector development, which in turn spur economic growth. The relationship between high quality corporate financial reporting and financial and private sector development works through several dimensions:

- First, through strengthening domestic financial architecture and reducing the risk of financial market crises and their associated negative economic impacts;
- Second, by contributing to foreign direct and portfolio investment and helping to mobilize domestic savings. Foreign direct investment (FDI) has been slow to materialize, negatively affecting employment in Bosnia Herzegovina. Bosnia

Herzegovina's poor growth record, negative trade balance and low FDI signal a business environment not conducive to robust private sector-led growth or increased domestic and foreign investment. Weaknesses in the legal framework continue to hinder private sector development and foreign investment;

- Third, through facilitating smaller-scale corporate borrowers' access to credit from the formal financial sector by lowering high costs of information and borrowing. Enterprise sector growth has been constrained by poor access to credit. Despite recent improvements in the financial sector, the level of banking intermediation in Bosnia Herzegovina remains among the lowest in the region;
- Fourth, by allowing investors to evaluate corporate prospects and make informed investment and voting decisions, which results in a better allocation of resources. Corporate financial reporting is also a gauge for market-based monitoring, which allows shareholders and the public at large to assess a company's management performance, and thereby promotes the active development of capital markets;
- Finally, by supporting economic integration, both regionally and globally.

2.2 The background to the development of this strategy

In 2004, a World Bank team prepared a Report on the Observance of Standards and Codes (ROSC) on accounting and auditing (A&A) in Bosnia Herzegovina. The ROSC A&A policy recommendations were agreed between the World Bank, the State and Entity Ministries of Finance and relevant BiH stakeholders. It was also agreed that a detailed strategy and action plan would be developed and implemented on the basis of these policy recommendations. The strategy and action plan, to be developed by BiH stakeholders, was to be implemented under the coordination of the State and Entity Ministries of Finance and with assistance from development partners.

As an immediate response to the A&A ROSC, Bosnia Herzegovina adopted uniform accounting and auditing laws at the Entity level and established an Accounting and Audit Commission (the Commission).

Following on from the A&A ROSC report and the preparation of the uniform accounting and auditing laws at the Entity level and establishment of the Accounting and Audit Commission, the Ministry of Finance in Bosnia Herzegovina set up a Steering Committee (SC) to develop a strategy and action plan to address the policy recommendations set forth in the A&A ROSC report with the aim of enhancing the quality of corporate financial reporting. The developments to date are mapped in [Figure 2-1: Reform path to date](#).

Country Owned Reform Agenda

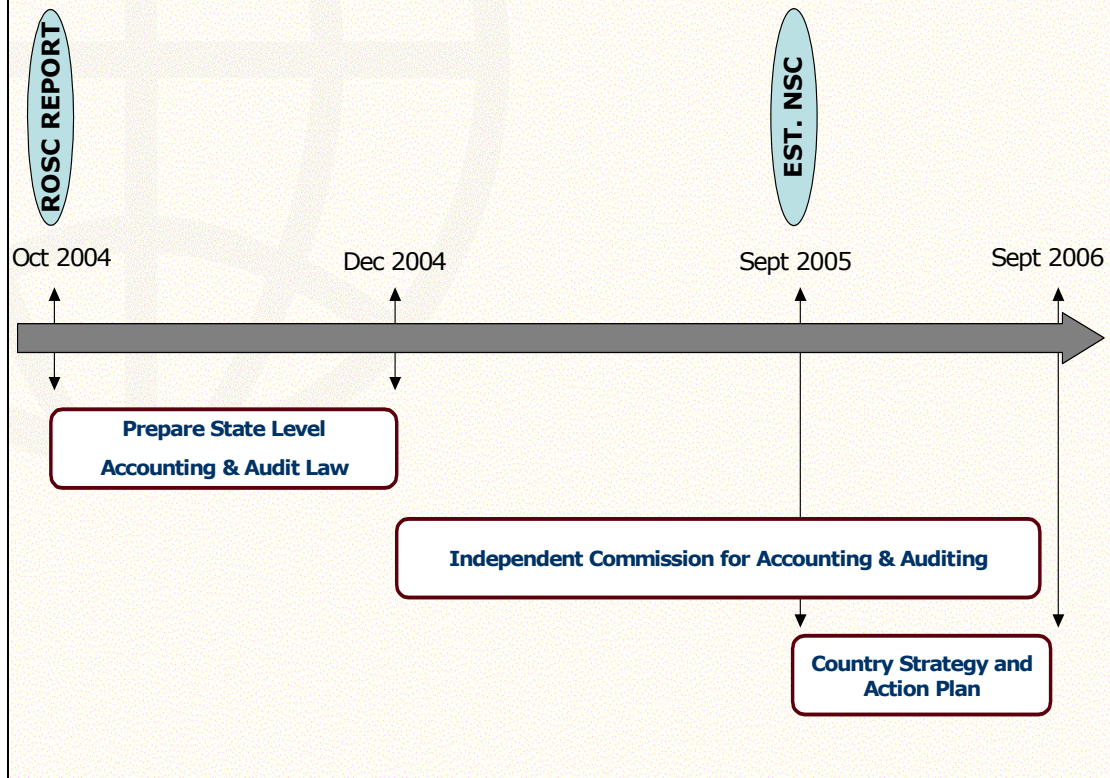


Figure 2-1: Reform path to date

The SC is made up by a multi-disciplinary group of public and private sector stakeholders with an interest in corporate financial reporting. It includes representatives from the government, financial sector regulators, the accountancy profession, academia, commercial banks, insurance companies and large and medium enterprises. The role and activities of the SC were to support the preparation of a strategy and action plan to address the requirements of the *acquis communautaire* relating to accounting and auditing. A World Bank Technical Assistance Program has supported the SC's work.

This strategy and action plan is intended to be the basis for discussions on technical assistance with development partners. With the completion of the action plan, there will be a need for an advisory group to provide assurance on the implementation of the reforms. The State and Entity Ministries of Finance will decide on the remit and structure of such an advisory group.

2.3 Strategic objectives and benefits

The enhancement of the quality of corporate financial reporting extends beyond the specific scope of accounting and auditing. The strategic objectives and benefits are identified below in Figure 2-2: The importance of high quality corporate financial reporting.

Strategic Objectives and Benefits	
European Integration	Adopting and implementing relevant portions of the <i>acquis communautaire</i>
Improved Access to Credit	Facilitating the access of smaller-scale corporate borrowers, including small and medium enterprises, to credit from the formal financial sector by shifting gradually from collateral-based lending decisions to lending decisions that are based on the financial performance of the prospective borrower
Private Sector Growth & Job Creation	Allowing shareholders and the public at large to assess management performance, thus influencing its behaviour and use of resources
Development Markets of Capital	Contributing to foreign portfolio investment; allowing investors to evaluate corporate prospects and make informed investment and voting decisions, which will result in a better allocation of resources
Financial Sector Development	Help mobilize domestic savings
Financial Stability	Strengthening Bosnia Herzegovina's financial architecture and reducing the risk of financial market crises and their associated negative economic impacts, including through increased transparency about the financial condition and performance of public interest entities

Figure 2-2: The importance of high quality corporate financial reporting

This strategy and action plan is about better corporate financial reporting, i.e. a vehicle to achieve a number of economic "goods" outlined in Figure 2-2 above. It is about achieving economic growth and EU integration through the adoption and implementation of the relevant portions of the *acquis communautaire* and other relevant benchmarks. This will result in an environment where users can place reliance on corporate financial reporting for their respective needs as illustrated in Figure 2-3: Benefits of Good Corporate Reporting.

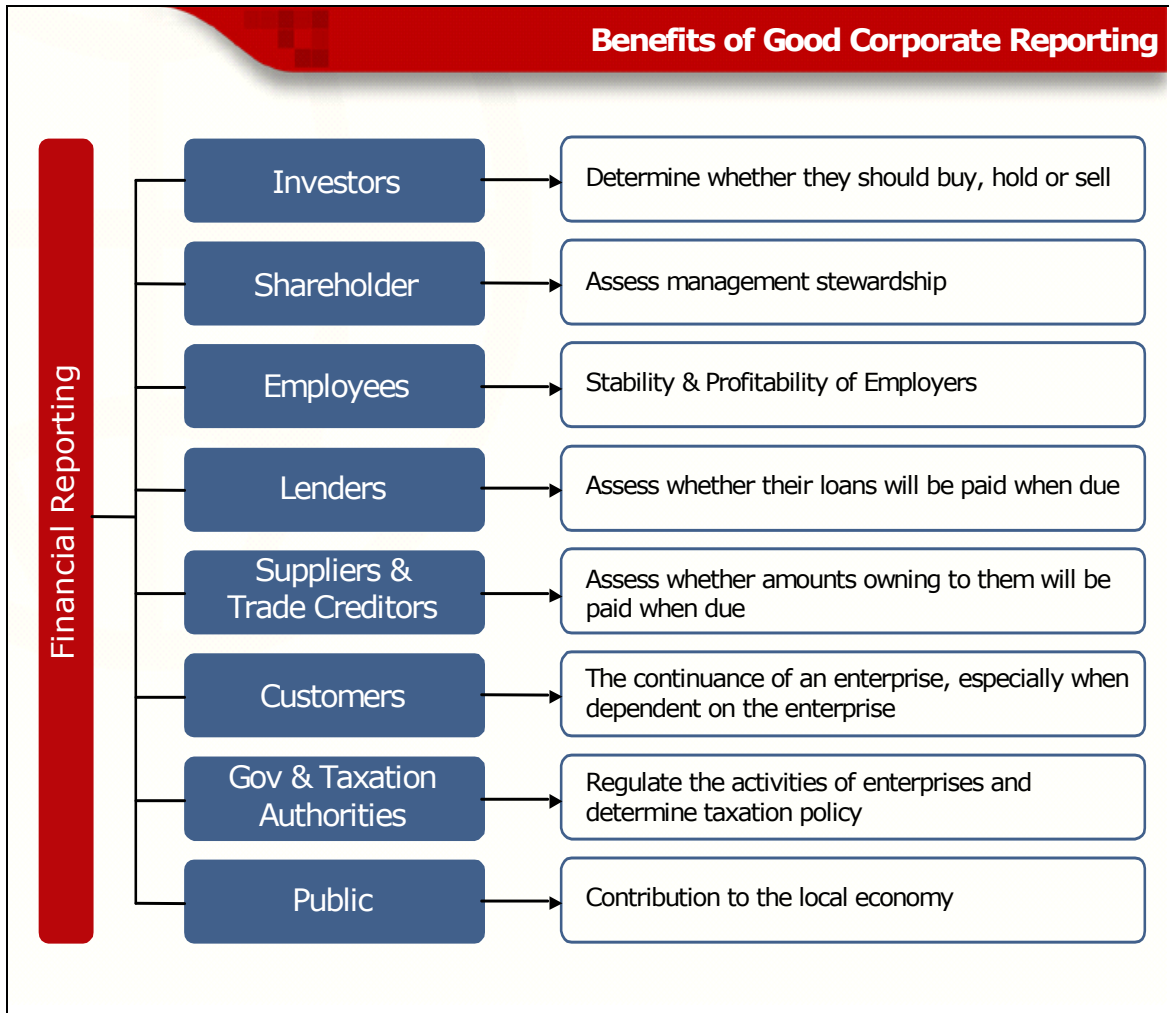


Figure 2-3: The Benefits of Good Corporate Reporting

2.4 The statutory and institutional frameworks

The SC has identified areas of work that require substantial strengthening in Bosnia Herzegovina under two pillars. The first pillar is the statutory framework and the second pillar is the institutional framework. Figure 2-4 outlines the objectives and benchmarks that will drive the strategy and action plan under these two key pillars.

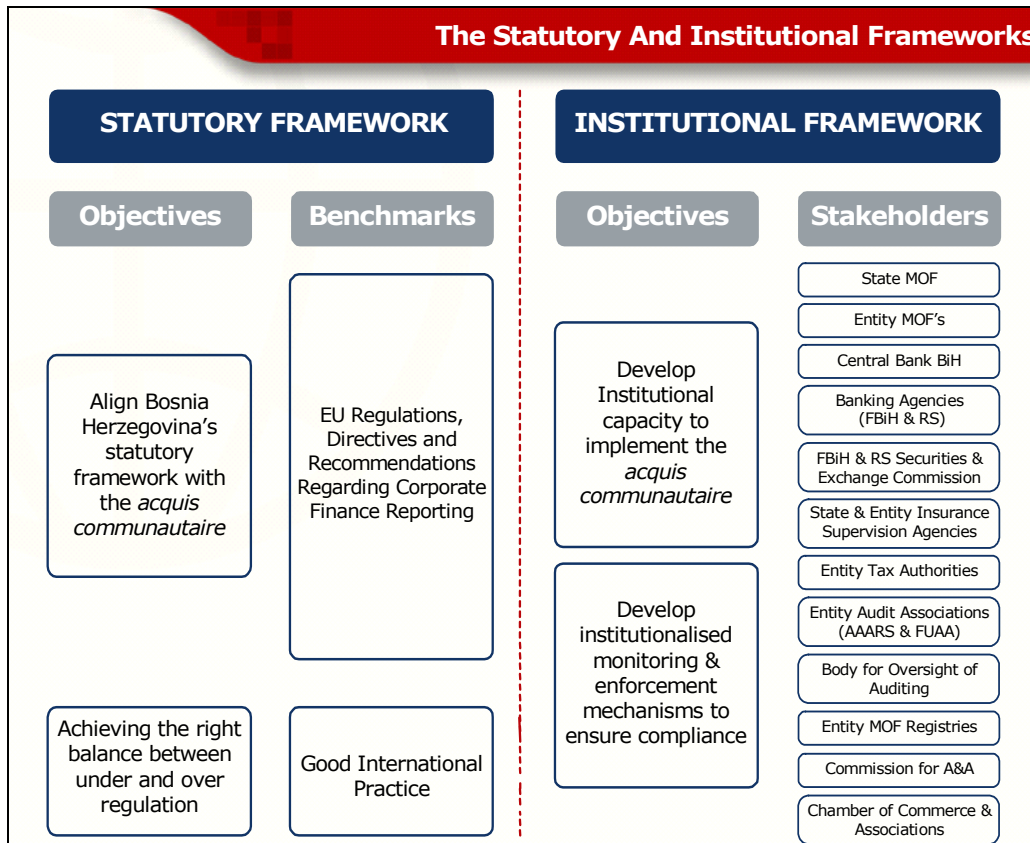


Figure 2-4: The Statutory & Institutional Framework

For the statutory framework the overarching theme is to align the Bosnia Herzegovina statutory framework with the *acquis communautaire* while achieving the right balance between “under- and over-regulation.” This means making full use of the exemptions available in the *acquis communautaire* in order to avoid imposing an unrealistic and unproductive burden on small and medium enterprises (SMEs) in Bosnia Herzegovina.

For the institutional framework the SC has identified a number of key stakeholders that will play a crucial role in implementing the *acquis communautaire* and in monitoring and enforcing its application. The institutions identified have either a direct or indirect role in the corporate financial reporting framework in Bosnia Herzegovina. For example the State and Entity Ministries of Finance and the entity level Profession Audit Institutes have important roles to play.

2.5 Benchmarks

As illustrated in Figure 2-5, the SC's approach to strengthening the statutory and institutional frameworks is driven by a primary benchmark, i.e. the *acquis communautaire* complemented by International Financial Reporting Standards (IFRS), International Standards on Auditing (ISA) and good international practice.

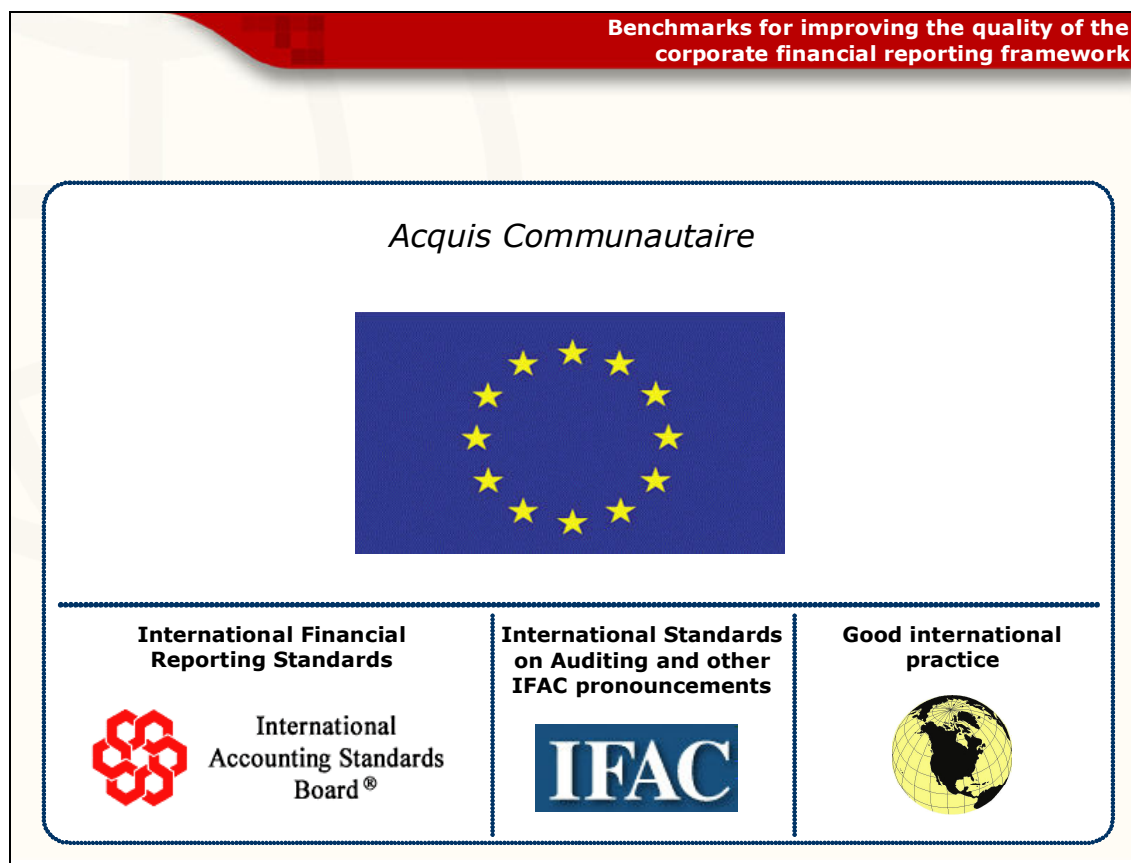


Figure 2-5: Benchmarks for improving corporate financial reporting

The *acquis communautaire*

The relevance of the *acquis communautaire* for Bosnia Herzegovina is twofold. First, it represents a high-quality model for the regulation of accounting and auditing, which may be applied to countries of differing characteristics. Second, the adoption of the *acquis communautaire*, relating to accounting and auditing, supports Bosnia Herzegovina's strategy to become part of the European Union.

In this regard two factors have influenced the SC in developing this strategy and action plan. Firstly, with regard to enforcement it is anticipated that Bosnia Herzegovina will need to demonstrate that it has not only adopted the *acquis communautaire* in law (statutory framework) but also that Bosnia Herzegovina has taken measures to ensure the *acquis communautaire* is actually implemented (institutional framework). Secondly, the SC

acknowledged that no blueprint exists on how exactly to implement and enforce the *acquis communautaire* and therefore has had regard to the experience of existing EU Member States.

Constructing a high-quality regulatory and institutional framework for accounting and auditing requires reforms to Bosnia Herzegovina's legal framework, institutions, and accounting profession, as well as changes in its accounting, auditing and business culture. This strategy and action plan sets out a number of reform activities developed in a holistic manner with due regard to Bosnia Herzegovina's ability to carry out such activities (both in terms of capacity and resources). In some instances, a relatively lenient rule that is robustly and consistently enforced is preferable to a good, rigorous one that is unenforceable, as the lenient rule can be progressively made more rigorous as circumstances allow. As a result, the SC has decided to set forth reform activities that, while challenging, can be carried out in the short to medium term.

International Financial Reporting Standards

As illustrated in Figure 2-5, the SC has also had regard to IFRS as a benchmark.⁴ The SC agrees with the ROSC report recommendation that IFRS are generally meaningful for Public Interest Entities (PIE) and would be too burdensome in most SMEs. Therefore, the fact that the SC uses IFRS as a benchmark does not imply that IFRS is suitable for all companies. The SC has not used these standards as an absolute benchmark but has endeavored to draw on these standards to complement the *acquis communautaire* in instances where the *acquis communautaire* is not specific enough.

International Standard on Auditing

The SC has also had regard to the standards, codes and statements issued by the International Federation of Accountants (IFAC) and its independent boards, including:

- International Standards on Auditing (ISA);⁵
- The Code of Ethics for Professional Accountants;⁶
- International Educational Standards (IES);⁷ and

⁴ The International Accounting Standards Board (IASB), an independent international organization, sets IFRS.

⁵ The International Auditing and Assurance Standards Board (IAASB) of IFAC sets International Standards on Auditing (ISA).

⁶ The Code of Ethics for Professional Accountants is developed by the International Ethics Standards Board for Accountants of IFAC.

- Statement of Membership Obligations (SMOs).⁸

As with IFRS, the SC has not used these standards, codes, and statements as absolute benchmarks but has endeavored to draw on them to complement the *acquis communautaire* in instances where the *acquis communautaire* was not specific enough.

Good international practice

Finally the SC has drawn on examples of good international practice as a useful reference for developing the strategy and action plan. Thanks to the technical assistance provided, for example by the World Bank's "Road to Europe – Program of Accounting Reform and Institutional Strengthening" (REPARIS) program, the assistance provided by the European Agency for Reconstruction and the assistance provided by the United States Agency for International Development, the SC has gathered examples of good international practice and drawn on this knowledge to understand:

- How EU Member States have adopted and implemented the *acquis communautaire*;⁹ and
- In areas where the *acquis communautaire* is too generic or silent (e.g., linkages between corporate income tax reporting and annual accounts), what approach is considered good international practice

These benchmarks also underpinned the assessment procedures that led to the policy recommendations of the A&A ROSC.

⁷ International Education Standards are developed by the International Accounting Education Standards Board of IFAC.

⁸ The SMOs serve as the foundation for the Member Body Compliance Program, which is overseen by IFAC's Compliance Advisory Panel. SMOs provide clear benchmarks to current and potential member bodies to assist them in ensuring high-quality performance by professional accountants.

⁹ During the year 2005, the NSC reviewed a number of discussion papers that outlined the statutory and institutional frameworks of a number of old and new EU Member States, including France, Germany, Ireland, the Slovak Republic and Slovenia.

The relevant portions of the *acquis communautaire*

The SC has reviewed the *acquis communautaire* and identified Chapter 6, Company Law, as particularly relevant to the establishment of a robust financial reporting framework. Figure 2-6 differentiates between “hard law” and “soft law.” Regulations (binding in all EU Member States without the need for any national implementing legislation) and Directives (binding with respect to the objectives to be achieved and the time limit within which such objectives must be reached; however, they leave to national authorities the choice of form and means for achieving those objectives) are considered “*hard law*.” Recommendations and Communications are considered “soft law.” Soft law are “rules of conduct which, in principle, have no legally binding force but which nevertheless, may have practical effects.”¹⁰

Corporate sector accounting & auditing within the <i>acquis communautaire</i>					
LEGISLATION	ACCOUNTING			AUDITING	
Regulations & Directives (Hard Law)	(A) ANNUAL ACCOUNTS DIRECTIVE (78/660/EEC)			(L) STATUTORY AUDIT DIRECTIVE (2006/43/EC)	Core
	(B) CONSOLIDATED ANNUAL ACCOUNTS DIRECTIVE (83/349/EEC)				
	BANKING	INSURANCE	CAPITAL MARKETS		Sector Specific
	(C) BANKING ACCOUNTS DIRECTIVE (86/635/EEC)	(E) INSURANCE ACCOUNTS DIRECTIVE (91/674/EEC)	(G) IFRS REGULATION (NO. (EC) 1606/2002 INCLUDING EU COMMISSION REGULATIONS ENDORSING INDIVIDUAL IFRS)		
	(D) CAPITAL REQUIREMENTS DIRECTIVE	(F) SOLVENCY DIRECTIVE (2001/13/EC)	(H) PROSPECTUS DIRECTIVE (2003/71/EC)		
Recommendations & Communications (Soft Law)	(K) COMMUNICATION ON MODERNISING COMPANY LAW & ENHANCING CORPORATE GOVERNANCE IN THE EU (COM/2003/284)			(M) STATUTORY AUDITOR'S INDEPENDENCE RECOMMENDATION (2002/590/EC)	
				(N) QUALITY ASSURANCE FOR THE STATUTORY AUDIT RECOMMENDATION (2001/256/EC)	

Figure 2-6: Corporate Sector Accounting and Auditing within the *Acquis Communautaire*

¹⁰ Snyder, F. 1993. “The Effectiveness of European Community Law: Institutions, Processes, Tools and Techniques.”

Taken together, these Regulations, Directives, Recommendations and Communications can be considered as the significant body of the *acquis communautaire*, relevant to corporate sector accounting. A brief summary of the fundamental Regulations, Directives, Recommendations and Communications is identified below:

Fundamental Accounting Directives

- (A) *Fourth Directive on Annual Accounts (78/660/EEC)*: This Directive coordinates Member States' provisions concerning the presentation and content of annual accounts and annual reports of companies with limited liability, the general principles for the valuation of items in the annual accounts (e.g., prudence), specific valuation rules (e.g., valuation rules for fixed assets), and the publication of annual accounts as set forth in the First Company Law Directive (68/151/CEE), as amended.
- (B) *Seventh Directive on Consolidated Accounts (83/349/EEC)*: This Directive coordinates national laws on consolidated (i.e., group) accounts and defines the circumstances under which consolidated accounts are to be drawn up. A parent company and all its subsidiaries are to be consolidated where either the parent company or one or more subsidiaries is established as a company with limited liability.

Regarding these two Directives, the SC has had regard to the requirements of the Directive, as amended, and the various options and maximum thresholds, which will require Bosnia Herzegovina policymakers to determine which options and thresholds, are suitable in the context of Bosnia Herzegovina.

Banking Sector

- (C) *Banking Accounts Directive (86/635/EEC)*: For annual accounts of banks and other credit institutions this Directive sets out rules concerning presentation and measurement in those areas where such rules are deemed necessary because of the particular nature of the entity.
- (D) *Capital Requirements Directive*: This Directive, which is generally known as the Capital Requirements Directive but technically comprises two Directives, introduces a supervisory framework in the EU, reflecting the Basel II rules on capital measurement and capital standards agreed at the G-10 level. The Directive makes the existing framework more comprehensive and risk-sensitive and fosters enhanced risk management amongst financial institutions, enhancing the effectiveness of the framework in ensuring continuing financial stability, maintaining confidence in financial institutions and protecting consumers. It is also designed to ensure that the capital requirements for lending to SMEs are appropriate and proportionate. EU Member States are to apply the Directive from the start of 2007, with the most sophisticated approaches being available from 2008. While the Capital Requirements Directive is not an "accounting" Directive per se, the SC has had regard to it

in order to ensure that financial reporting reforms in the context of the strategy and action plan are conducive to better and consistent approaches to banking supervision.¹¹

Insurance Sector

- (E) *Insurance Accounts Directive (91/674/EEC)*: For annual and consolidated accounts of insurance undertakings this Directive provides specific rules concerning presentation and measurement in those areas where such rules are deemed necessary because of the particular nature of the insurance industry.
- (F) *Solvency Directives*: An insurance company should have a solvency position that is sufficient to fulfill its obligations to policyholders and other parties. Insurance undertakings in the EU are subject to the same solvency margin requirements to provide the same protection of policyholders' interests as well as to create a level playing field between undertakings. The SC has had regard to the current solvency regime, which recently amended and updated as part of the "Solvency 1" package, including Directives 2002/13/EC (non-life insurance) and 2002/83/EC (life insurance). In addition, the SC has considered the implications of the "Solvency 2 project," which analyses subjects such as a more risk-based approach, the harmonization of the establishment of technical provisions, new risk transfer techniques and recent developments in financial reporting.

Capital Markets

- (G) *Regulation (EC) No. 1606/2002 of the European Parliament and Council*: The Regulation requires listed companies, including banks and insurance companies, to prepare their consolidated accounts in accordance with endorsed IFRS beginning 2005. EU Member States also have the option of extending the requirements of this Regulation to unlisted companies and to the production of annual accounts. European Commission Regulations endorse the standards as agreed and when required.¹²
- (H) *Prospectus Directive (2003/71/EC)*: This Directive together with European Commission Regulation No. 809/2004 sets out the information contained in prospectuses as well as the format, and the rules for publication of such prospectuses and dissemination of advertisements. It is a cornerstone in the creation of the single market for financial services

¹¹ To reduce barriers arising from the responsibilities of separate national supervisory authorities, supervisors are required to work more closely together, including in deciding on applications by financial institutions to use the more sophisticated methodologies. The Committee of European Banking Supervisors (CEBS) has an important role in promoting consistency of approach between different supervisors.

¹² For example, Regulation (EC) No. 1725/2003 of September 29, 2003 (plus annexes) endorsed all existing International Accounting Standards (IASs), including related Standard Committee Interpretations (SICs), except for IAS 32 and 39 and related SICs 5, 16 and 17, which deal with the accounting and disclosure of financial instruments.

and the completion of the EU Financial Services Action Plan. By harmonizing the necessary disclosure requirements, the new legal framework as a whole creates an effective "single passport" for both EU and non-EU issuers. In other words it means that once a prospectus is authorized in one Member State, it can be used in all the others, cutting red tape and costs for issuers. In the context of Bosnia Herzegovina, the SC has had regard to the corporate financial reporting implications of the Directive and the European Commission Regulation especially in the context of nascent capital markets.

- (I) *Transparency Directive (2004/109/EC)*: This Directive sets out minimum transparency requirements for listed companies, raising the quality of information available to investors on companies' performance and financial position. The SC has had regard to the disclosure requirements set forth in the Directive, which complete a package of EU Financial Services Action Plan measures, including Regulation 1606/2002 and the Prospectus Directive (see above). Under the Directive, all securities issuers will have to provide annual financial reports within four months after the end of the financial year. Also, investors in shares will receive more complete half-yearly financial reports.
- (J) *Undertakings for the Collective Investment of Transferable Securities (UCITS) Directive (85/611/EEC)*: The Directive, as amended, sets out the common rules to permit collective investment undertakings situated in EU Member States to market their units in other EU Member States (single passport). The SC has had regard to the corporate financial reporting implications of the Directive.

Fundamental Accounting Communication

- (K) *Communication on Company Law and Corporate Governance (COM/2003/284)*: The European Commission held a consultation on the Commission's Communication on "Modernizing Company Law and Enhancing Corporate Governance in the European Union: A Plan to Move Forward." The Plan, adopted on May 21, 2003, proposed a set of initiatives aimed at strengthening shareholders' rights, reinforcing protection for employees and creditors, and increasing the efficiency and competitiveness of European business.

Fundamental Auditing Directive

- (L) *Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts* (also known the "new Eighth EU Company Law Directive", *amending Council Directives 78/660/EEC and 83/349/EEC and repealing the Council Directive (84/253/EEC)*), clarifies the duties of statutory auditors and sets out certain ethical principles to ensure objectivity and independence. It introduces a requirement—rather than a recommendation—for external quality assurance, ensures robust public oversight over the audit profession and improves cooperation between regulatory authorities in the EU. The SC has had regard to this new Directive with a view to propose further reform activities in the areas where the enacted Bosnia Herzegovina audit laws currently differ from the Directive.

Fundamental Auditing Recommendations

- (M) *Recommendation 2002/590/EC on statutory auditors' Independence in the EU:* The Recommendation features a set of high level principles and recommends that statutory auditors be prohibited from carrying out audits if they have any relationship with their client that might compromise their independence. Although the Recommendation is not a legally binding instrument, it provides a clear benchmark of good practice for the EU audit industry and was duly considered by the SC.
- (N) *Recommendation 2001/256/EC on Quality Assurance for the Statutory Audit:* The Recommendation sets minimum standards for external quality assurance systems for statutory audits in the EU. The aim of quality assurance is to ensure that statutory audits are conducted in compliance with the established auditing standards and that the auditors respect ethical rules, including independence.