

1 EXECUTIVE SUMMARY

1.1 Introduction

This paper sets forth a country strategy and action plan to enhance the quality of financial reporting in the Republic of Macedonia (Macedonia). The strategy was developed by a National Steering Committee (NSC) comprised of public and private sector stakeholders with an interest in financial reporting which was established in 2005¹. This country strategy and action plan set out a clear program of reforms to enhance Macedonia's legal framework, institutions, and accounting profession, as well as its accounting, auditing and business culture, to achieve high quality financial reporting.

1.2 Benefits of enhancing financial reporting

The enhancement of financial reporting should not be viewed as an objective for its own sake: it is much more than this. High quality financial reporting is the cornerstone of a well functioning market economy and the bedrock of a robust financial system. Improving the quality of financial reporting in Macedonia will have a significant and positive impact on the economy by:

- Reducing the risk of financial market crises and their associated negative economic impacts by strengthening the domestic financial architecture;
- Contributing to foreign direct and portfolio investment and helping to mobilize domestic savings;
- Facilitating smaller-scale corporate borrowers' access to credit from the formal financial sector by lowering high costs of information and borrowing;
- Allowing investors to properly evaluate corporate prospects and make informed investment and voting decisions, which results in a lower cost of capital and a better allocation of resources;
- Allowing shareholders and the public at large to assess a company's management performance, thereby promoting the active development of capital markets; and
- Supporting economic integration, both regionally and globally.

1.3 Drivers of enhanced financial reporting in Macedonia

The NSC confirmed that good financial reporting depends on the adoption and application of a number of different benchmarks, standards, codes and practices. The primary

¹ See Appendix C for decision to establish National Steering Committee

benchmark is the *acquis communautaire*² relating to company law, financial reporting, auditing, financial markets, and financial institutions complemented as detailed on page 28 (Section 2.5), by International Financial Reporting Standards (IFRS), International Standards on Auditing (ISA) and good international practice. Proper transposition and implementation of the *acquis communautaire* has become even more important after the European Union (EU) granted Macedonia candidate status on December 17, 2005.

The NSC took account of the experience of relevant EU Member States in recognizing that a successful country strategy must address both statutory and institutional issues. It is not enough to mandate enhanced financial reporting. The improved statutory framework must also be implemented and enforced by suitably resourced institutions. The country strategy and action plan identifies actions relating to these two key pillars: the statutory framework and the institutional framework.

The NSC has borne in mind Macedonia's capacity to carry out the activities proposed. In some instances, a relatively lenient rule that is robustly and consistently enforced is preferable to a rigorous one that is unenforceable, as the lenient rule can be progressively made more rigorous as circumstances allow. As a result, the NSC has decided to set out reform activities that, while challenging, can be carried out in the short to medium term.

The NSC has also had regard to the 2003 World Bank Report on the Observance of Standards and Codes (ROSC³) on accounting and auditing in Macedonia. The ROSC policy recommendations were agreed between the World Bank, the Ministry of Finance and country stakeholders and thus formed a significant platform on which to develop a country strategy and action plan.

1.4 The strategy to achieve enhanced financial reporting

² The entire body of European Union laws is known, collectively, as the *acquis communautaire*. The term is most often used in connection with preparations by accession countries to join the European Union. They must adopt, implement and enforce all parts of the *acquis* in order to be allowed to join the European Union. The *acquis communautaire* includes all primary legislation (treaties), secondary legislation (Regulations, Directives etc.) and case law (judgments of the European Court of Justice and European Court of First Instance).

³ See Appendix B for the complete ROSC report.

The benefits of enhanced financial reporting are significant. The actions required to achieve these benefits are also considerable. The NSC has identified a number of high-level objectives that form the basis for the country strategy to be delivered by the individual actions set out in the plan.

- 1) Enhancing the Framework for Financial reporting;
- 2) Strengthening Key Stakeholders in the Financial Reporting Framework;
- 3) Supporting the Audit Profession;
- 4) Supporting Education, Training & Public Awareness.



Figure 1-1: Country Strategy & Action Plan

The individual actions to achieve these high level objectives are listed in Chapter 4. In deciding on the specific actions, the NSC undertook a review of the current financial reporting regime in Macedonia. This review was carried out through a series of interviews and meetings with key stakeholders. It produced a summary of the progress made in the implementation of the ROSC recommendations and of the outstanding issues that still need to be addressed.

With respect to the institutional framework the NSC has identified a number of key stakeholders that will play a crucial role in implementing the country strategy and action

plan. The Ministry of Finance (MoF), the National Bank of the Republic of Macedonia (NBRM), the Securities and Exchange Commission (SEC), the Public Revenue Office (PRO), the Insurance Supervisory Department (ISD), the Central Registry (CR), the Institute of Certified Auditors (ICA), the Council for the Advancement and Oversight of Auditing (CAOA), the Commercial Banking Association, academia, chambers of commerce & other associations, the judiciary and the general public all have a role to play, either directly or indirectly.

Enhancing the Framework for Financial reporting

The achievement of a consistent, predictable and practical financial reporting framework is one of the key benchmarks of a robust financial system.

In developing the financial reporting framework the primary goal is to provide a balanced approach to financial reporting and auditing requirements in Macedonia, that meets the needs of the different users of financial information, that is consistent and predictable and importantly that does not impose unnecessary burdens on the corporate sector.

As outlined in section 1.3 the *acquis communautaire* provides a primary benchmark for the delivery of such a framework. The alignment of the current financial reporting requirements in primary and secondary legislation with those of the *acquis communautaire* will significantly encourage the development of an enhanced financial reporting framework in Macedonia (*Action 1*).

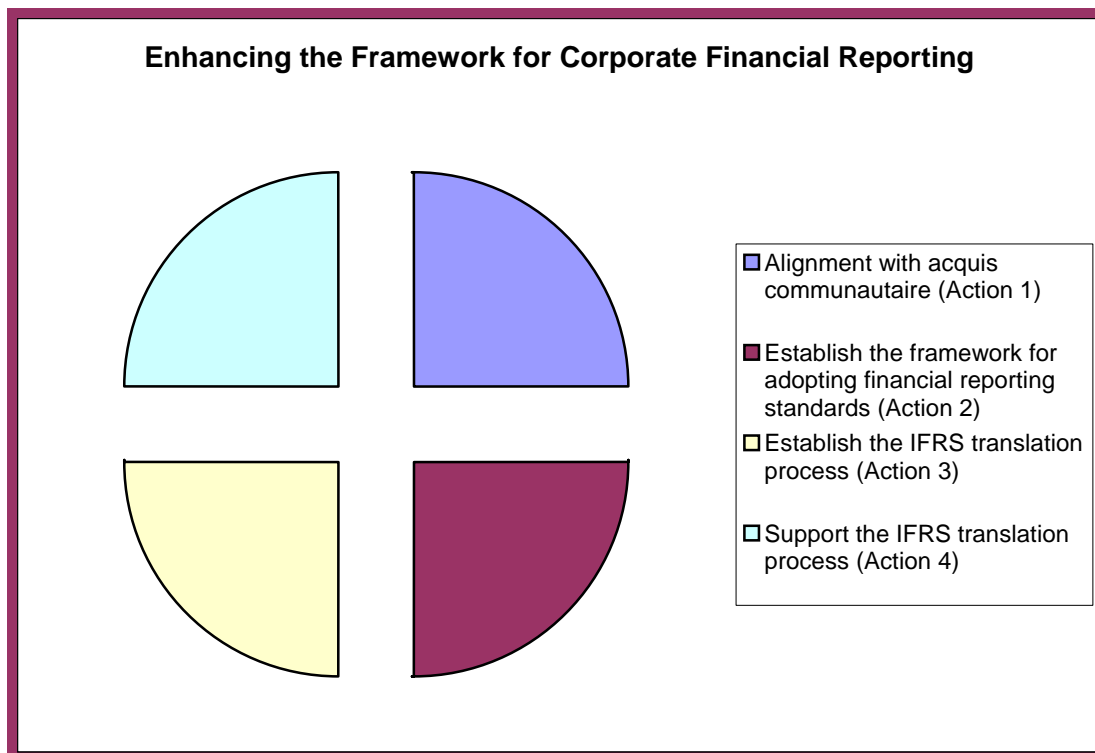


Figure 1-2: Enhancing the Framework for Financial reporting

An effective financial reporting environment is underpinned by suitable financial reporting (accounting) standards.

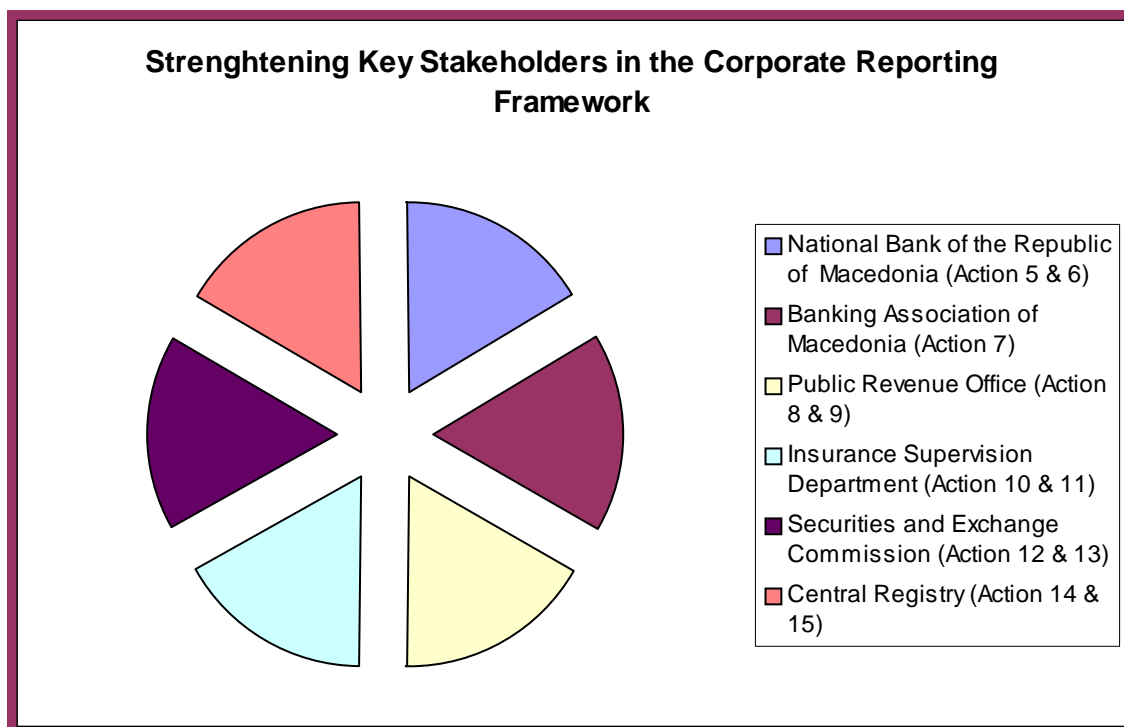
The adoption of financial standards conducive to transparent financial reporting will help preparers and users of financial statement in Macedonia. Suitable financial reporting standards must address the needs of different types of entities, such as public interest entities and small & medium enterprises.

The development of a framework for the on-going and continuous adoption of suitable financial reporting standards in Macedonia, through the development of a body to coherently manage this process, will address a fundamental weakness in the financial reporting framework – the lack of suitable available financial reporting standards (*Action 2*). Supporting the preparation of procedures and processes to facilitate that structure addressing the on-going translation requirements for financial reporting standards in Macedonia (*Action 3*), and the provision of support to ensure an on-going and permanent effective and efficient translation process to be implemented (*Action 4*), are additional separate activities which will support high-quality financial reporting in Macedonia.

Strengthening Key Stakeholders in the Financial Reporting Framework

This strategy took account of the experience of relevant EU Member States in recognizing

that an enhanced financial reporting must be implemented and enforced by suitably resourced institutions. For example the National Bank of the Republic of Macedonia has a key role to play in enforcement of IFRS through its own statutory powers and prudential reporting requirements. The goal of these actions is to introduce a rigorous enforcement regime that works in conjunction with a suitable financial reporting framework to produce high-quality financial reporting in Macedonia.



- Figure 1-3: Strengthening Key Stakeholders in the Financial Reporting Framework

The banking sector as a whole represents an important segment of both preparers and users of financial reporting in Macedonia and thus is a critical area in which to establish the expectation for and delivery of good quality financial reporting.

For the National Bank of the Republic of Macedonia this program will review the legislation and regulations applicable to the banking sector to ensure alignment of the legislative framework with the relevant portions of the *acquis communautaire* and to ensure consistency of banking legislation with other relevant domestic legislation (*Action 5*). The strategy would offer significant support to the Supervisory Department of the NBRM to strengthen the institutional capacity to supervise, monitor and enforce the application of IFRS in banking financial reporting (*Action 6*).

Resources used to build capacity within the Commercial Banking Association will in the longer term allow for the development of a key partner to the NBRM, creating a culture of compliance and ultimately enhanced financial reporting within the sector. For the Commercial Banking Association the strategy will support the development of strong co-operation among commercial banks and other key stakeholders in addition to fostering the dialogue with the NBRM in relation to the strengthening of financial reporting in commercial banks (*Action 7*).

Tax reporting in Macedonia currently uses a significant proportion of the accounting capabilities of the country. Resources used to clarify, simplify and co-ordinate the tax and financial reporting environments will contribute significantly to the overall importance placed on financial reporting in Macedonia, leading in the longer-term to enhanced financial reporting. For the Public Revenue Office the strategy would support establishing a statutory framework that provides a predictable tax base and in designing an efficient tax assessment process while reducing the compliance cost imposed on companies (*Action 8*). Furthermore the strategy would support the establishment of an institutional framework that implements an efficient tax assessment process resulting in an effective tax assessment and enforcement (*Action 9*).

Developing key specialized financial sectors in areas including insurance and pensions is a strategic goal for any country aspiring to develop a robust and growing economy. Such specialist areas require specialist financial reporting and supervision. For the Insurance Supervisory Department of the Ministry of Finance, the strategy would support the delivery of a consistent legislative and regulatory framework that supports a modernized reporting environment for the insurance industry in line with the *acquis communautaire* (*Action 10*). Furthermore the strategy would support the development of the capability to monitor and to ensure compliance with the financial reporting legislation and regulations for insurance undertakings in Macedonia (*Action 11*).

The establishment of a strong effective and sophisticated capital market is a cornerstone of a successful economy in any region of the world. Strong effective and sophisticated capital markets require suitable regulations (including financial reporting requirements) and institutionalized enforcement mechanisms. For the Securities and Exchange Commission the strategy would support and develop the legislative and regulatory framework for listed entities (*Action 12*). Additionally the strategy would support the implementation and enforcement of the statutory powers to develop a culture of compliance and ultimately enhanced financial reporting for listed entities in Macedonia. This culture can be exported to the wider financial sector and beyond in the longer term (*Action 13*).

Institutional and statutory strengthening programs will assist in the preparation of high-quality financial reporting that will meet the needs of a wide range of users such as investors, lenders and other creditors. Such high-quality financial reporting is a prerequisite for the raising funds in capital markets and the banking sector, both of which are essential for economic growth.

However these high-quality annual accounts and consolidated accounts are only useful if they can be obtained quickly and easily by the public. For the Central Registry the strategy would ensure that Macedonian legislation and regulations comply with relevant portions of the *acquis communautaire* relating to the publication and filing of financial information including the principle of compulsory disclosure, minimum transparency requirements and are consistent with other relevant domestic legislation (*Action 14*). In addition the strategy would contribute to a significant enhancement in the public availability of quality financial information through a program of operational, hardware and software support (*Action 15*). These actions will allow interested parties to access electronic annual accounts and consolidated accounts of relevant companies quickly and easily.

Supporting the Audit Profession

The adoption of an enhanced financial reporting framework will only be effective to the extent that enterprises adhere to it. Strengthening key regulatory stakeholders is one method of ensuring enterprises adhere to financial reporting requirements. The statutory audit of selected annual accounts and consolidated accounts (for example public interest entity annual accounts) is another effective method for encouraging adherence to financial reporting standards.

Macedonia is currently missing this essential pillar for ensuring the quality and consistency of financial reporting - the presence of a reliable, independent auditing profession with ultimate allegiance to company creditors, shareholders, and other stakeholders. The support and development of the audit profession in Macedonia has been identified as a core goal under this strategy and action plan.

Supporting the Audit Profession

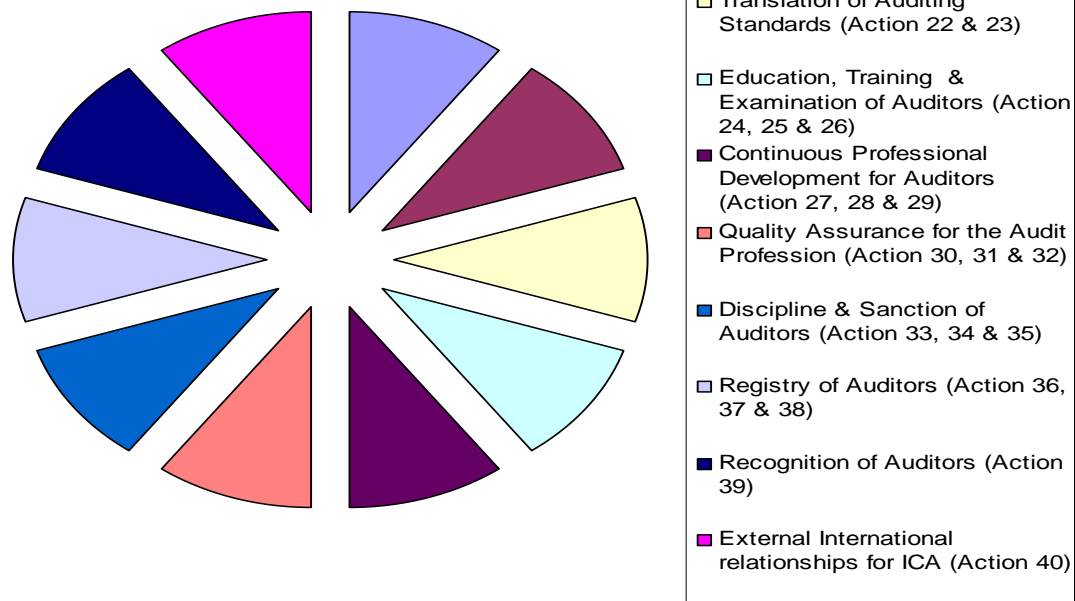


Figure 1-4: Supporting the Audit Profession

The audit profession must develop its internal regulations and procedures as identified in the activities to support the profession in this strategy. However clearly and specifically in light of recent worldwide international accounting scandals (Enron, Parmalat etc.) and in consideration of recent European Union legislation (New Eighth Company Law Directive on the Statutory Audit) a system of external independent public oversight of the audit profession must be implemented in Macedonia. In addition effective public oversight over the audit profession is a vital element in the maintenance and enhancement of confidence in the audit function.

The new audit law has mandated a structure to undertake these activities. This strategy will support the design, establishment and development of the Council for the Advancement & Oversight of Audit (CAOA) to help assure regulators, investors and the public at large that audited annual accounts and consolidated accounts can be relied upon to provide an accurate picture of the financial health of the audited companies (*Actions 16, 17 & 18*). The program of support will help to ensure that the CAO A will develop as an effective and efficient organization that will be capable of fulfilling its legislative mandate in addition to underpinning the regulatory structure of the auditing profession in Macedonia in the longer-term.

In directly supporting the audit profession this strategy will assist the establishment and development of the newly formed Institute of Certified Auditors (ICA) in Macedonia. This will include firstly supporting the three-member commission mandated in the special provisions of the Audit Law to facilitate a transition from the current unstructured auditing environment to the initiation of the ICA in Macedonia (*Action 19*). Secondly to assist the ICA in designing structured processes and procedures that will allow for the development of a *modus operandi* of the organization that is effective, efficient and in line with international good practice (*Action 20*) and finally to support the ICA in building sufficient capacity for the efficient and effective implementation of the structured processes and procedures identified by this strategy (*Action 21*).

Effective auditing procedures are implemented through adherence to suitable international benchmarks, specifically the International Standards on Auditing. The on-going availability and enforcement of these standards is fundamental. This strategy will develop and support a properly functioning translation committee, under the control of the ICA, which will produce on an on-going basis the translated text for auditing standards and other relevant pronouncements. This will provide the basic knowledge for the development of the profession that will in turn improve the quality of auditing in Macedonia along with all the associated benefits that such an improvement would bring (*Action 22 & Action 23*).

A full functioning audit profession requires the development of an accounting education and training program that will produce competent statutory auditors capable of making a positive contribution over their lifetime to the profession and society in which they work. This strategy has identified the design, implementation and on-going development of such an educational program under the control of the ICA as a key activity under this strategy (*Actions 24, 25 & 26*).

This strategy has identified the long-term development of the audit profession in Macedonia as a key goal. This encompasses ensuring that statutory auditors remain competent and develop new skills to remain effective in their jobs and careers. This will help maintain ICA members' employability and their reputation with employers, clients and the public. It will also help maintain the ICA reputation for producing and supporting high caliber professionals. This strategy has identified the design, implementation and on-going development of such a continuing professional development program under the control of the ICA as a key activity under this strategy (*Actions 27, 28 & 29*).

Demonstrating that the performance of the statutory audit is monitored and reviewed (quality assurance) and enforced (sanction & discipline) is a key method of building public

trust in the statutory audit. The establishment of public trust in the audit profession will in turn increase the use of and reliance on audited annual accounts and consolidated accounts. This is a significant objective for this strategy.

Quality assurance is the auditing profession's principal means of demonstrating to the public and to regulators that auditors are performing at a level that meets the established auditing standards and ethical rules. Designing, implementing and supporting a suitable quality assurance program will be a positive step in this direction for the auditing profession in Macedonia. It also allows the profession to encourage quality improvements in auditing methods (*Actions 30, 31 & 32*).

Designing, implementing and supporting a suitable sanction and disciplinary program that will support the quality assurance activities of the ICA will in the longer term allow for the safeguarding the public interest by maintaining and enhancing the standards of conduct of members and member firms of the auditing profession and by seeking to deter future acts of misconduct through its work (*Actions 33, 34 & 35*).

The public registration of statutory auditors is an important step in building public confidence in the profession and in establishing the ICA as the organized professional body mandated to lead the profession. This register will help to assist in identifying persons acting without licenses, allow the public to identify the proper authorities if a complaint against a statutory auditor is required to be lodged, increase public confidence in registered auditors, and assist the ICA in the regulation of the profession on an on-going basis (*Actions 36, 37 & 38*).

The old Auditing Law, in the time it was passed, did not anticipate the possibility for verifying certificates of the certified auditors who have obtained them through following the certification programs by renowned professional associations (ACCA and others). These professionals are involved in the auditing profession through the Big Four, but, unfortunately, they still haven't obtained local certificate for certified auditor. Due to lack of regulation the Ministry of Finance was not in a position to make this step and accept these experts as equivalent to domestic. The strategy covers the need of making a balance between the offer of statutory auditors on one hand and the demand for statutory audits in Republic of Macedonia, on the other hand. By the accepted solutions from the New Eight Directive for Business Law related to the verifying of the qualifications obtained through professional associations in the EU member states, the new Auditing Law commences this process. This strategy will support the process of verification through institutional strengthening of the ICA and the Ministry of Finance, in which authority this complex

question is included. The activation of all human resources in the auditing profession, without any doubt, will improve the quality of financial statements auditing in Macedonia (Action 39).

To help drive internal improvements and to encourage the efficient and effective running of the ICA, the development of relationships with similar regional auditing institutes, will be very critical to the development of the audit profession in Macedonia. This strategy will support the development of external relationships for the ICA at Regional and European Union level (Action 40)

Supporting Education, Training & Public Awareness

Financial reporting plays a crucial role in a well functioning modern economy. A clear understanding, by future generations of the Macedonian entrepreneurs, lawyers, bankers, creditors and of course statutory auditors, of the significant role played by high-quality financial reporting in a successful economy will greatly enhance the opportunities for the development of the Macedonian economy in the future.

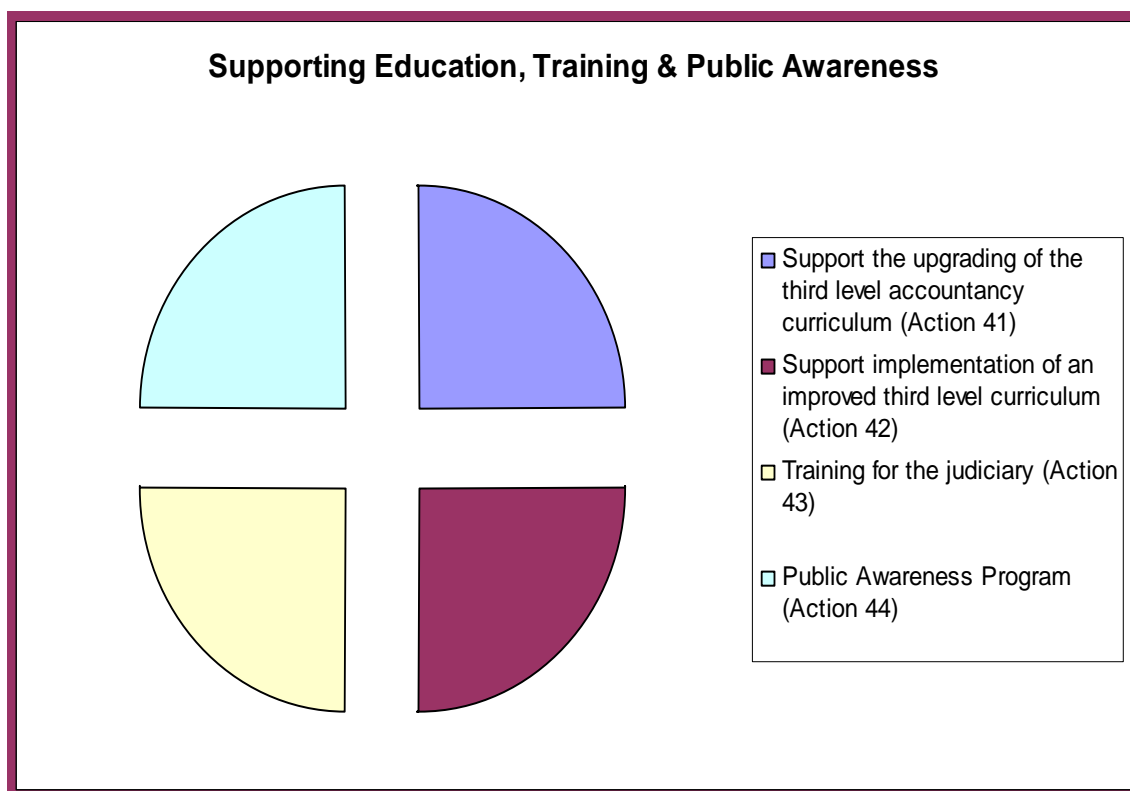


Figure 1-5: Supporting Education, Training & Public Awareness

This understanding is developed by a strong curriculum in accounting and auditing at the third level of education in Macedonia. This is important not only directly for accountancy students but for other disciplines also (e.g., business administration, law, economics) to ensure all sectors of a functioning economy can make informed decision based on reliable financial information. For example future entrepreneurs should appreciate the potential benefits that accrue in producing quality annual accounts and consolidated accounts, leaders of listed entities should see that the cost of capital decreases with the enhancement of financial reporting and the general public should be aware of the importance of being able to place trust in annual accounts and consolidated accounts of companies that hold significant pension investments.

The resources required to initiate a program of activities leading to the enhancement of the curriculum in accountancy will lead to an improvement in the knowledge of entrants to the auditing training programs in the long-term. Importantly also, the improved knowledge of all third level students taking an accounting module will feed into increasing the overall knowledge base relating to the importance of good financial reporting (*Action 41 & 42*).

The understanding of financial reporting requirements can be important for the protection of key stakeholders. Without investors economies will not develop. Investors in companies must have some protection if directors or management have misled or ignored fiduciary duties. The judicial process is a key ingredient in the overall corporate transaction among the parties involved—the stockholders, directors, management, and state government (legislative, executive, and judicial). Investors have certain expectations of the role of courts in the enforcement of fiduciary duties. This strategy acknowledges that the judiciary require a well-designed and implemented training program that would increase judges understanding of the importance of good financial reporting and the responsibilities and rights of relevant stakeholders (*Action 43*).

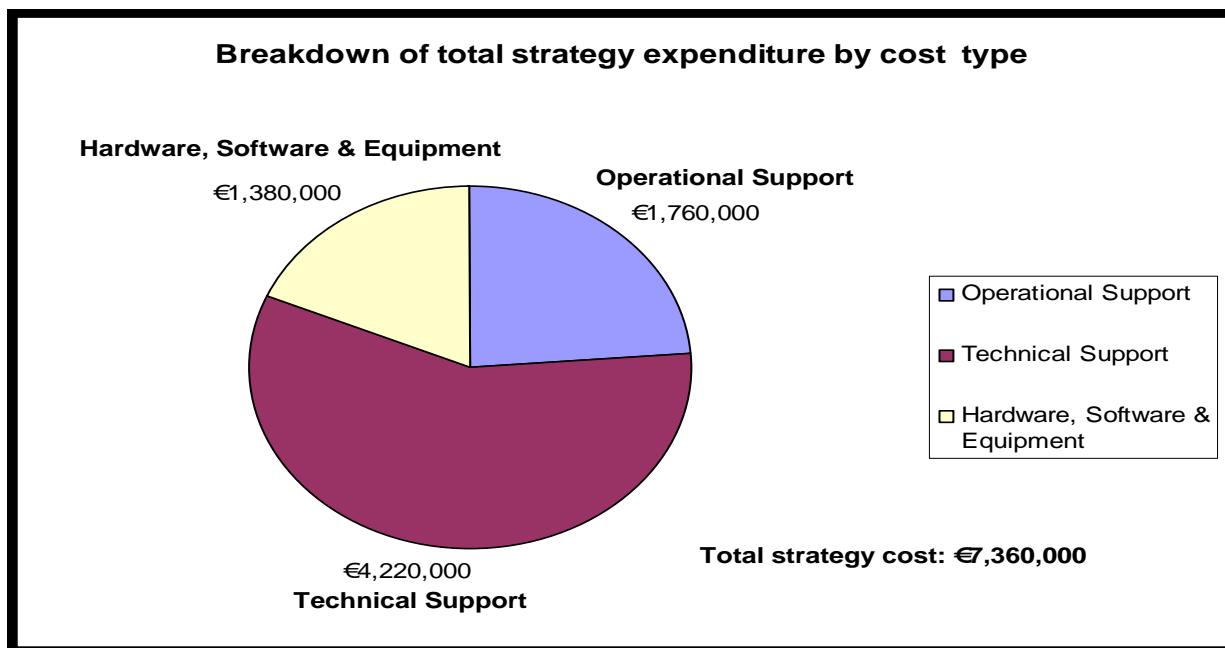
Promoting awareness of good financial disclosure and transparency in respect of financial reporting will in the long term lead to increased confidence in financial reporting in Macedonia, increase the public demand for good financial disclosure and transparency, reduce the risk of significant fraud by increasing the awareness of peoples' rights and responsibilities and deepen the local knowledge of financial reporting increasing the potential investor base in Macedonia. A well-designed and implemented public awareness program that would increase the public demand for good financial reporting in Macedonia (*Action 44*).

1.5 Funding requirements for the strategy and country action plan

When addressing budget and resource requirements, the NSC has split requirements into specific areas, which are:

- **Suitably qualified external technical assistance:** This is particularly important considering the technical nature of many of the activities and the requirement to absorb international good practices.
- **Operational Support:** The NSC has identified the need for direct operational support to the relevant stakeholders identified in the strategy and action plan. Such operational support is primarily important in the start-up phase of certain activities and will be phased out over a period of one to three years depending on the activities.
- **Hardware, Software & Equipment:** The NSC has further identified the requirement for specific hardware, software and equipment needs as an additional important external resource requirement.

In addition regional technical assistance will allow Macedonia to share experiences with relevant countries in the region and deliver economies of scale in specific technical areas. The NSC has identified the World Bank Road to Europe – Program of Accounting Reform and Institutional Strengthening (REPARIS) as a vehicle for the delivery of regional technical assistance⁴.



Below we are detailed the estimated strategy costs by action and by cost type. The total strategy cost is estimated at €7,360,000. Below this expenditure is broken down into cost

⁴ Please refer to www.worldbank.org/reparis for additional details

types. The total estimated expenditure on operational support for this strategy is €1,760,000. The total estimated cost for technical support is €4,220,000 and the total estimated cost for direct hardware, software and equipment costs is estimated at €1,380,000.

<i>Action</i> \ <i>Costs</i>	<i>Operational</i>	<i>Technical</i>	<i>Hardware/ Software, Equipment</i>	<i>Total Costs</i>
<i>1) Enhancing the Framework for Financial reporting</i>	€95,000	€80,000	€10,000	€485,000
<i>2) Strengthening Key Stakeholders in the Financial Reporting Framework</i>	€60,000	€1,920,000	€800,000	€2,780,000
<i>3) Supporting the Audit Profession</i>	€95,000	€1,610,000	€470,000	€2,775,000
<i>4) Supporting Education, Training & Public Awareness</i>	€10,000	€10,000	-	€1,320,000
<i>Total Costs</i>	€1,760,000	€4,220,000	€1,380,000	€7,360,000

Table 1-1: Strategy costing by Action and cost type

Further detailed analysis of the strategy estimated costs are detailed below. In Figure 1.7 we have detailed the estimated strategy costs by activity for the enhancement of the financial reporting framework. There are 4 individual actions under this project. The total estimated cost of these actions is €485,000.

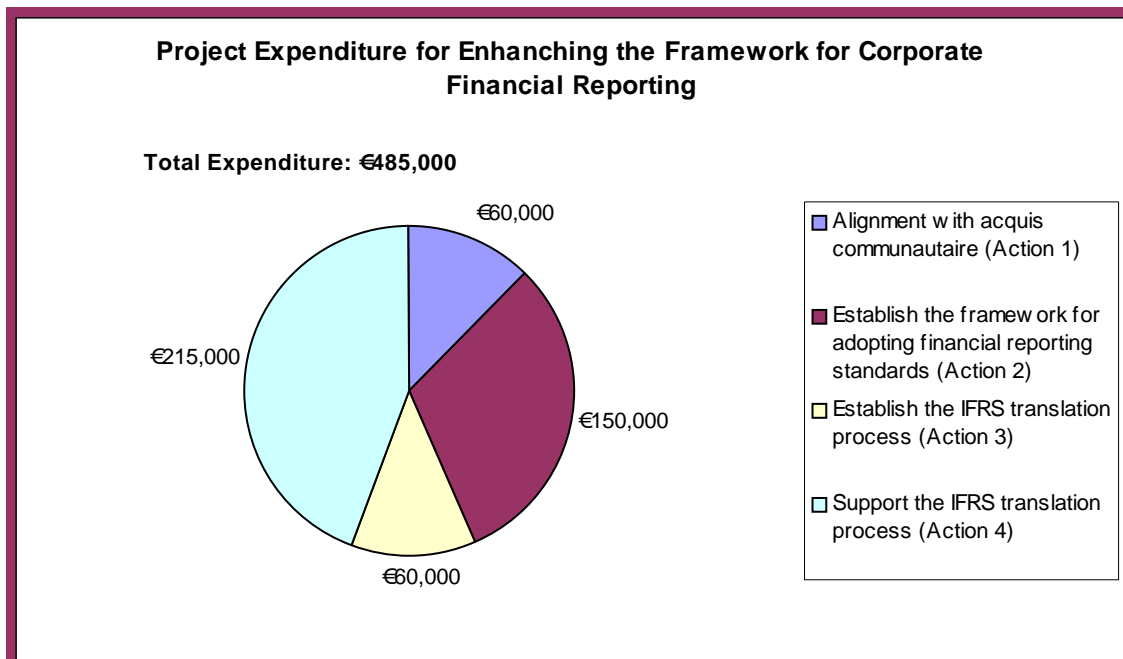


Figure 1-7: Project Expenditure for Enhancing the Framework for Financial reporting

In Figure 1.8 we have detailed the estimated strategy costs by activity for the strengthening program for key stakeholders in the corporate reporting framework. There are 11 individual actions under this project. The total estimated cost of these actions is €2,780,000.

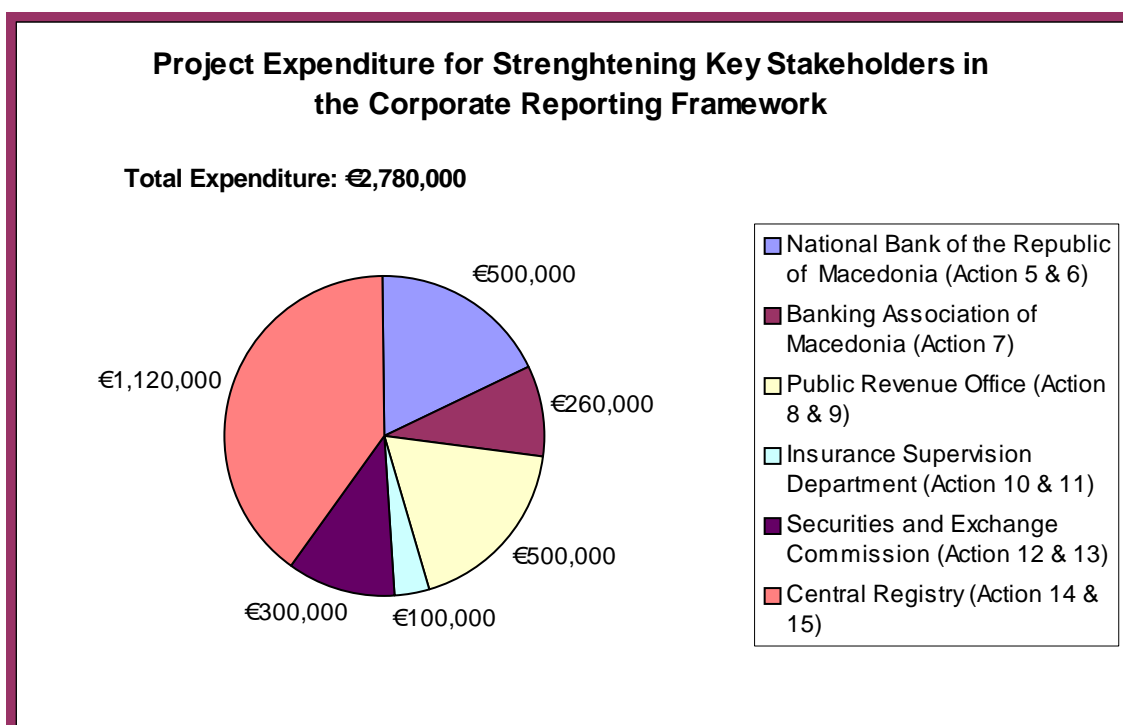


Figure 1-8: Project Expenditure for Strengthening Key Stakeholders in the Corporate Reporting Framework

In Figure 1.9 we have detailed the estimated strategy costs by activity for the support of the audit profession. There are 25 individual actions under this project. The total estimated cost of these actions is €2,775,000.

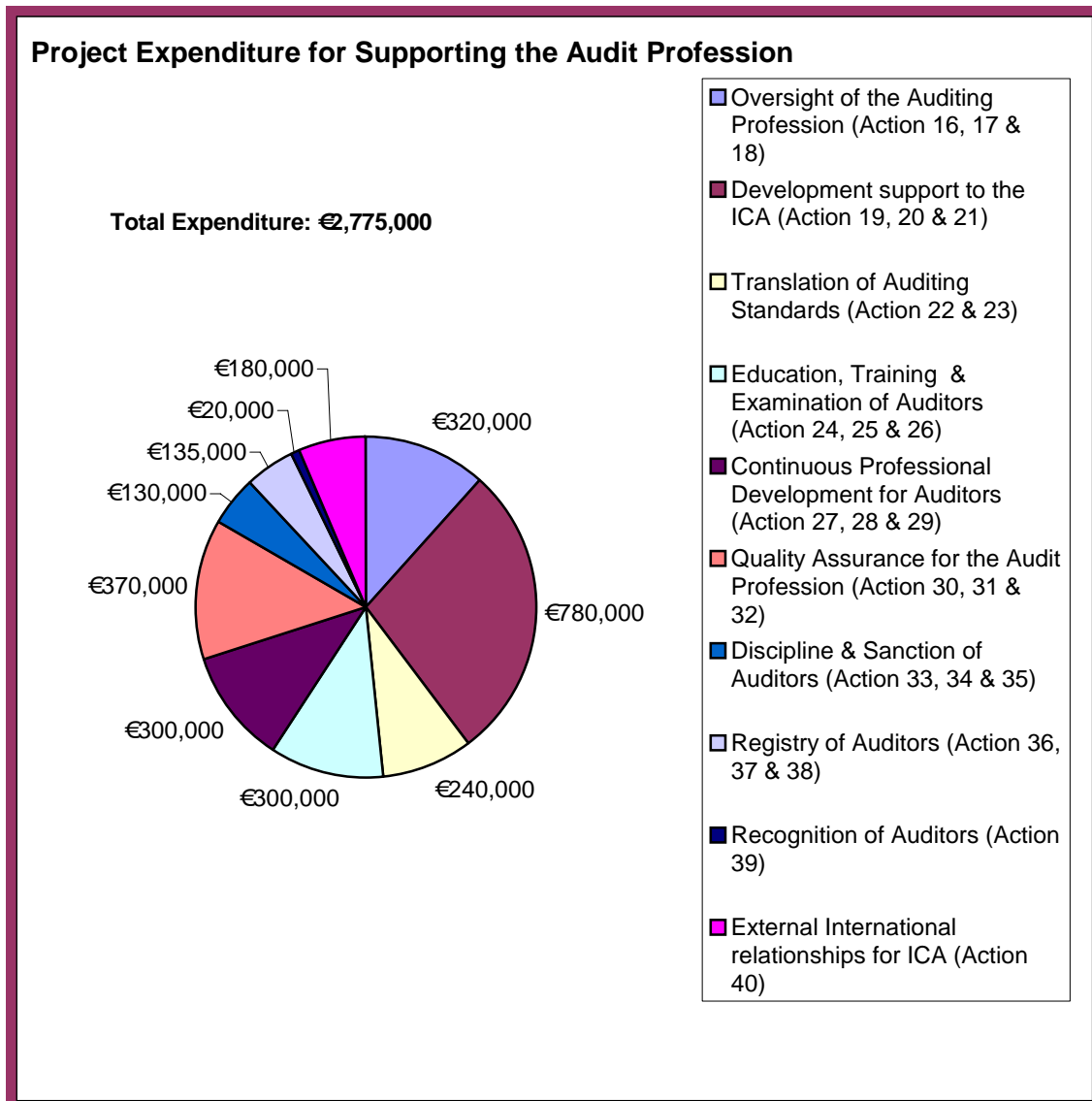


Figure 1-9: Project Expenditure for Supporting the Audit Profession

In Figure 1.10 we have detailed the estimated strategy costs by action for educational programs, training and public awareness program. There are 4 individual actions under this project. The total estimated cost of these actions is €1,320,000.

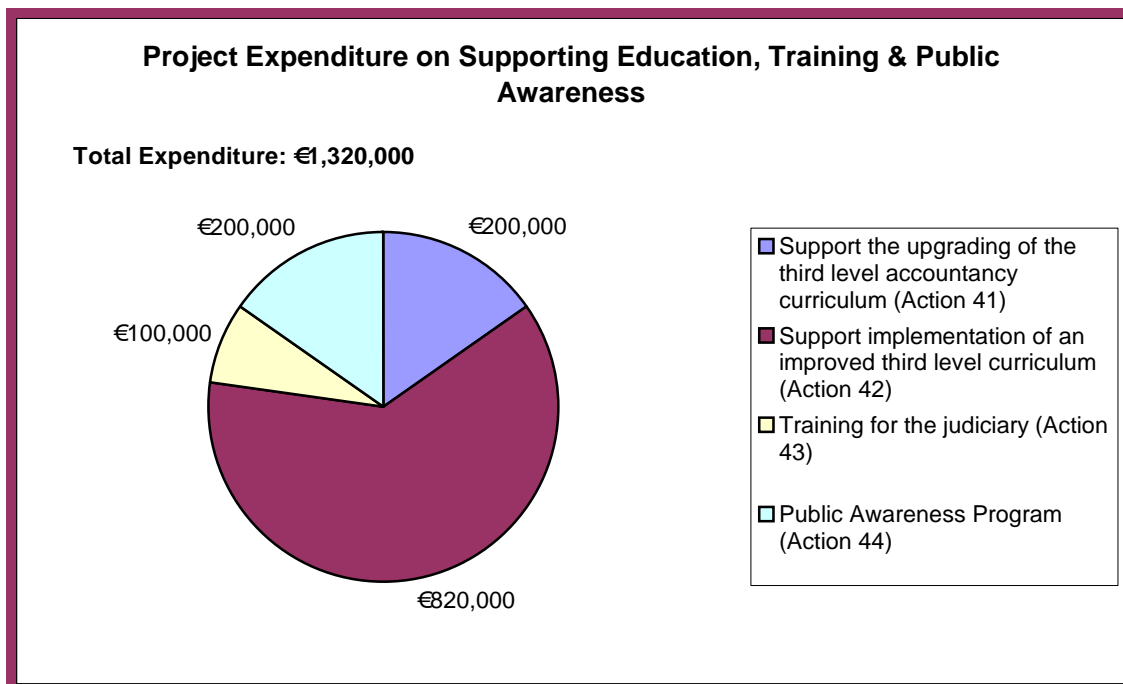


Figure 1-10: Project Expenditure on Supporting Education, Training & Public Awareness

Please refer to Appendix D for addition information relating the estimated cost of this strategy.

1.6 The implementation of the country strategy and action plan

For each action presented on page 48, the strategy shows the objective to be attained, a detailed description of the task, and the outcome, which will be achieved. Linkages between actions are common. The delivery bodies for each of the activities are identified, and clear responsibilities, accountabilities and timeframes for the deliverables of the actions are specified. The costs of each action are estimated, and the resources required are broken down between those to be provided internally and those to be provided externally. External resource requirements are broken down into specific categories such as technical assistance or hardware support.

1.7 The next steps...

The country strategy and action plan are also intended to be the basis for discussions on technical assistance with development partners. Now that the country strategy and plan have been drawn up, there is the need for an advisory group to ensure implementation of the reforms. It is proposed that the Minister of Finance should decide on the remit of such an advisory group.

2 INTRODUCTION

2.1 The Strategic context

A sound 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 financial reporting in Macedonia 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 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 financial reporting. In contrast good financial reporting is conducive to financial sector development and private sector development, which in turn spur economic growth. The relationship between high quality 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 Macedonia. Macedonia’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 Macedonia 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. 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 2003, a World Bank team prepared a Report on the Observance of Standards and Codes (ROSC) on accounting and auditing (A&A) in Macedonia. The ROSC policy recommendations were agreed between the World Bank, the Ministry of Finance and country stakeholders. It was also agreed that a detailed country strategy and action plan would be developed and implemented on the basis of these policy recommendations. The country strategy and action plan, to be developed by in-country stakeholders, was to be implemented under the coordination of the Ministry of Finance and with assistance from development partners.

As an immediate response to the A&A ROSC, Macedonia undertook a significant reform of its audit legislation resulting in the enactment of a new audit law based on the *acquis communautaire*.

Following on from the A&A ROSC report and the preparation of the new audit law, the Ministry of Finance in Macedonia set up a National Steering Committee⁵ (NSC) to develop a country 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 financial reporting. The developments to date are mapped in Figure 2-1: Reform path to date.

⁵ See Appendix C for the decision of the Ministry of Finance to establish the NSC.

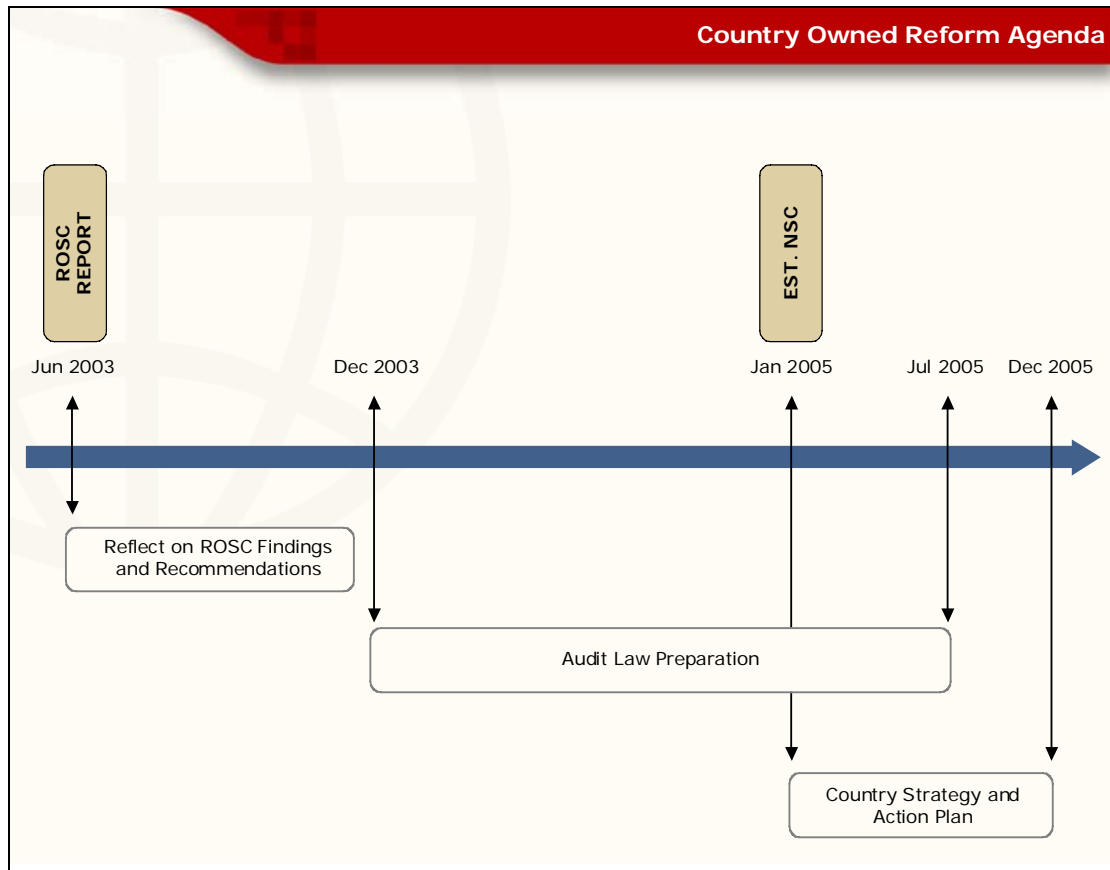


Figure 2-1: Reform path to date

The NSC is made up by a multi-disciplinary group of public and private sector stakeholders with an interest in 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 NSC were to support the preparation of a country 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 NSC's work.

This country strategy and action plan is intended to be the basis for discussions on technical assistance with development partners. With the completion of the country action plan, there will be a need for an advisory group to provide assurance on the implementation of the reforms. The Minister 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 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 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 which 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 Macedonia'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 financial reporting

This country strategy and action plan is about better 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 financial reporting for their respective needs as illustrated in Figure 2-3: Benefits of Good Corporate Reporting.

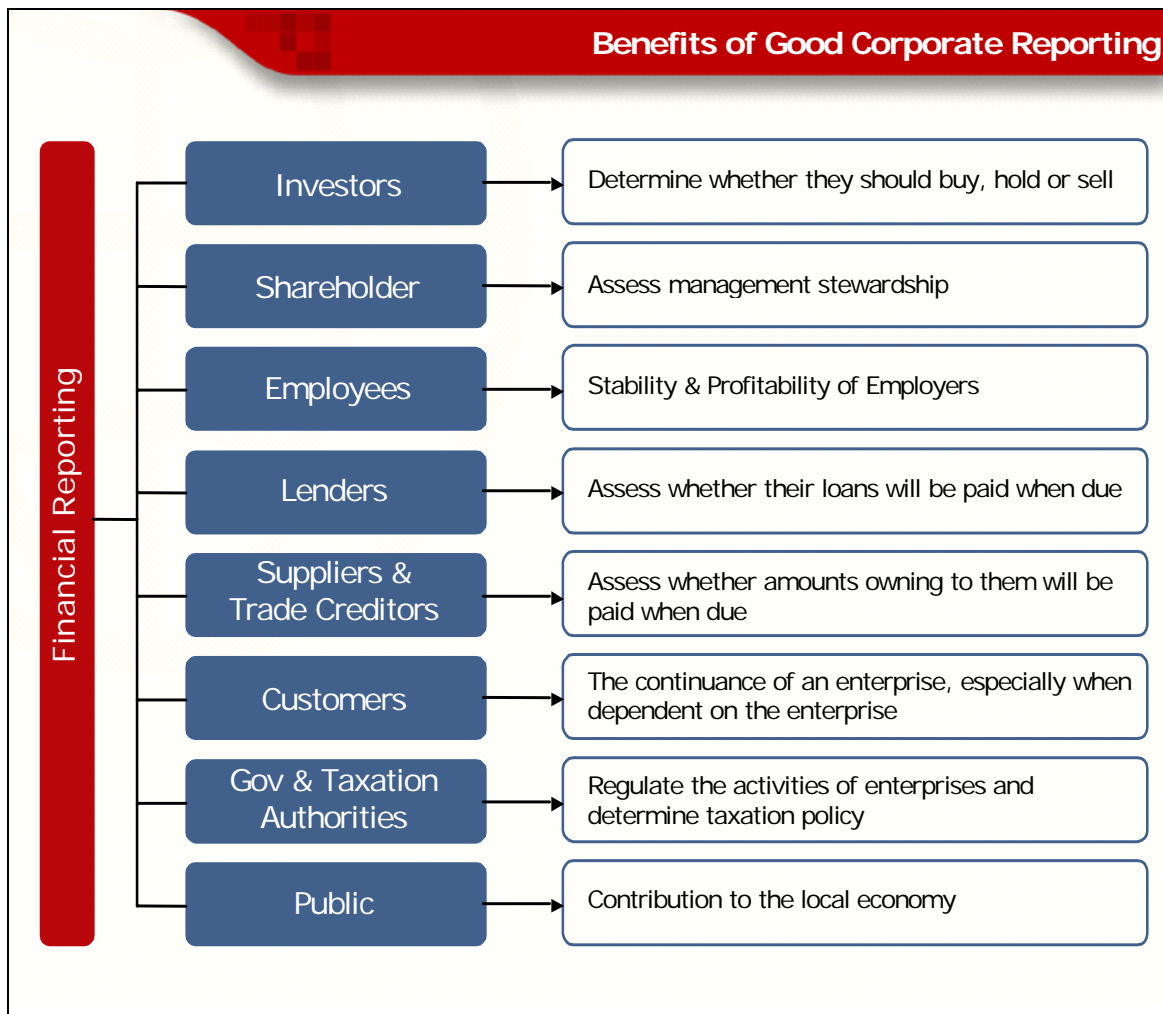


Figure 2-3: The Benefits of Good Corporate Reporting

2.4 The statutory and institutional frameworks

The NSC has identified areas of work that require substantial strengthening in Macedonia 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 country strategy and action plan under these two key pillars.

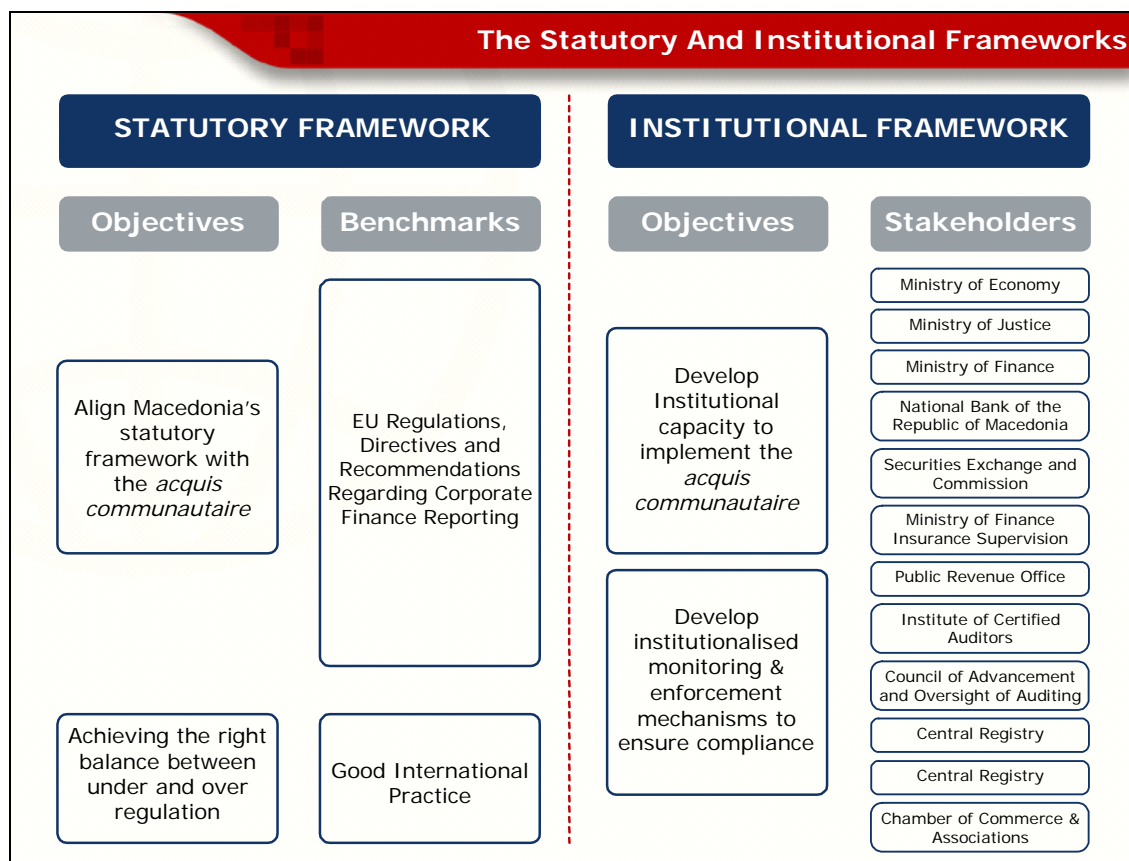


Figure 2-4: The Statutory & Institutional Framework

For the statutory framework the overarching theme is to align the Macedonian 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 Macedonia.

For the institutional framework the NSC 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 financial reporting framework in Macedonia. For example the Ministry of Finance, the Institute of Certified Auditors, and the Central Registry have very direct roles to play in certain areas of the financial reporting framework while for example the Chamber of Commerce and the Banking Association have less direct but, nonetheless, important roles to play.

2.5 Benchmarks

As illustrated in Figure 2-5, the NSC’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.

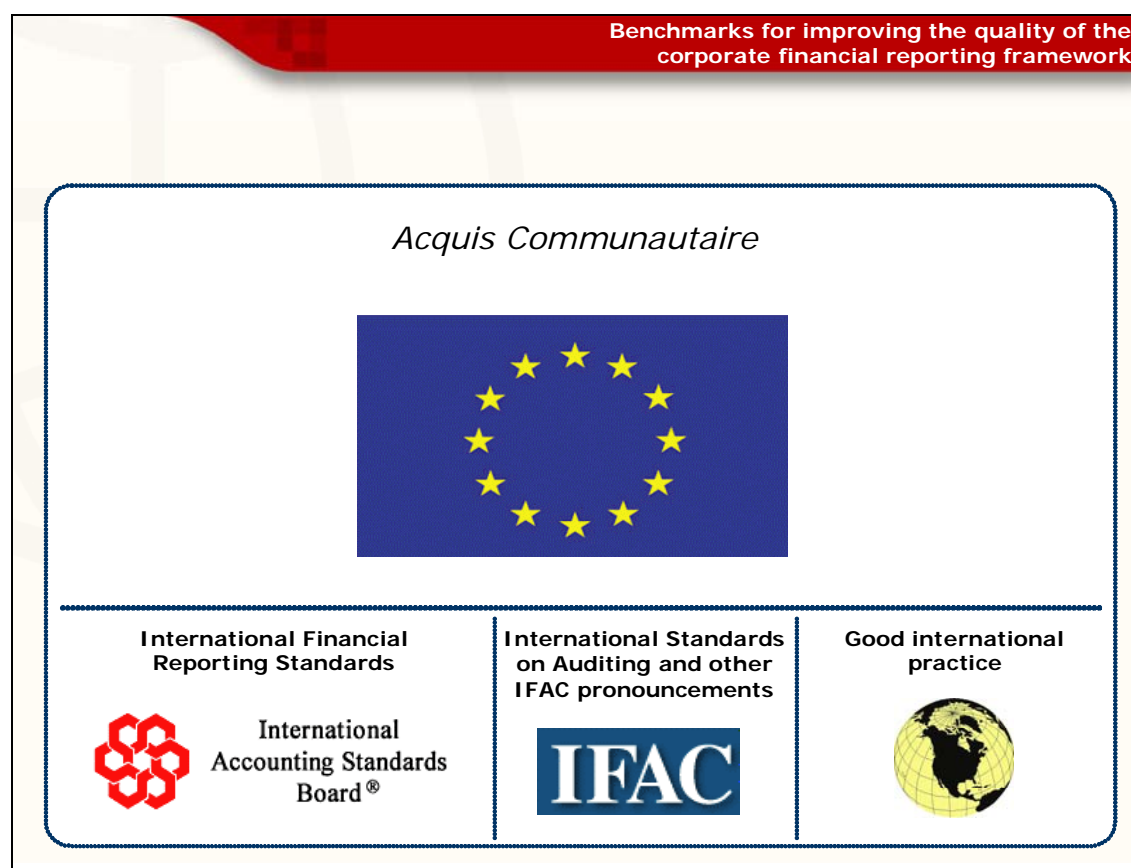


Figure 2-5: Benchmarks for improving financial reporting

The *acquis communautaire*

The relevance of the *acquis communautaire* for Macedonia 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 Macedonia’s strategy to become part of the European Union. This has become of increased importance now the EU has granted the Republic of Macedonia candidate status.

In this regard two factors have influenced the NSC in developing this strategy and action plan. Firstly, with regard to enforcement it is anticipated that Macedonia will need to demonstrate that it has not only adopted the *acquis communautaire* in law (statutory framework) but also that Macedonia has taken measures to ensure the *acquis communautaire* is actually implemented (institutional framework). Secondly, the NSC 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 Macedonia's legal framework, institutions, and accounting profession, as well as changes in its accounting, auditing and business culture. This country strategy and action plan sets out a number of reform activities developed in a holistic manner with due regard to Macedonia'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 NSC 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 NSC has also had regard to IFRS as a benchmark.⁶ The NSC agrees with the ROSC report recommendation that IFRS are generally meaningful for *Public Interest Entities* (PIE)⁷ and would be too burdensome in most SMEs. Therefore, the fact that the NSC uses IFRS as a benchmark does not imply that IFRS is suitable for all companies. The NSC 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 NSC 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);⁸
- The Code of Ethics for Professional Accountants;⁹
- International Educational Standards (IES);¹⁰ and

⁶ The International Accounting Standards Board (IASB), an independent international organization, sets IFRS.

⁷ Within this paper the term public interest entity is used to refer to those entities in which the general public has an interest by virtue of the nature of their business (e.g., banks, insurance undertakings, etc.), their size, or their range of stakeholders.

⁸ The International Auditing and Assurance Standards Board (IAASB) of IFAC sets International Standards on Auditing (ISA).

⁹ The Code of Ethics for Professional Accountants is developed by the International Ethics Standards Board for Accountants of IFAC.

¹⁰ International Education Standards are developed by the International Accounting Education Standards Board of IFAC.

- Statement of Membership Obligations (SMOs).¹¹

As with IFRS, the NSC 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 NSC has drawn on examples of good international practice as a useful reference for developing the country strategy and action plan. Thanks to the technical assistance provided, for example by the World Bank “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 NSC 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*;¹² 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 as show in Figure 2-6: A&A ROSC Findings.

¹¹ 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.

¹² 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 Germany, France, Ireland, Slovenia, and the Slovak Republic.

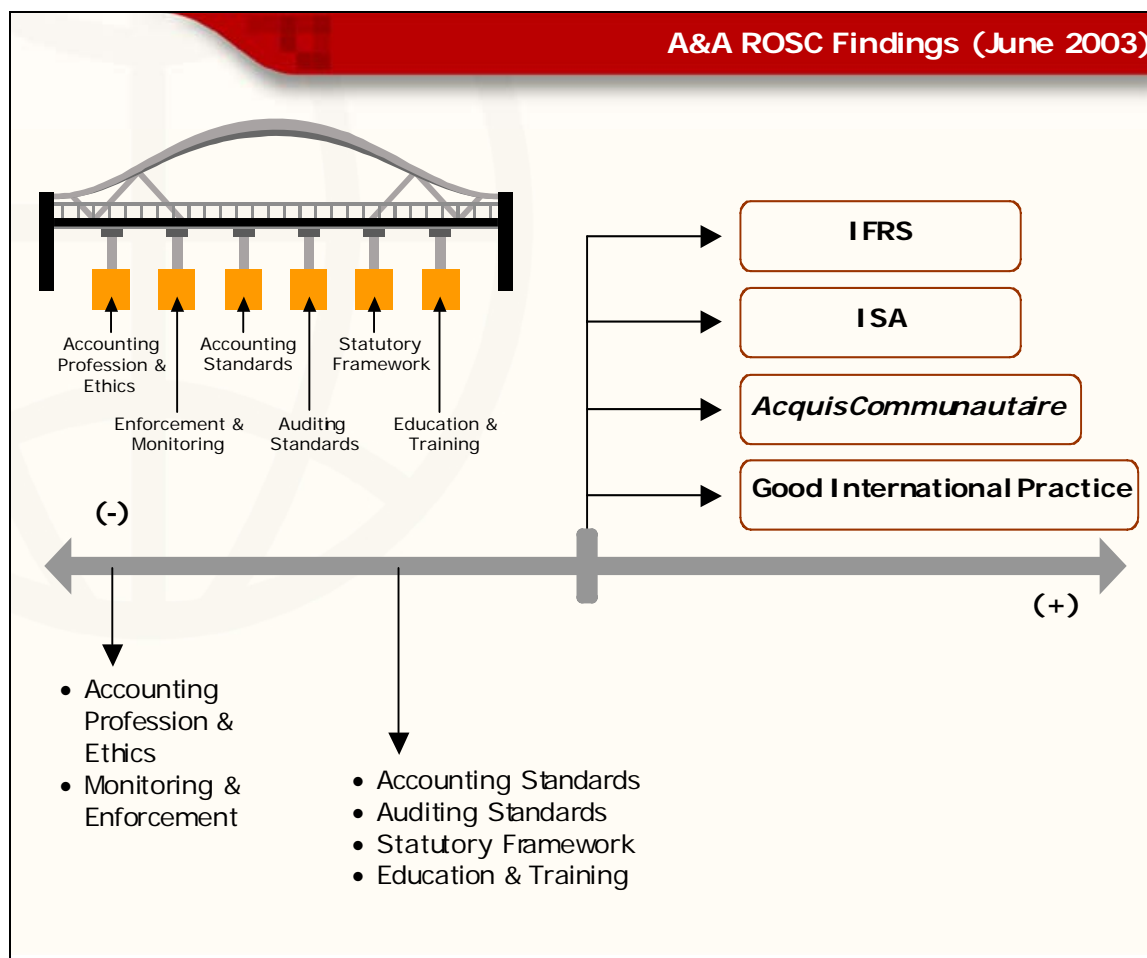


Figure 2-6: A&A ROSC Findings

The relevant portions of the *acquis communautaire*

The NSC has reviewed the *acquis communautaire* and identified Chapter 6, Company Law, as particularly relevant to the establishment of a robust financial reporting framework. Figure 2-7 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.”¹³

¹³ Snyder, F. 1993. “The Effectiveness of European Community Law: Institutions, Processes, Tools and Techniques.”

LEGISLATION	ACCOUNTING			AUDITING	
Regulations & Directives (Hard Law)	(A) ANNUAL ACCOUNTS DIRECTIVE (78/660/EEC)			(L) STATUTORY AUDIT DIRECTIVE	Core
	(B) CONSOLIDATED ANNUAL ACCOUNTS DIRECTIVE (83/349/EEC)				
	<i>BANKING</i>	<i>INSURANCE</i>	<i>CAPITAL MARKETS</i>		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)			
		(I) TRANSPARENCY DIRECTIVE (2004/109/EC) (J) UCITS DIRECTIVES (2001/107/EC) & (2001/108/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 2-7: Corporate Sector Accounting and Auditing within the *Acquis Communautaire*

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 NSC has had regard to the requirements of the Directive, as amended, and the various options and maximum thresholds, which will require Macedonian policymakers to determine which options and thresholds, are suitable in the context of Macedonia.

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 NSC has had regard to it in order to ensure that financial reporting reforms in the context of the country strategy and action plan are conducive to better and consistent approaches to banking supervision.¹⁴

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 NSC has had regard to the current solvency regime, which recently

¹⁴ 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.

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 NSC 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.¹⁵
- (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 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 Macedonia, the NSC has had regard to the 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 NSC 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

¹⁵ 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.

investment undertakings situated in EU Member States to market their units in other EU Member States (single passport). The NSC has had regard to the 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) *Statutory Audit Directive*: This Directive (also known the "new Eighth EU Company Law Directive"), which will replace the existing Eighth 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 NSC has had regard to this new Directive with a view to propose further reform activities in the few areas where the recently enacted Macedonian audit law differs 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 NSC.
- (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.