

3 GAP ANALYSIS

The purpose of this chapter is to undertake a gap analysis to identify the actions that are required to achieve the benchmarks identified in Chapter 2. The NSC carries out a review of the existing situation through a series of interviews and meetings with key stakeholders to produce a summary of the progress made in the implementation of the recommendations of the ROSC and of the outstanding problems and issues that still need to be addressed.

3.1 The Statutory Framework for Accounting

Accounting in Macedonia is regulated by the Trade Company Law (Official Gazette of RM” No. 28/04) and by the Rulebook for Accounting Standards (Official Gazette of RM” No. 40/97 and 73/99). The Trade Company Law defines five types of companies:

- General partnership companies;
- Limited partnership companies;
- Limited liability companies;
- Joint-stock companies; and
- Limited partnerships by share.

In this strategy and action plan the NSC is primarily concerned with large and medium size enterprises organized as joint-stock companies, companies with securities listed on the stock exchange, and large and medium size enterprises organized as limited liability companies. The Trade Company Law defines thresholds for identifying the size of companies: large, medium sized, small enterprises. The classification of companies is now based upon the thresholds below:

<i>Type of company</i>	<i>Small</i>	<i>Medium</i>	<i>Large</i>
<i>Thresholds</i>			
<i>Number of employees</i>	Less than 50	Less than 250	Greater than 250
<i>Annual turnover</i>	Not more than €2,000,000	Not more than €10,000,000	Greater than €10,000,000
<i>Average asset</i>	Not more than €2,000,000	Not more than €11,000,000	Greater than €11,000,000

Table 2-1: Company definition thresholds in Macedonia

The Trade Company Law requires the following companies to prepare their annual/consolidated accounts in accordance with IFRS as published in the Official Gazette of Macedonia (The last version of IFRS (2004) was published in the Official Gazette in 2005):

- Large companies;
- Medium sized companies;
- Banks;
- Insurance undertakings;
- Companies listed on the Stock Exchange; and
- Companies being part of the consolidated accounts of some of the above mentioned types of companies.

Gap

The statutory framework is not consistently aligned with the *acquis communautaire*. The statutory accounting framework should be fully harmonized, in both primary and secondary legislation, with the Fourth EU Company Law Directive on annual accounts and the Seventh EU Company Law Directive on consolidated accounts.

The statutory framework itself is not perfectly consistent. Full alignment of domestic legislation is a key factor in allowing for the development of a consistent statutory framework. Alignment of the Trade Company Law with other relevant domestic legislation should be undertaken specifically for example with the new Audit Law.

Consideration should be given to the experience of other EU Member States in finding the right balance between over and under regulation. This can be achieved by imposing IFRS, beyond what is required under the *acquis communautaire*, only when meaningful. Subjecting SMEs to simplified financial reporting requirements and providing exemptions from statutory audit are examples of finding this balance.

Illustrated Analysis

Reporting Thresholds for Small and Medium Sized Enterprises

The common view among stakeholders is that IFRS is too onerous for SMEs and that managers and those preparing SME accounts do not have the skills or knowledge to apply IFRS. Hence, in line with the *acquis communautaire*, the NSC proposes to require a simplified financial reporting framework to SMEs, which meets the needs of intended users

(e.g., lenders) and the capacity of preparers. In this regard, the NSC has had regard to the *acquis communautaire*, the experience of other Member States, and the IASB SME project.

Macedonian legislation does not endorse any of the existing interpretations of IFRS

Macedonia has not endorsed any of the existing interpretations published by the International Financial Reporting Interpretations Committee. This may hamper rigorous and uniform application of IFRS in Macedonia. The International Financial Reporting Interpretations Committee (IFRIC) provides guidance on financial reporting issues not specifically addressed in IFRS, or issues where unsatisfactory or conflicting interpretations have developed. This is an important component of the IFRS financial framework.

3.2 The Statutory Framework for Auditing

The statutory audit and the auditing profession are regulated under the Audit Law, which was approved by Parliament in September 2005. Macedonia has passed a law that addresses a significant portion of the requirements of the new Eighth EU Company Law Directive. This was a significant step for Macedonia in its progression towards an enhanced financial reporting environment. As outlined in Chapter 2, the new Eighth EU Company Law Directive puts into EU legislation a significant body of requirements governing national auditing frameworks. The new Audit Law addresses to some degree issues such as the mandating of a structured audit profession and the independent oversight of the audit profession.

According to the Trade Company Law (Article 478) the following enterprises are subject to statutory audit:

- Large and medium size enterprises organized as joint-stock companies;
- Companies with securities listed on the stock exchange; and
- Large and medium size enterprises organized as limited liability companies.

The statutory audit is obliged to be performed in accordance with new and amended International Standards of Auditing (ISA) issued by the International Auditing and Assurance Standards Board (IAASB), as published in Official Gazette. The last publication of ISA (2004 version) was undertaken in 2005.

Gap

The new Audit Law is a sound basis upon which to build a framework for auditing in Macedonia. However the statutory auditing framework should now be fully harmonized, in both primary and secondary legislation, with the new Eighth EU Company Law Directive.

While acknowledging the initial progress in amending the Audit Law in 2005, full alignment is proposed between the audit legislation and the new Eighth EU Company Law Directive.

Illustrated Analysis

Statutory consistency with the new Eighth EU Company Law Directive

Article 31.5 of the new Eighth EU Company Law Directive states that “the system of public oversight must have the right, where necessary, to conduct investigations on statutory auditors and audit firms and must have the right to take appropriate action.” Article 8 of the Audit Law currently mandates an Oversight Body for the auditing profession (Council for the Advancement and Oversight of Auditing) to monitor specific activities of the audit profession. However, the Audit Law does not specifically state that the Council for Advancement and Oversight of Auditing has the right to take any actions based on its monitoring activities.

3.3 The Institutional Framework for Accounting & Auditing

Gap

Macedonia is missing one of the essential pillars for ensuring the quality and consistency of financial reporting: that is the presence of a reliable, independent auditing profession with ultimate allegiance to company creditors, shareholders, and other stakeholders. These fundamental activities, which internationally are generally undertaken by the auditing profession, subject to suitable public oversight, have only been mandated by legislation in late 2005. A significant institutional program of activities is now required to implement the articles of the Audit Law.

There have been many attempts to organize a professional institute (Macedonian Association of Certified Auditors and Council of Certified Auditors; Association of Accountants, Financial Workers, and Auditors), but for a variety of reasons such an institute has never been sustained on a long-term basis. In the absence of such an organization, the Ministry of Finance has acted as the main agent regulating the auditing profession.

Illustrated Analysis

Approval, Continuous Education and Mutual Recognition of statutory auditors

The auditing profession in Macedonia has significant gaps in relation to the education, training, approval, continuous education, and the mutual recognition of auditors. The

current level of activity in these areas in Macedonia does not constitute a realistic effective structure. All stakeholders agree that a detailed program of activities is required, if Macedonia is to meet current EU requirements. The new Institute for Certified Auditors should establish suitable committees to address these issues within a structured environment. Suitable international benchmarks as identified in Chapter 2 will allow the profession to develop the structures required to produce competent professional auditors capable of making a positive contribution over their lifetime to the profession in which they work.

Registration of statutory auditors & Audit Companies

Macedonia does not currently hold a register of statutory auditors and audit firms. It is difficult to determine whether a statutory auditor or an audit firm has been approved, where it is officially located and how (in the case of firms) they are organized. The actions required to develop and maintain this register have been mandated in the new Audit Law, however the institutional capacity required to actually implement the articles of the Audit Law are not yet in place in Macedonia.

Professional ethics and professional secrecy for statutory auditors

Macedonia is currently unable to demonstrate that statutory auditors and audit firms comply with robust professional ethics. In particular, observers note widespread non-compliance with the requirement for auditor independence. One audit firm in Macedonia, reportedly, audits the annual accounts of a company where one of its audit partners serves on the Board of Directors. Also, examples exist of audit partners who incorporate two separate legal entities (for example, an audit firm and a consulting company) to circumvent the letter of the law.

Quality Assurance for the Statutory Audit

Effective quality assurance programs have been absent in Macedonia to date. Quality assurance is a vital element in the maintaining confidence in the audit function. There is currently a lack of confidence in the auditing profession in Macedonia. Quality assurance is addressed in the articles of the new Audit Law. However, the institutional capacity to carry out the quality assurance of statutory auditors and audit firms has not yet been developed in Macedonia.

Capacity of the auditing profession

The auditing profession does not have the capabilities to respond to the pool of companies that require auditing. Although approximately 900 companies are required to be audited,

there are only 173 licensed auditors in public practice and only 25 audit firms are registered with the Ministry of Finance. Establishing a well-functioning professional organization, as part of an overall strategy to enhance the quality of financial reporting in Macedonia, will help to address the shortage of auditors and enhance the credibility and attraction of the profession.

Translation of IFRS and ISA into the Macedonian language

Article 479, paragraph 2 of the Company Trade Law states that “commercial entities shall be obliged to prepare and submit annual and consolidated accounts in accordance with the adopted International Accounting Standards, published in the Official Gazette of the Republic of Macedonia. The International Accounting Standards shall be updated on an annual basis, so as to be harmonized with the current standards, as revised, amended or adopted by the International Accounting Standards Board.” Article 479, paragraph 6 of the Company Trade Law states that the “auditor shall apply International Standards on Auditing published in the Official Gazette of the Republic of Macedonia, updated on an annual basis to incorporate all amendments adopted by IFAC.” However, the time gap between the previous publication in the Official Gazette of IFRS and ISA in 1998, and the most recent publication in 2005, was almost seven years.

3.4 The Statutory Framework Bank Financial Reporting

The statutory framework for the National Bank of Macedonia is the Law on the National Bank of the Republic of Macedonia (Official Gazette of RM No. 3/02, 51/03, 85/03, 40/04 and 61/05) and for the banking sector is the Banking law (Official Gazette of RM No. 63/00, 37/02, 51/03 and 85/03). A new Decree for Banks, Savings Banks and Other Financial Companies is currently being drafted.

Gap

The statutory framework for the banking sector should be fully aligned with the requirements of the Capital Requirements Directive, the Banking Accounts Directive and the new Eighth EU Company Law Directive to achieve better alignment between the statutory audit and the banking supervision functions.

The NSC developed the actions relating to the banking sector in line with the ROSC recommendation that the supervisory department of the NBRM should clearly distinguish between prudential and general-purpose financial reporting. Prudential accounting requirements (e.g., loan loss provisioning in the banking sector) should not affect IFRS-based annual accounts and consolidated accounts. Where regulators need additional (unpublished) information for prudential supervision purposes, this should be by way of

topping-up IFRS. Given that regulators have a keen interest in ensuring that the fundamental IFRS-based annual accounts and consolidated accounts are correct (since their reports would be built on that foundation) this would mobilize them to assist in the enforcement of shareholder- or stakeholder oriented annual accounts and consolidated accounts as well. As the requirements of Basle II are being integrated in the Capital Adequacy Directive (CAD 3), it is essential for the banking sector in Macedonia to focus on embracing the changes within Basle II if they are to comply with the *acquis communautaire*.

In February 2006, the NBRM adopted a detailed Supervisory Development plan, as a roadmap that should allow NBRM to gradually move to a more risk-based approach in the next several years. One of the key preconditions for introducing the risk-based supervision is accurate financial reporting.

Illustrated Analysis

Gaps in the legislative framework

Several gaps exist in the legislative framework. Clear responsibility and accountability for annual and consolidated accounts (that reflect the economic and risk positions of the banks) have not been explicitly assigned, although the Company Law requirement, that the executive member of the board of directors or the officer appointed by the management board, signs the annual accounts is a step forward. Accurate and truthful financial reporting (to the supervisor and public) is not explicitly required, therefore, if (materially) inaccurate annual or consolidated accounts are provided, the Board and executive management cannot be held responsible, nor are they required to amend and republish (where applicable) the accounts.

Inadequate NBRM Regulatory Authority

Currently bank prudential accounting requirements affect the preparation of general-purpose annual accounts and consolidated accounts. Banks are required to prepare their annual and consolidated accounts in accordance with IFRS as published in the Official Gazette (i.e., the 2004 translation of IFRS). However, banks calculate impairment in the secured and unsecured portion of loans and receivables on the basis of a provisioning matrix that specifies fixed provisioning rates for the number of days a loan has been classified as non-performing (as required by the NBRM). While the NBRM methodology may be appropriate for prudential purposes, the results may differ from the recoverable amount of originated loans and receivables under IAS 39, *Financial Instruments: Recognition and Measurement*. IAS 39 requires impairment or bad debt losses to be

calculated as the difference between the assets carrying amount and the present value of expected future cash flows discounted at the financial instrument's original effective interest rate.

3.5 The Institutional Framework for Bank Financial Reporting

The NBRM is a key stakeholder in the financial reporting framework in Macedonia. The Bank Regulation Department of the NBRM has a very important role in supervising the operations of commercial banks, saving houses and other financial institutions and is a standard setting body for these institutions. Although official approval is reserved to the Ministry of Finance, this Department is responsible for drafting relevant regulations and instructions for submission to the Ministry.

Gap

The relationship between bank auditors and supervisors in Macedonia needs to be strengthened to their mutual advantage. There is a need to take account of the Basel Committee's Core Principles for Effective Banking Supervision, the Joint Forum under the aegis of the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS) in dealing with issues common to the banking, securities and insurance sectors, including the regulation of financial conglomerates. There is a need to reflect on the IAASB and BCBS guidance on the relationship between auditors and the supervisors of banks. Specifically the following issues should be addressed:

- The primary responsibilities of the board of directors and management;
- The essential features of the role of statutory auditors;
- The essential features of the role of supervisors;
- The relationship between bank supervisors and the statutory auditors; and
- Additional ways in which the auditing profession can contribute to the supervisory process.

In addition there is a need to address the availability of sufficient technical expertise to assist the banking sector and the National Bank of Macedonia to address these challenges.

Illustrated Analysis

Lack of enforcement activities

There is a lack of enforcement arrangements empowering the bank supervisor's to expand the disclosure requirements for banks and increase the frequency of public disclosure of banks' financial position. Furthermore there is a need to require banks, as "public interest entities," to expand their disclosure of governance arrangements, ownership and Board structures, etc. There is a need for a system that empowers the supervisor to impose or seek realistic sanctions on officers, directors or employees of a bank who assist or facilitate non-compliance with IFRS.

Technical knowledge within Regulatory Authorities

Financial institutions will have to modify their information systems, and both they and the NBRM need training to build their capacity to apply the new standards. The lack of knowledgeable professionals within regulatory authorities hampers effective monitoring and enforcement.

3.6 The Statutory & Institutional Framework for Listed entities

The Securities and Exchange Commission (SEC) of the Republic of Macedonia is an autonomous and independent organization with a status of a legal entity. The Securities Law is published in the "Official Gazette of the Republic of Macedonia" No. 95/2005, No. 63/2000, 103/2000, 34/2001, 4/02, 37/2002, 31/2003 and 85/2003. The new law was adopted on the November 7, 2005. The new law takes consideration of the principles set forth by IOSCO and seeks to harmonize the Macedonian legislation with relevant EU Directives.

Gap

Because of resource constraints and lack of accounting expertise, the SEC does not review the annual and consolidated accounts of listed companies to determine if the companies have met their disclosure requirements. The Macedonian Stock Exchange, also, does not enforce accounting standards. Additionally lack of enforcement power in SEC prevents other actions to counter activities that are in breach of the law.

3.7 The Statutory & Institutional Framework for the Insurance Entities

The Insurance Supervision Department of the Ministry of Finance (MoF-IS) is the regulatory authority in this sector. Macedonia's insurance sector¹⁶ is one of the smallest in Europe.

Gap

The Insurance sector suffers from weak governance practices and the supervisory capacity is limited. The Insurance Act does not set specific accounting, auditing, and reporting requirement regarding insurance companies. The MoF-IS does not distinguish between regulatory and general-purpose annual accounts and consolidated accounts.

3.8 The Statutory & Institutional Framework for Taxation

Currently all legal entities are required to submit a tax return, which is processed by the Public Revenue Office (PRO). The Public Revenue Office (PRO) published a new tax law in the Official gazette in February 2006.

Gap

General-purpose annual accounts and consolidated accounts are often influenced by taxation rules and regulations. In order to satisfy the requirements of taxation authorities regarding recognition of revenues and expenses, the preparers of general-purpose annual accounts and consolidated accounts of small and medium-size private companies and public interest entities often deviate from financial reporting standards and follow tax rules. For example, companies do not provide for bad debt until such time as they sue the debtor, or the receivable is three-years overdue, which results in overstated accounts receivables. Transparency and accountability suffer from the emphasis on tax reporting.

Additionally, a gap in the statutory and institutional framework exists in relation to reviewing the possible effects of the utilization IFRS in a company's annual accounts on corporate income tax reporting in the Macedonia.

3.9 The Framework for the Publication and Filing of Financial Statements

Trade companies are obliged to submit their annual accounts to the Central Register of the Republic of Macedonia. These annual accounts should provide the opportunity for ratio analysis, liquidity, solvency, profitability, debt-to-equity and other ratios on the company's condition and performance.

¹⁶ For further analysis of this sector please refer to the final report and presentation prepared by the EU funded technical assistance project to the Ministry of Finance in the Field of Insurance Related Legislation in FYR of Macedonia.

Gap

Annual accounts and consolidated accounts filed with the Public Revenue Office and the registers within the Central Registry are abridged. Such abridged statements may mislead investors and other users. According to the Trade Companies Law, the annual accounts, financial statements, consolidated annual accounts and financial statements, approved financial statements, approved consolidated annual accounts and financial statements should in precise terms be submitted to the Central Register.

The annual accounts include Income Statement, Balance Sheet, Tax Balance and separate data for public evidence. The financial statements include Balance Sheet, Income Statements, Statement of Stockholders Equity, Statement of Cash Flows, company's policies used and other notes with explanations prepared in accordance to the International Accounting Standards.

The approved financial statements with the annual report for working of the company and the report for completed audit by certified auditing firm, the consolidated accounting with the statement for working of the company, approved consolidated annual accounts and approved consolidated financial statements with the annual report for working of the company and conducted audit, are submitted to the Central Register at precisely defined term.

The Central Register accepts, checks, processes and analyses the data contained in the annual accounts. Thus, the Central Register has so far made analysis of the liquidity, solvency, profitability in the subject's operation through preparation of document for the solvency in accordance to the Public Procurements Law and the Regulation for preparation of documents for solvency.

The Central Register offers possibility of electronic sending of data from the annual accounts through prepared software solution. But, continual development of the operative, hardware and software support for improving the software solution of electronic sending of data from the annual accounts is needed.

Also, the Central Register should allow on line access to the data from annual accounts through using the international practice, what requires external technical and operative support.

3.10 The Framework for Education and Training

Gap

Education and training in Macedonia relating to accounting and auditing has progressed considerable in recent years. However, due to the significant developments internationally, a program of activities is urgently required to ensure that the current requirements converge

towards the adoption of IFRS and international good practice. Although universities started adapting their curricula approximately seven years ago to cover internationally recognized accounting and auditing standards and significant progress has been achieved in many areas, some faculty members are not up to date with recent accounting trends. In addition, the quality of accounting education is compromised by the lack of IFRS training material translated into the Macedonian language.

Besides that, the quality of the accounting education is also affected by the lack of educational material for IFRS translated into Macedonian. The limited financial resources which the Ministry of Education and Science is separating for the public universities for publishing books and additional materials translated into Macedonian burdens the process of renewing and innovating the curriculum. The strategy and the action plan should allow cooperation with professors from accredited institutions from the EU member states and wider, transfer of experiences, knowledge and financial resources for publishing quality educational materials in Macedonian, which will be in pace to the last regulation in the area of accounting and auditing.

Illustrated Analysis

University Curriculum

In some instances University curricula do not cover business ethics. Academic institutions in Macedonia place little emphasis on the study of business ethics. Formal education can enhance aspiring professionals' awareness of ethical problems and can influence their reasoning and judgment with respect to ethical dilemmas. Also, the quality and availability of Macedonian language textbooks, case studies and other training materials on ISA and IFRS are insufficient, particularly in terms of practical application of standards. This is predominantly result of the limited financial resources for developing and publishing books and manuals in the area of accounting and auditing.

The departments for accounting and auditing would have use if in their curriculum are involved courses related to the latest regulation in the scope of accounting and auditing, practical examples based on the proper use of the standards and case studies, all in order to provide that the graduated students are prepared to work as accountants (not as bookkeepers or tax adjustment officials) and easily to involve into the process of professional certification for obtaining the title of certified auditor in Macedonia.