

## **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 2005<sup>1</sup>. 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

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<sup>1</sup> See Appendix C for decision to establish National Steering Committee

benchmark is the *acquis communautaire*<sup>2</sup> 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 (ROSC<sup>3</sup>) 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**

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<sup>2</sup> 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).

<sup>3</sup> 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

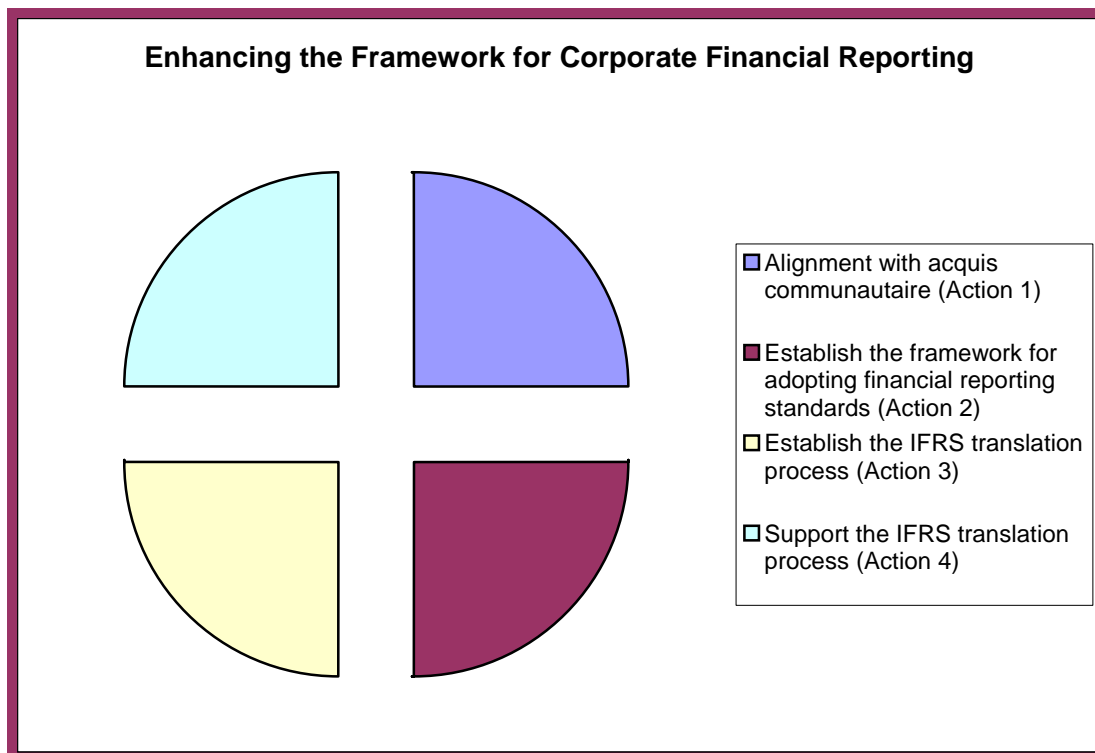
plan. The Ministry of Finance (MoF), the National Bank of the Republic of Macedonia (NBRM), the Securities and Exchange Commission (SEC), the Public Revenue Office (PRO), the Insurance Supervisory Department (ISD), the Central Registry (CR), the Institute of Certified Auditors (ICA), the Council for 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.

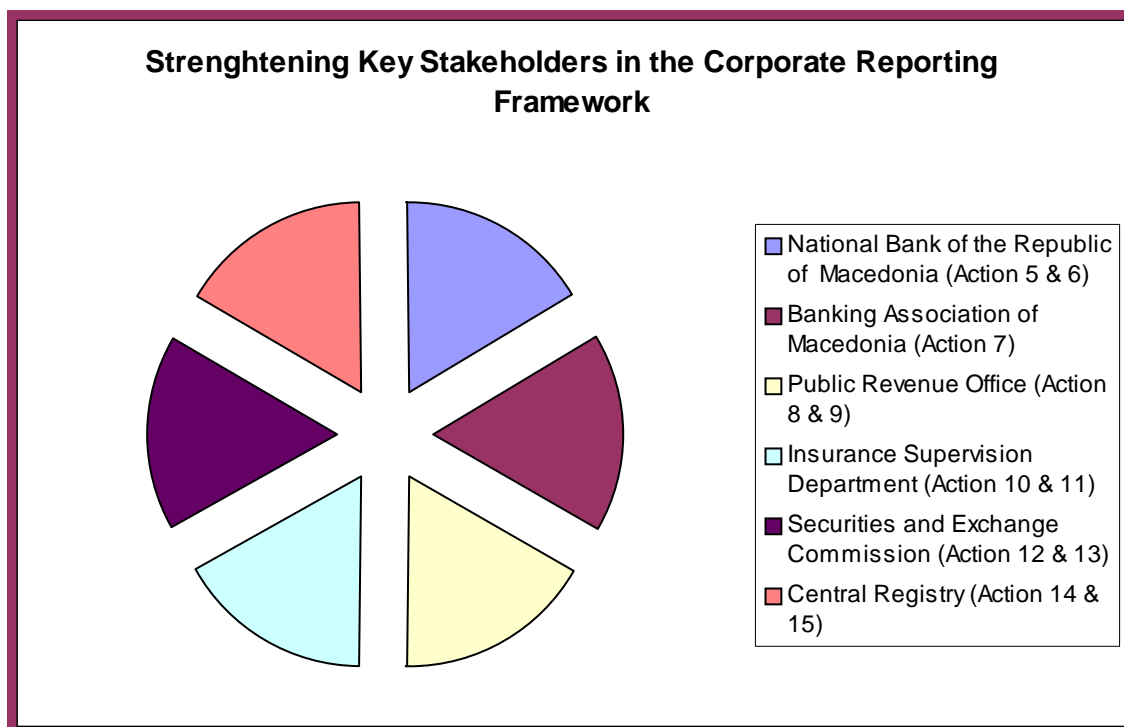
The adoption of financial standards conducive to transparent financial reporting will help preparers and users of financial statement in Macedonia. Suitable financial reporting standards must address the needs of different types of entities, such as public interest entities and small & medium enterprises.

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.

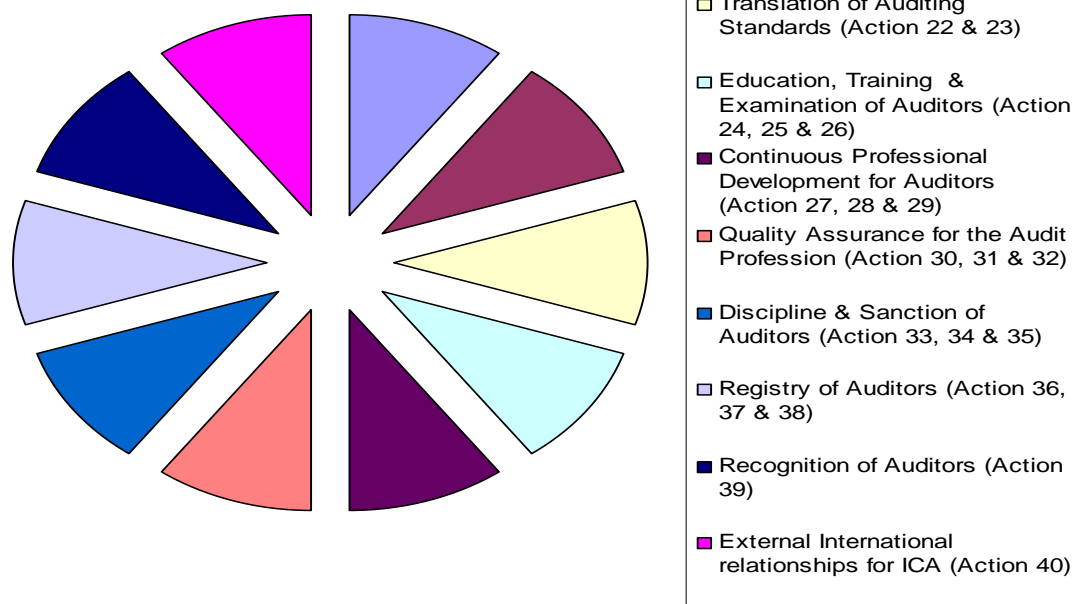
However these high-quality annual accounts and consolidated accounts are only useful if they can be obtained quickly and easily by the public. For the Central Registry the strategy would ensure that Macedonian legislation and regulations comply with relevant portions of the *acquis communautaire* relating 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*).

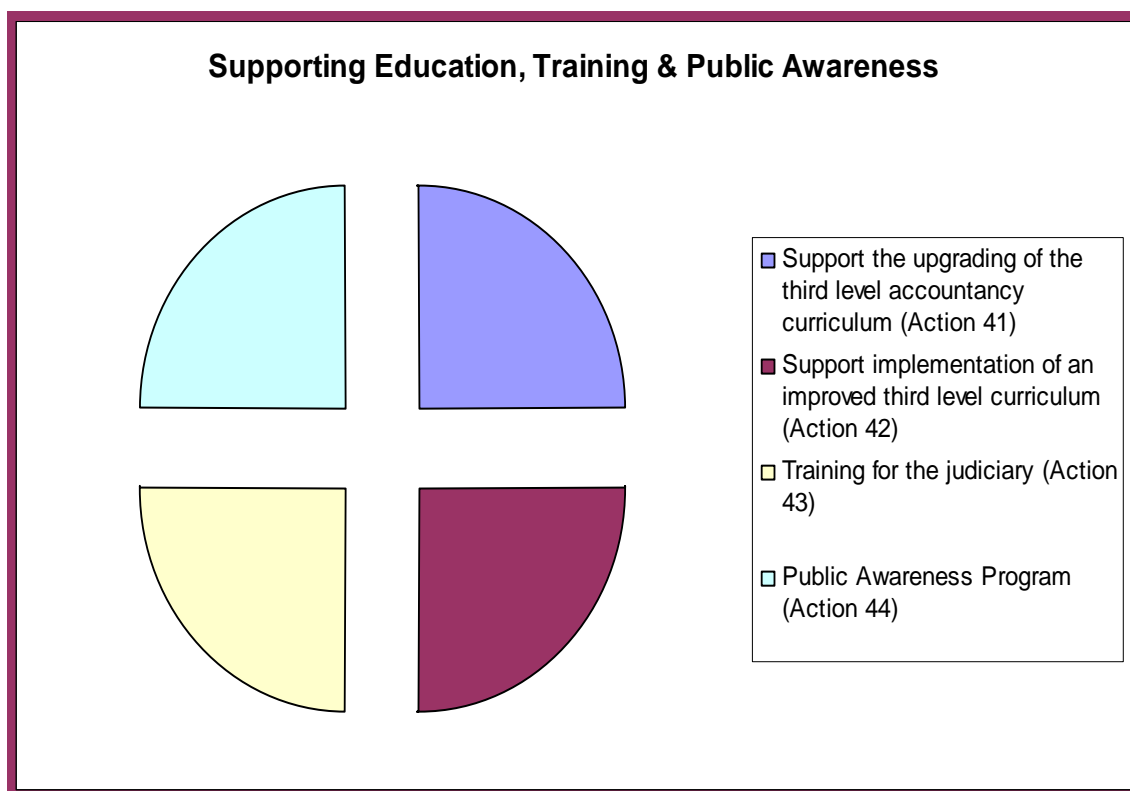
The old Auditing Law, in the time it was passed, did not anticipate the possibility for verifying certificates of the certified auditors who have obtained them through following the certification programs by renowned professional associations (ACCA and others). These professionals are involved in the 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*).

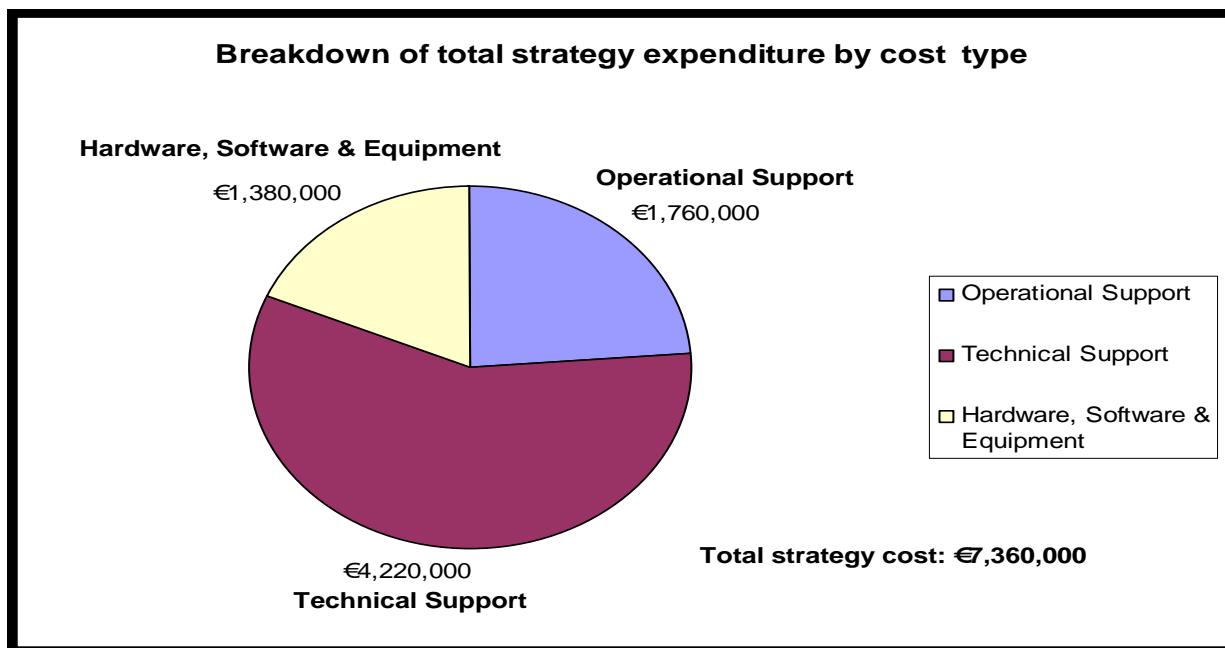
Promoting awareness of good financial disclosure and transparency in respect of financial reporting will in the long term lead to increased confidence in financial reporting in Macedonia, increase the public demand for good financial disclosure and transparency, reduce the risk of significant fraud by 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 assistance<sup>4</sup>.



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

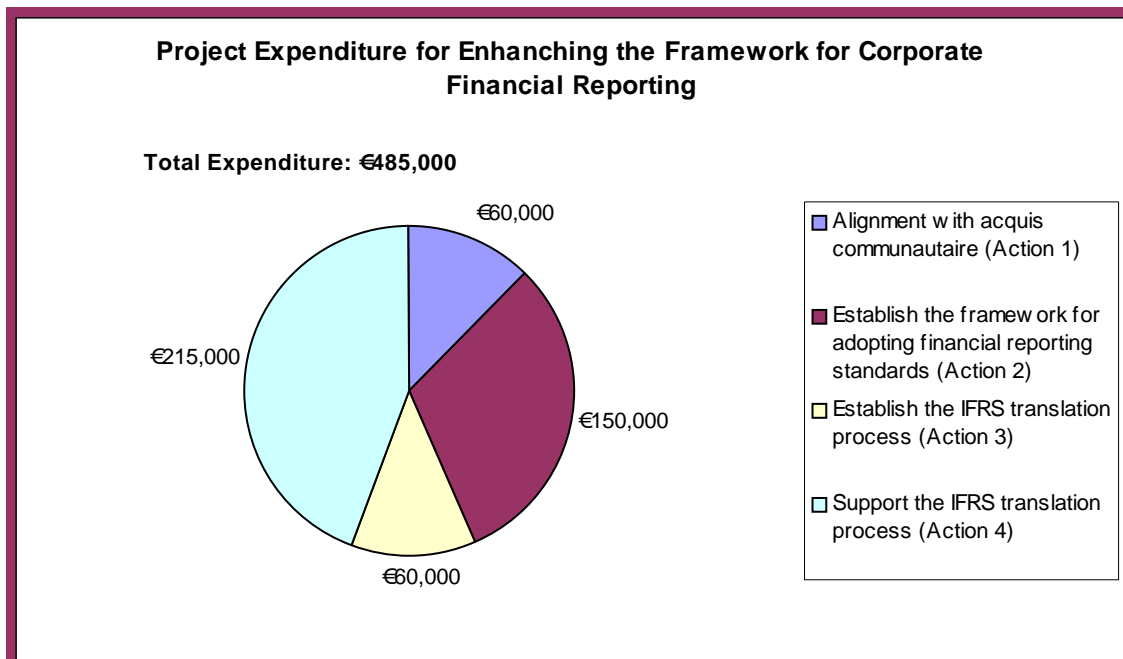
<sup>4</sup> Please refer to [www.worldbank.org/reparis](http://www.worldbank.org/reparis) for additional details

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 &amp; 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

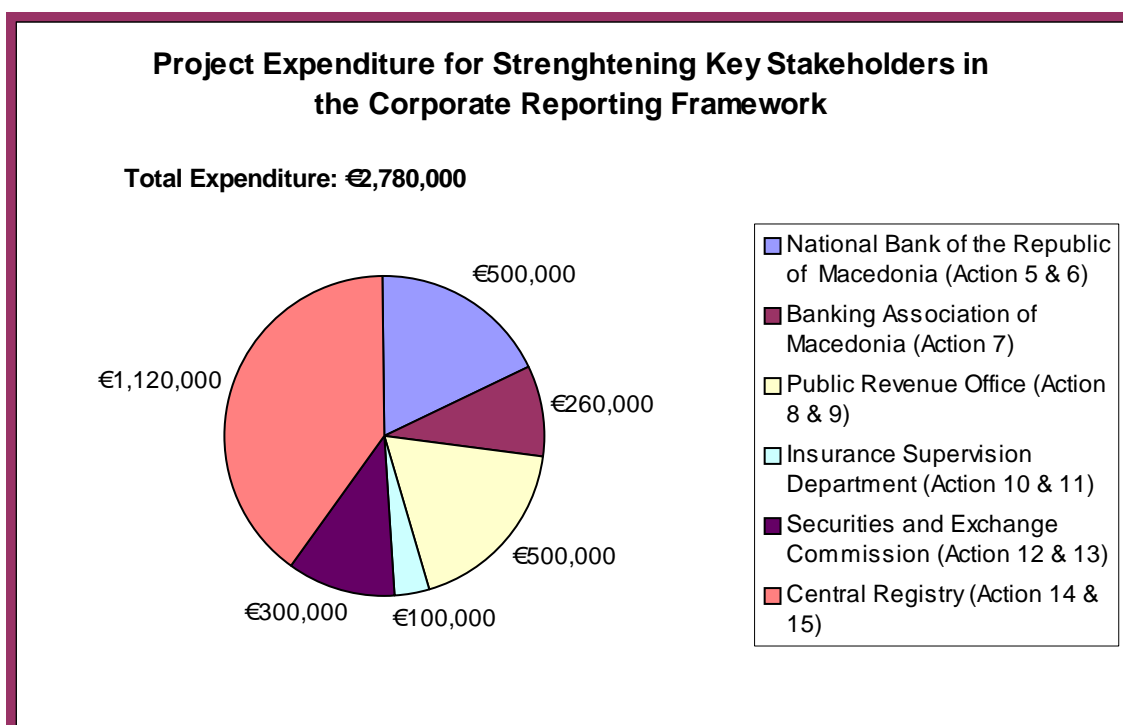
**Table 1-1: Strategy costing by Action and cost type**

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.



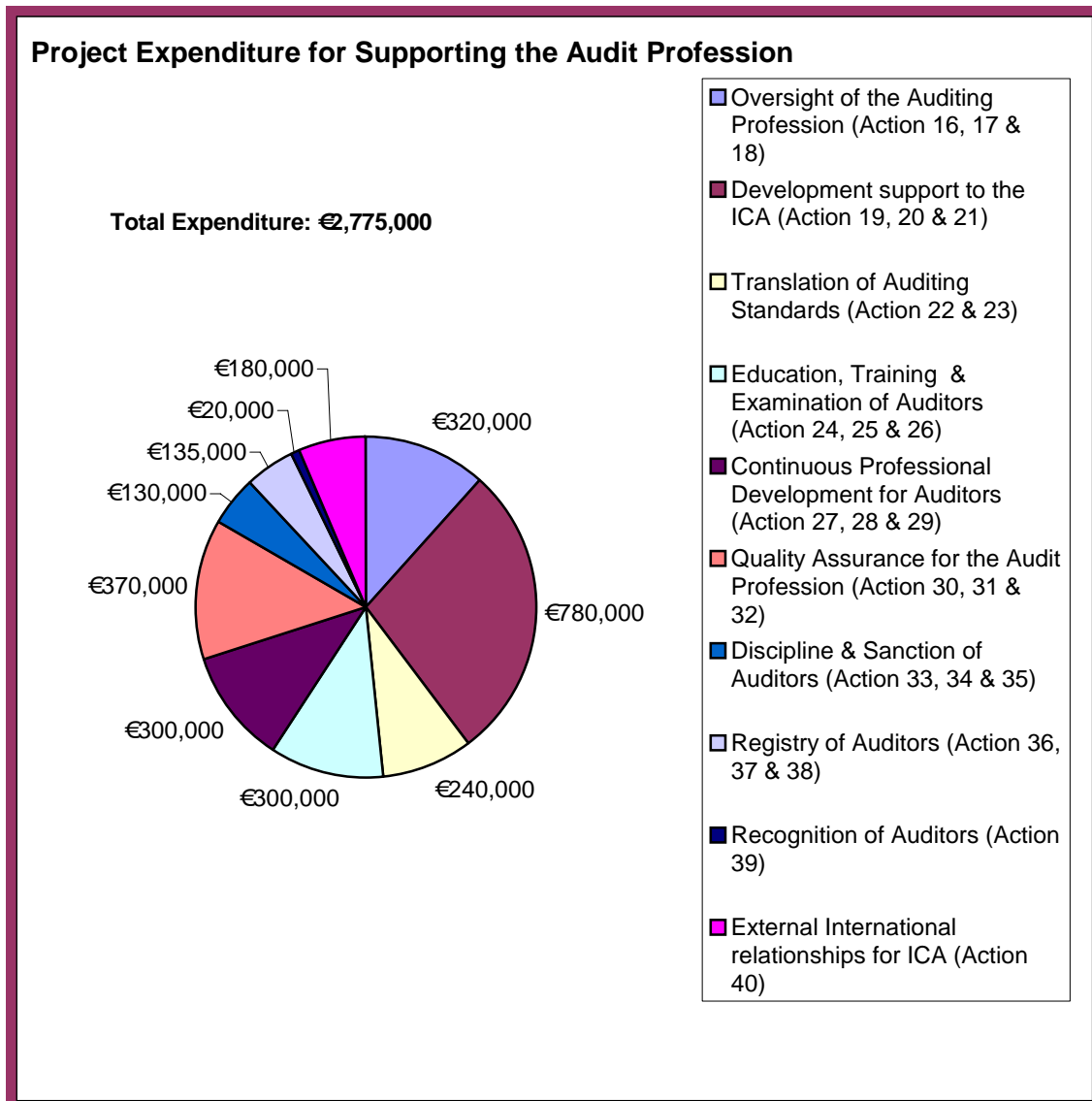
**Figure 1-7: Project Expenditure for Enhancing the Framework for Financial reporting**

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.



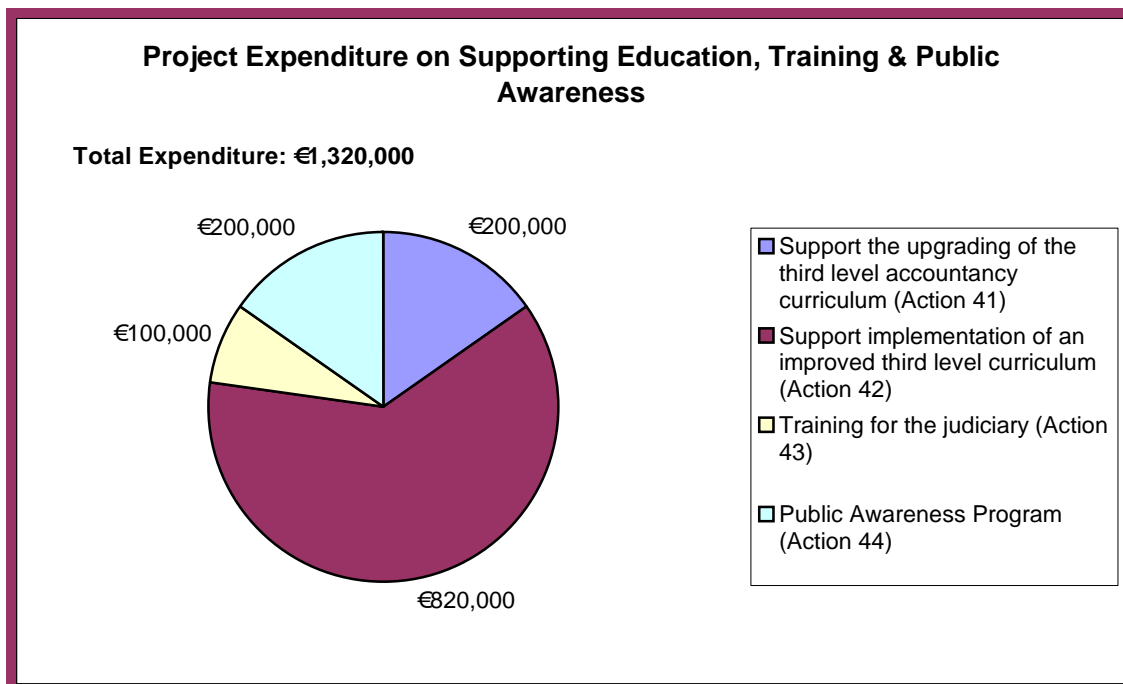
**Figure 1-8: Project Expenditure for Strengthening Key Stakeholders in the Corporate Reporting Framework**

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.