

REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC) Bosnia and Herzegovina

ACCOUNTING AND AUDITING

October 19, 2004

Contents

Executive Summary

I. Introduction

II. Institutional Framework

III. Accounting Standards as Designed and as Practiced

IV. Auditing Standards as Designed and as Practiced

V. Perception on the Quality of Financial Reporting

VI. Policy Recommendations

Acronyms and Abbreviations

EXECUTIVE SUMMARY

This report provides an assessment of accounting, financial reporting, and auditing requirements and practices within the enterprise and financial sectors in Bosnia and Herzegovina (BiH). It uses International Financial Reporting Standards (IFRS), International Standards on Auditing (ISA), and the relevant portions of European Union (EU) law (also known as the *acquis communautaire*), as benchmarks.

Following four years of conflict, the Dayton Peace Agreement (December 1995) established Bosnia and Herzegovina with a central government, two first-order administrative divisions (also referred to as the “Entities”), and one internationally-supervised district (Brcko). The two Entities have different accounting and auditing regulatory frameworks, and two different capital markets systems, which is not conducive to a business-enabling environment for the country. Enterprises registered in both Entities are required to maintain two sets of accounting records and are subject to different accounting and financial reporting requirements, which significantly add to the cost of doing business in Bosnia and Herzegovina and impede foreign investment and private sector growth. Accounting and auditing are among the critical areas where further enhancements are needed to create a “single economic space” and improve the competitiveness of the economy.

In order to modernize its legal and regulatory framework, Bosnia and Herzegovina seeks to gradually enact legislation that draws upon internationally accepted practices, including IFRS-inspired accounting standards and ISA-based auditing standards, and the relevant portions of the *acquis communautaire*. Bosnia and Herzegovina has still a significant way to go before it will have enacted the relevant portions of the *acquis communautaire*. In addition—like EU Member States—Bosnia and Herzegovina must address significant issues in the design and strengthening of suitable institutions to implement and enforce the *acquis communautaire* principles.

In practice, compliance with accounting requirements is not effectively and consistently enforced due to deficiencies in the three core pillars of the enforcement regime: management, statutory auditors, and regulators. While the Banking Agencies seek to enforce accounting standards in credit institutions, their mandate implies a focus on prudential requirements rather than compliance with accounting standards in general-purpose financial statements. The securities market and insurance regulators aim to, but do not

EXECUTIVE SUMMARY (continued)

effectively enforce accounting standards in general-purpose financial statements. Among unregulated enterprises, including government business enterprises and large- and medium-size privately held enterprises, enforcement rests on corporate managers and directors, and statutory auditors.

This report shows that managers and auditors do not consistently comply with accounting and auditing requirements, which has an adverse impact on the economy. Corporate managers have to improve their business culture, from one of concealing their enterprise's financial condition and performance or massaging earnings to reduce taxation, to letting the unvarnished numbers tell the story. The audit profession has to commit to quality, including through continuous professional education, and independence, and discipline auditors behind failed audits.

This report recommends significant changes to law and regulations to align the statutory framework with evolving internationally accepted practices, including the relevant portions of the *acquis communautaire*. As the new laws and regulations come into force, priorities will then turn toward building the monitoring, supervisory, and disciplinary regimes necessary to ensure effective compliance. Such policy reforms and institutional capacity building will contribute to promoting private sector growth through several means:

- Strengthening the country's financial architectureⁱ 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 groups, which currently do not prepare consolidated financial statements;
- Contributing to foreign direct and portfolio investment and helping to mobilize domestic savings;
- Facilitating the access of smaller-scale corporate borrowers, including small- and medium-size enterprises, to credit from the formal financial sector by lowering the barrier of high costs of information and borrowing;
- Improving the assessment and collection of taxes on corporate profits;
- Allowing investors to evaluate corporate prospects and make informed investment and voting decisions, which will result in a lower cost of capital and a better allocation of resources;
- Allowing shareholders and the public at large to assess management performance, thus influencing its behavior (financial reporting is also a building block of a market-based monitoring of companies); and
- Facilitating Bosnia and Herzegovina's eventual integration into the European Union.

i. A country's financial architecture can be understood as the legal and regulatory framework, institutions, policies and practices that pertain to the management and prevention of banking, currency, and debt crises. Effective national systems are a key pillar of a robust international financial architecture.

I. INTRODUCTION

1. This assessment of accounting and auditing practices in Bosnia and Herzegovina (BiH) is part of a joint initiative of the World Bank and the International Monetary Fund (IMF) to prepare Reports on the Observance of Standards and Codes (ROSC). The assessment focuses on the strengths and weaknesses of the accounting and auditing environment that influence the quality of corporate financial reporting and involves a review of both mandatory requirements and actual practice. It uses International Financial Reporting Standards (IFRS),¹ International Standards on Auditing (ISA), and the relevant portions of European Union (EU) law (also known as the *acquis communautaire*) as benchmarks and draws on international experience and good practices in the field of accounting and audit regulation.

2. Following four years of conflict, the Dayton Peace Agreement (December 1995) established Bosnia and Herzegovina (BiH) with a central government, two first-order administrative divisions (also referred to as “Entities”), and one internationally supervised district—Brcko District. The two administrative divisions are the Bosniak/Croat Federation of Bosnia and Herzegovina (FBiH) and the Bosnian Serb-led Republika Srpska (RS). The two administrative divisions enjoy a high level of autonomy. Each has different laws and institutions, including Ministries of Finance.

3. Bosnia and Herzegovina has a population of approximately 4.2 million, and a Gross National Income (GNI, *Atlas Method*) per capita of US\$1,270. The country inherited a limited banking sector dominated by state-owned banks that were saddled with large nonperforming portfolios, as well as numerous small, under-capitalized private banks. The state-owned banks were privatized by the end of 2002 in the RS and there are still seven state-owned banks in the FBiH. As of the end of 2003, 37 banks had operating licenses (27 in the FBiH and 10 in the RS). The insurance sector has gained some importance, attracting foreign direct investment; private investors, domestic and foreign, dominate it.

4. Capital markets are in their early stage. Institutions, such as the securities market regulators, the Sarajevo Stock Exchange (in FBiH), and the Banja Luka Stock Exchange (in RS) were recently created. The Sarajevo Stock Exchange has 485 listed companies and 11 privatization investment funds with a market capitalization of approximately US\$1.2 billion, which represents 25 percent of 2003 GDP. The Banja Luka Stock Exchange has only three listed companies and 13 privatization investment funds plus 642 on the free market list, with a market capitalization of approximately US\$760 million, which represents 35 percent of 2003 GDP. Trading is primarily related to privatization vouchers. Small- and medium-size enterprise (SME) development continues, with a significant increase in private businesses; but it is difficult for them to secure debt (or equity) financing to fund their growth.

II. INSTITUTIONAL FRAMEWORK

A. Statutory Framework

5. **The two Entities have different accounting and auditing regulatory frameworks, which is not conducive to a business-enabling environment for the country.** The FBiH and the RS each have accounting and auditing laws with no uniformity of requirements between them and no legal framework at the state level. Accounting standards, accreditation of accountants, and licensing of auditors fall under

¹ Within this report, IFRS refer to both International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board and the Standards issued by the Board of the International Accounting Standards Committee, and each applicable Interpretation of the International Financial Reporting Interpretations Committee.

two separate regimes.² Enterprises registered in both Entities are required to maintain two sets of accounting records and are subject to different accounting and financial reporting requirements, which significantly add to the cost of doing business in BiH and impede foreign investment and private sector growth. Accounting and auditing are among the critical areas where further enhancements are needed to create a “single economic space” and improve the competitiveness of the economy.

6. **A new Framework Accounting and Auditing Law (the State Framework Law) was adopted on June 29, 2004, and published in the Official Gazette of BiH on September 10, 2004, which addresses many—but not all—of the weaknesses in the statutory framework identified in this report.** The State Framework Law sets out provisions of the general legal framework on the basis of which each Entity has prepared a draft Implementing Law which are in the process of being adopted by their respective Parliaments.

7. **Regarding accounting and audit regulation, BiH has a long way to go to attain compliance with the *acquis communautaire*.** The existence of a well-developed *acquis communautaire* for accounting and audit regulation should facilitate the choice of appropriate models to follow. After enacting laws and regulations that conform to the *acquis communautaire*, BiH will however have to address significant issues in the design and strengthening of suitable institutions to implement and enforce the *acquis communautaire* requirements.³ Finally, policymakers must stay abreast with ongoing changes to the *acquis communautaire*, which represent the European Union response to recent corporate scandals.

A.1 Statutory Framework in the Federation of BiH

8. **Business activities in the FBiH are primarily regulated by the Law on Business Companies, which is partly based on EU Company Law Directives.** The Law on Business Companies, passed in June 1999 and amended in 2002, recognizes four types of companies: general partnerships, limited partnerships, joint stock, and limited liability. Limited liability companies cover those with a small number of shareholders and a minimum capital of KM2,000 (approximately US\$1,300⁴); and joint stock companies cover those with a large number of owners and a minimum capital of KM50,000 (approximately US\$32,500).

9. **The responsibility of board members for the probity of financial statements is adequate, but directors do not always act accordingly.** Under the Law on Business Companies, the probity of a company’s financial statements is a responsibility of the board. However, in practice, the tradition of the former Yugoslav accounting system—where the chief accountant was responsible for the probity of financial statements—can have an adverse impact. Directors, lacking attention to the task, do not always review the financial statements or the critical accounting policies and practices applied by the company. Generally, directors are focused on bottom-line figures and not on the importance of disclosing transparent and reliable financial information.

² An auditor licensed in the FBiH is not authorized to conduct a statutory audit in the RS unless also licensed in the RS (and vice-versa). An auditor must therefore be licensed in both the FBiH and the RS to carry out cross-entity work in BiH. The ROSC team is not aware of any practitioner licensed to practice in both Entities. The recently enacted State Framework Law should resolve this issue (refer to paragraph 36).

³ The portions relevant to accounting and audit regulation are primarily found in Chapter V of the *acquis communautaire*: the Fourth, Seventh, and Eighth EU Company Law Directives and Regulation 1606/2002 on the use of International Accounting Standards, but also the “soft *acquis*” of the European Commission set out in the Recommendations on Auditor’s Independence (May 16, 2002) and on Quality Assurance for Statutory Audits (November 15, 2000), as well as the “forthcoming *acquis*” flagged in the Communication of the European Commission to the Council and the Parliament “Reinforcing the Statutory Audit in the EU” (May 21, 2003) and the proposal for a new Eighth EU Company Law Directive (March 2004).

⁴ Value based on the rate applicable on November 2, 2004 (KM1.54 = US\$1).

10. **The Institute of Accountants and Auditors (IAA) drives accounting and audit policymaking in the FBiH.** Despite its mandate, the IAA does not ensure in either fact or perception that the public interest is the overriding principle for policymaking. The Accounting Law and the Audit Law provide the main accounting and auditing regulations, which are supplemented by the Codex.⁵ The IAA has the exclusive right to regulate accounting and audit, but the governance and membership arrangements of the IAA are inadequate to ensure that professionalism, quality, and public interest are the overriding principle for accounting and audit policymaking (refer to paragraph 38 below). According to the latest draft of the FBiH Implementing Law, the IAA will be abolished, and the FBiH Ministry of Finance will assume the IAA's responsibilities. The ROSC team supports this improvement in the regulation of accounting and auditing in the FBiH.

11. **The FBiH Accounting Law does not establish a clear statutory framework conducive to transparent and reliable financial reporting.** The FBiH Accounting Law, passed in 1995 and amended in 1999, addresses a wide spectrum of accounting matters, including bookkeeping, accounting and financial reporting, statistics,⁶ and staffing of accounting departments. The Law requires all companies to prepare semi-annual and annual financial statements in conformity with "IFRS and related EU Directives." Such loosely worded financial reporting requirements lack clarity and hence may not be enforceable.

12. **Although it refers to IFRS and EU Directives, the Accounting Law actually requires compliance with the Codex and FBiH Accounting Standards, which fall short of IFRS.** The Institute of Accountants and Auditors issues FBiH Accounting Standards. Although the Accounting Law requires that FBiH Accounting Standards be in accordance with IFRS, the ROSC team found that FBiH Accounting Standards fall short of IFRS (see Section III). Also, the Accounting Law defines some accounting principles, such as "inequality," "causality," "individual assessment," "inventory taking," and "intangibility of opening balances," which do not conform with the IFRS conceptual framework. Therefore, financial statements prepared in conformity with FBiH legal requirements cannot claim "full IFRS" compliance.⁷

13. **The Law on Banks requires banks to prepare financial statements in conformity with IFRS, the translation of which is dated 1998 and falls short of current "full IFRS."** The Law on Banks does not set out specific filing or publication requirements for general-purpose financial statements. Therefore, banks must comply with requirements set out in the Accounting Law and follow the FBiH Bank Agency's modes and ways of reporting. Banks are required to appoint a statutory auditor. The statutory auditor is required to state in his/her report whether the bank's financial statements are prepared in conformity with IFRS. Moreover, the Accounting Law requires banks (and all other enterprises) to prepare consolidated financial statements if they "have an equity investment in other entities".⁸ The ROSC team noted that most banks have no subsidiaries and consequently do not present consolidated financial statements.

14. **Insurance companies are required to prepare their financial statements in conformity with the FBiH translation of IFRS, which is outdated and does not include insurance contract and technical reserve accounting requirements.** The Property and Person Insurance Law (1995, amended

⁵ The Codex was the General Chart of Accounts under the former Yugoslav system and was retained in 1998 by the IAA to facilitate the adoption of new standards.

⁶ For example, the Law defines the coefficients published by the Bureau of Statistics, yet such definitions do not belong in the Accounting Law.

⁷ "Financial statements should not be described as complying with IFRS unless they comply with all the requirements of each applicable Standard and each applicable Interpretation of the Standing Interpretations Committee," in IAS 1, *Presentation of Financial Statements*, paragraph 11; and IAS 1 (revised 2003), paragraph 14.

⁸ Article 17 of the Accounting Law.

1998) does not set specific accounting, auditing, and reporting requirements regarding insurance companies. Consequently, insurance companies have no further obligation than do any enterprises.

15. **The Law on Securities (1998, amended 1999) imposes specific accounting requirements on listed companies and additional filing requirements on listed companies (e.g., publication on the Securities Commission website), but these are not enforced for most companies.** Listed companies are required to file audited financial statements with the FBiH Securities Commission within two months of the general meeting of shareholders, publish abridged financial statements in one newspaper, and make them available to their shareholders and to the public upon request. In practice, most listed companies, with the exception of most listed banks and insurance companies, do not file their audited financial statements with the FBiH Securities Commission.⁹ The Law sets out sanctions for noncompliance, but these sanctions are not enforced since institutionalized enforcement capacity of the FBiH Securities Commission is very weak.

16. **The existing Accounting Law imposes the same accounting and financial reporting requirements on small and medium enterprises as on public interest entities.**¹⁰ These requirements are too complex and not geared to the identified needs of users of SME financial statements. The Accounting Law does not take advantage of the provisions allowed under the Fourth and Seventh EU Company Law Directives to exempt SMEs from an excessive accounting burden. The new FBiH Implementing Law referred to in paragraph 10 is being drafted by the Ministry of Finance and will replace the existing Accounting Law. The new Implementing Law contains provisions to exempt some SMEs from an excessive accounting burden; however, the ROSC team recommends that the size thresholds be raised (see paragraph 81).

17. **The existing Law on Auditing requires that most public interest entities be audited.** While the Law on Auditing does not use the term *public interest entity*, it mandates a statutory audit only in listed companies, banks, and insurance companies. While the Law takes advantage of the exemption allowed under the Fourth EU Company Law Directive in order not to impose an excessive audit burden on small- and micro-enterprises, it fails to impose statutory audit requirements on a number of large and medium enterprises, which should be audited in accordance with the Fourth EU Company Law Directive. In addition, the ROSC team found that a significant number of listed companies do not comply with audit requirements. The new FBiH Implementing Law referred to in paragraph 10 is being drafted by the Ministry of Finance and will replace the existing Auditing Law. The new Implementing Law does include a definition of a public interest entity and provisions for the statutory audit of such entities.

18. **The legal mechanisms pertaining to statutory auditors' appointment and termination are deficient.** Neither the Law on Business Companies nor the existing Law on Auditing states that shareholders should appoint the statutory auditor. In addition, the Laws do not include any termination mechanisms that could provide additional safeguards to auditor's independence. Hence, a statutory auditor may resign or be dismissed to avoid an audit qualification. The reasons for dismissal and resignation do not have to be disclosed to the responsible oversight authorities. The Law on Auditing

⁹ Only 200 reports were received from listed companies in 2003, and 130 are supposed to be on the website (<http://www.komvp.gov.ba>); however, they could not be accessed by the ROSC team.

¹⁰ Within this report, *public interest entities* mean enterprises in which the general public has an interest by virtue of the nature of their business, their size, their number of employees, or their range of stakeholders. Examples of *public interest entities* include banks, insurance companies, investment funds, pension funds, listed companies, and large enterprises. This definition is consistent with the concept discussed and developed during the preparation of the Recommendations on quality assurance and auditor independence in the EU Committee on Auditing. The proposal for a new Eighth EU Company Law Directive includes further guidance on this matter.

states that the auditor has the right, but not the obligation, to attend the general meeting of shareholders in order to “raise questions and give answers and opinions.”¹¹

19. **The Law on Banks includes additional legal requirements concerning statutory audits of banks.** These bank-specific requirements have not been extended to insurance and listed companies. The Law on Banks provides that the appointment of a bank statutory auditor is subject to prior approval by the FBiH Banking Agency. The FBiH Banking Agency assesses the auditor’s acceptability based on experience and independence but lacks a written and well-known process for such assessment (e.g., the reasons for barring an auditor from auditing a bank are not disclosed), and the auditor has no right of appeal. In a number of instances, the FBiH Banking Agency has rejected the appointment of the auditor proposed by a bank.

20. **The Accounting Law requires that the person responsible for preparing financial statements hold an “independent accountant” license issued by the Institute of Accountants and Auditors.** No accountant or auditor can provide any accounting or auditing services without being trained, certified, and licensed by the IAA. Under this monopoly, nobody can prepare financial statements; perform any legal or contractual audit; provide accounting, management or organization advisory services; and even provide tax consulting without having an IAA certification and IAA license, which must be renewed every two years. The ROSC team recognizes that the asymmetry of knowledge between professionals and users of services may require adequate rules on education in the public interest. However, the IAA does not have a proven track record evidencing the quality of its qualification requirements (refer to paragraph 39 below). It is therefore questionable why the legislature granted the IAA members a monopoly in the delivery of accountancy services. The FBiH draft Implementing Law will abolish the IAA and consequently cancel these dispositions and requirements. The ROSC team views this development as a positive one; it is also consistent with the trend away from such monopolistic rules, as evidenced by the recent debate on the *acquis communautaire* (Chapter VI – Competition Policy).^{12, 13}

21. **Financial statements are not publicly available.** The Accounting Law requires enterprises to file financial statements with the Bureau for Payment Transactions (ZPP). Since the Bureau was dissolved in 2000, there is no actual requirement to make financial statements publicly available, except for listed companies. The FBiH does not have a unified access portal giving stakeholders access to (audited) financial statements. A few listed companies provide audited financial statements to the FBiH Securities Commission, but in practice, financial statements are very difficult to obtain, except for bank financial statements, which are generally available. This falls short of the requirement of the First EU Company Law Directive.¹⁴

A.2 *Statutory Framework in the Republika Srpska*

22. **Business activities in the Republic Srpska are primarily regulated by the Law on Enterprises, which is partly based on EU Company Law Directives.** The Law on Enterprises, passed

¹¹ Law on Auditing, Article 28.

¹² The overall context is that in 2000, in Lisbon, the European Council set the ambitious goal for the EU of becoming the most competitive and dynamic knowledge-based economy in the world by 2010 as set out in “Competition in Professional Services: New Light and New Challenges,” by Mr. Mario Monti, Commissioner for Competition, European Commission, March 21, 2003.

¹³ A country’s ability to assume the obligations of EU membership is assessed based on 31 negotiating chapters. Chapter VI deals with competition policy.

¹⁴ Please refer to Articles 2 and 3 of the First Council Directive (68/151/EEC), as amended by Directive 2003/58/EC of the European Parliament and Council.

in July 1998 and amended in 2003, recognizes two main types of companies: business and public (i.e., government business enterprises).¹⁵ Types of business include joint stock, limited liability companies, general partnerships, and limited partnerships.

23. **The collective responsibility of board members and directors for the probity of financial statements is adequate, but directors may not always act accordingly.** Under the Law on Enterprises, the probity of a company's financial statements is a responsibility of the board. The Law on Enterprises and the RS Accounting Law (refer to paragraph 24 below) state that all persons who have participated in the production of false financial statements are subject to jail sentences ranging from three months to five years or to fines ranging from KM5,000 to KM50,000 (US\$3,250 to US\$16,230). In practice, though, directors in the RS have a similar approach to financial reporting as their counterparts in the FBiH (refer to paragraph 9 above).

24. **The RS Accounting Law and related secondary legislation do not establish a clear statutory framework conducive to transparent and reliable financial reporting and disclosure.** The RS Accounting Law, passed in 1999 and amended in 2002, adopted IFRS and ISA as the applicable accounting and auditing framework for all companies. The RS Association of Accountants and Auditors (RS AAA) translated all IAS/IFRS into Serbian in 1999. The translated version was issued as RS Accounting Standards. However, RS Accounting Standards have not kept pace with changes in IFRS, and stakeholders point to translation issues, which also impede compliance. All IFRS enacted after 1999 and all post-1999 amendments to existing IFRS are not applicable in the RS. Therefore, financial statements prepared under legal requirements cannot claim compliance with "full IFRS." The legal requirement to prepare financial statements twice a year in accordance with the Ministry of Finance's standard format adds complexity to the application of full IFRS.¹⁶ The ROSC team hopes that the final version of the new RS Implementing Law will address these issues.

25. **Although it refers to IFRS, the RS Accounting Law actually requires compliance with RS Accounting Standards, which fall short of IFRS.** The Law requires the RS Association of Accountants and Auditors to "translate, publish and enact" RS Accounting Standards, which will apply for a transitional period (from 2002 to 2007), until the RS is prepared to adopt "full IFRS." The Law requires that RS Accounting Standards be IFRS based.

26. **Banks are required to present legal entity financial and consolidated statements in conformity with the 1999 translation of IFRS.** The Law on Banks, passed in 2003,¹⁷ requires the supervisory board to present an annual report that includes audited financial statements. Directors, members of management, and supervisory boards have an individual and joint responsibility towards all internal and external persons.¹⁸ These financial statements are generally audited by the local member firms of international audit firm networks. The Law on Banks does not set out specific filing or publication requirements for general-purpose financial statements. Therefore, banks merely have to comply with the requirements set out in the Law on Accounting, which require publication of abridged financial statements in the Official Gazette within 15 days of their approval by shareholders (effectively within close to seven months of the year-end). This requirement is ineffective, as it does not ensure a timely disclosure of all information necessary for a complete accounting and disclosure to investors (in

¹⁵ This report uses the term "government business enterprise" rather than "state-owned enterprises" to conform with the terminology of the International Public Sector Accounting Standards set by the Public Sector Committee of the International Federation of Accountants (IFAC).

¹⁶ The Ministry of Finance sets out the standard format of the balance sheet, the income statement, and the cash flow statement. The regulation setting out the standard format is issued in the RS Official Gazette.

¹⁷ Law on Banks, Article 63.

¹⁸ Law on Banks, Article 230.

the case of listed banks), depositors, and other stakeholders. Abridged disclosure is inadequate because the absence of all financial statement components, and in particular the absence of note disclosures, precludes investors from assessing whether a bank's securities are a sound investment and other users, including correspondent banks, from using financial statements for other decision-making purposes.

27. **The Securities Act imposes additional filing requirements on listed companies.** Listed companies have to follow the Rules on Reporting and Disclosure by Companies Issuing Securities to Public and Rules on Trade of Securities. The Rules, issued by the RS Securities Commission, require companies to file audited financial statements for the three preceding years and to publish extracts from the financial statements in daily newspapers. The Securities Commission requires the publication of full financial statements of listed companies within nine months of the fiscal year-end. In May 2004, listed on the Banja Luka Stock Exchange were only three issuers that are subject to these reporting and disclosure requirements. In practice, issuers do not file their financial statements with the Securities Commission.

28. **Insurance companies are not required to comply with specific accounting, auditing, and financial reporting requirements.** The Accounting Department of the Ministry of Finance has not yet prepared insurance accounting regulations concerning financial statements. The RS Insurance Law sets out the composition of technical provisions but not the measurement principles.

29. **The Accounting Law imposes the same accounting and financial reporting requirements on small- and medium-size enterprises as on public interest entities.** These requirements are too complex and not geared to the identified needs of users of SME financial statements. The Accounting Law does not take advantage of the provisions allowed under the Fourth and Seventh EU Company Law Directives to exempt SMEs from an excessive accounting burden. The RS AAA is, however, preparing a simplified accounting framework for SMEs.

30. **Enterprises in the RS face significantly greater audit burdens than enterprises in the FBiH and in most EU Member States.** The RS Law on Enterprises requires that all private and public companies—except small companies¹⁹—appoint a statutory auditor. These thresholds are considerably lower than those in the Fourth EU Company Law Directive and will result in the audit of financial statements when there is no public interest requirement. Such an over-extensive audit requirement may undermine audit quality, even for the *public interest entities*, since the entire culture of quality and compliance becomes polluted, with no countervailing safeguards.

31. **The Law on Enterprises requires the shareholders to appoint a statutory auditor but fails to determine termination mechanisms (except for banks and insurance companies, refer to paragraph 32 below).** The Law does not include any termination mechanisms that could provide additional safeguards to auditor's independence. Hence, a statutory auditor may resign or be dismissed to avoid an audit qualification. The reasons for dismissal and resignation do not have to be disclosed to the responsible oversight authorities.

32. **There are additional legal requirements concerning audits of banks and insurance companies.** These bank- and insurance-specific requirements have not been extended to listed companies.²⁰ As in the FBiH (refer to paragraph 18 above), the appointment of a bank statutory auditor is subject to prior approval by the banking supervisors. The Ministry of Finance must approve the statutory

¹⁹ Under the temporary RS Accounting Standards, small companies are defined as employing less than 50 employees, with annual sales of less than 8,000 times the "average salary" in the RS, and with total assets valued at less than 6,000 times the "average salary" in the RS.

²⁰ The fact that listed companies were overlooked is however less of a concern in the RS than in the FBiH, since there are only two companies listed on the Banja Luka Stock Exchange.

auditor selected by the insurance undertaking. The RS Law on Banks requires the bank supervisory board to appoint a statutory auditor and an audit committee, which is responsible for monitoring the statutory auditor. The RS Insurance Law requires the board of directors of an insurance company to appoint a statutory auditor. Internationally, it is increasingly common for external auditors to be recommended by an independent audit committee of the board or an equivalent body and to be appointed either by that committee/body or by shareholders directly. The requirement that the board of directors of an insurance company appoint the statutory auditor does not recognize that the auditors owe a duty of due professional care to the company rather than to a group of executive directors with which they may interact for the purpose of their work.

33. **Financial statements are not publicly available.** The RS does not have a unified access portal giving stakeholders access to (audited) financial statements. In practice, financial statements are still very difficult to obtain. This falls short of the requirement of the First EU Company Law Directive. The Ministry of Finance is aware of this problem, and it has drafted a law that will require financial reports prepared from 2004 onwards to be made publicly available.

B. The Profession

34. **The accounting and audit profession is highly fragmented, which results in inefficient use of scarce resources.** The profession is segregated between the two Entities. In addition, the profession is further fragmented in FBiH by the co-existence of more than one different professional organization.²¹

35. **The State Framework Law promotes a unified profession under the aegis of an Independent Standards Commission established by the Council of Ministers of BiH.** The State Framework Law prescribes the establishment of an independent standards commission²² to monitor the implementation of accounting and auditing standards by the professional bodies. The State Framework Law states that the Commission is responsible for translating and disseminating IASB and IFAC standards and interpretations; establishing qualification requirements; and administering professional examinations, among other activities. The State Framework Law is a significant positive move towards a unified accounting profession, and the establishment of the Independent Standards Commission will have an instrumental role to play in ensuring that accountants are properly trained and adequately qualified. However, the self-regulatory regime set forth in the State Framework Law falls short of the requirements set out in the proposal for a new Eighth EU Company Law Directive. The proposed Directive states that effective public oversight over the accounting profession is a vital element in the maintenance and enhancement of confidence in the audit function. The current lack of confidence is partly based on a public perception throughout the EU that a self-regulating profession runs a serious risk of conflicts of interest in dealing with its shortcomings. Therefore, a credible element of public oversight over the audit profession is crucial, as it ensures that oversight has sufficient public integrity and independence.

The RS and FBiH draft Implementing Laws set forth a system of public oversight for which the Ministry of Finance is responsible; thus, it acts as a proxy of the public interest. However, the ROSC team believes such oversight falls short of good practices in EU Member States, as no one stakeholder can claim to adequately represent the interests of the public at large. A proper proxy for the public interest should draw upon a wider constituency, including not only the Ministry of Finance, but also the Securities and

²¹ There were several accounting associations in the FBiH. Three associations have recently merged and are in discussion with the RS AAA for an alliance. However, the activities of his unified body in FBiH would still overlap with the activities of the FBiH IAA if the draft FBiH Implementing Law is not passed.

²² This commission will have a board of seven members from the accountancy profession, including three each from the FBiH and the RS, and one from the District of Brcko, to be elected annually. During the first six months of operations (subject to extension), an independent international advisor will chair the commission.

Exchange Commission, the National Bank, academia, etc. Although there is no one blueprint as to how to set up an effective public oversight mechanism, BiH should take an approach to public oversight that is aligned with the principles set forth in the proposed new Eighth Company Law Directive and draw upon the evolving experience of EU Member States.²³

In addition, the scope of oversight performed by the Ministry of Finance is not in line with the *acquis communautaire*. The Ministry licenses auditors, but cannot refuse to license an auditor if he or she is licensed by the Independent Standards Commission. The Ministry of Finance also oversees the audit profession, but it has no sanctions at its disposal. The policy recommendations in paragraph 83 propose a public oversight system that represents a minimum requirement for an adequate public oversight in BiH in line with the *acquis communautaire*.

36. The State Framework Law creates a countrywide platform for statutory audits. Audits performed and audit reports issued by an auditor licensed in any of the two Entities and the Brcko District will be recognized in all Bosnia and Herzegovina without any additional requirements.

37. The State Framework Law sets out a grandfathering process. Auditors licensed under the current regime will be entitled to keep their licenses if they comply with Art. 6.2 of the State Framework Law, which requires that all accounting professionals undertake at least 120 hours of continuing professional education over a three-year period. Specifically with regard to the RS, authorized auditors will be allowed to keep their licenses only if they complete a special 40-hour continuing professional education (CPE) course in Advanced Auditing and pass an examination within 12 months. In other parts of BiH, auditors need only comply with the 120-hour CPE requirement, with no examination. Hence, only if continuing professional education requirements are rigorously enforced and an adequate level of quality of CPE is maintained will it be possible to achieve a gradual withdrawal of audit licenses by unqualified members, and an improvement of the quality of professionals. This must also be linked with disciplinary sanctions against members who do not comply with CPE requirements.

B.1 The Profession in the Federation of BiH

38. The FBiH Law on Auditing recognizes the profession largely as regulated by the Institute of Accountants and Auditors, an offspring of the Ministry of Finance. While the Law on Auditing established the IAA as a separate public entity, the IAA remains related to the Ministry of Finance. The management board comprises seven members appointed by the Government for renewable four-year terms. Most current members are academics and former civil servants of the Ministry of Finance. Among IAA duties that the Law requires are setting accounting and auditing standards; organizing certification and licensing of accountants and auditors; providing continuing professional education; maintaining registers of auditors, including audit firms and individuals; adopting a professional code of ethics for members and controlling the quality of audit activity and members' professional conduct; and handling complaints against auditors. Although the IAA licenses accountants and auditors, the IAA is not a professional association (i.e., accountants and auditors are not IAA members and have no say in the IAA management and operations). The IAA is not accountable to the general public either. According to the State Framework Law and draft FBiH Implementing Law, the Institute shall be abolished (see paragraph 10)

²³ Article 31 of the proposed Directive requires that an adequate public oversight system: (a) be governed by non-practitioners knowledgeable in the areas relevant to statutory audit, or at least a majority of non-practitioners; (b) have ultimate responsibility for the oversight of: the approval and registration of statutory auditors and audit firms; the adoption of standards on ethics, internal quality control of audit firms and auditing; and continuous education, quality assurance and investigative and disciplinary systems; (c) have the right, where necessary, to conduct investigations of statutory auditors and audit firms, and must have the right to take appropriate action.

39. **The right to conduct statutory audits of financial statements is reserved for individuals and audit firms licensed by the IAA.** The IAA has licensed approximately 230 individual auditors and 60 audit firms, and it has certified approximately 3,500 accountants (refer to paragraph 20 above). Among international audit firm networks, only two are present in the FBiH. Three voluntary professional associations merged in May 2003 into the Union of Accountants, Auditors, and Financial Workers of the FBiH (SRRiF-FBiH). The SRRiF-FBiH seeks to (a) enhance accounting and auditing practices in the FBiH through the implementation of IFRS, ISA, and the International Federation of Accountants (IFAC) Code of Ethics for Professional Accountants; (b) protect members' interests; (c) develop and enhance accounting education in line with international standards; (d) promote the use of modern accounting and financial methods and techniques; (e) certify and license FBiH accountants and auditors in line with the guidelines issued by IFAC and the United Nations Conference on Trade and Development (UNCTAD). The SRRiF-FBiH has 3,000 members. While the objectives of the SRRiF-FBiH may be conducive to the betterment of the profession, it lacks any statutory recognition to effectively influence audit quality, since the IAA is the only recognized audit regulatory body in the FBiH. The abolishment of IAA should permit to transfer resources and tasks to the professional association, which will be recognized by the Independent Standards Commission (see paragraph 10).

40. **In accordance with the Law on Auditing, the IAA adopted the 1998 IFAC Code of Ethics for Professional Accountants, which falls short of the current IFAC Code of Ethics (revised November 2001).** Significant differences between the 1998 and 2001 versions may affect an auditor's independence. In addition, the Law on Auditing does not prevent a statutory auditor from performing bookkeeping services, consulting services, tax consulting, designing and implementing financial information systems, and conducting appraisal or valuation services for a client contemporaneously with the statutory audit of the financial statements, provided these services are delivered by a separate department of the audit firm. Such loose independence requirements may not provide an adequate framework to identify and mitigate threats to independence (of mind and in appearance).

41. **The FBiH legislation relating to auditor's liability is poorly drafted and has never been tested.** Several issues exist concerning the current FBiH legislation governing auditors' activities:²⁴

- In cases where the auditing activity has not been conducted in accordance with the Law on Auditing or Code of Ethics, the Law on Auditing states that the IAA director is required to penalize the auditor or audit firm with a suspension from 6 to 12 months, or permanent removal from the register. A weakness here is that the penalty is based on the unsupported decision of one person instead of a procedure, including a Chamber of Discipline. However, the IAA has never imposed any of these sanctions. The untested application of sanctions and the insufficient organization of the disciplinary system are not enough to ensure professional discipline and respect for standards and the code of ethics.
- The Law on Auditing and other regulations include provisions pertaining to the auditors' civil liability, including an obligation to take out liability insurance. The Law does not define whether the liability extends to third parties (e.g., creditors, investors, or any person relying in good faith on the auditor's opinion) and whether it can be capped. In the absence of such provision, lawyers contend that third parties would be in a difficult position to prove before a court that they have title and legal standing to pursue a claim for damages against an auditor.

²⁴ This report outlines the legal principles applicable to each of the above areas and some miscellaneous issues, but does not attempt to give anything more than an introduction to the issues. This report is not meant to give exhaustive rendition of the law nor legal advice to its readers.

- The Law on Auditing also establishes monetary penalty provisions, with fines from US\$2,500 to US\$12,500 against an audit firm, and from US\$500 to US\$750 against an auditor. These penalties are written mainly to prevent any person or firm not licensed by the IAA to carry out any audit activity, rather than to sanction any breach with respect to standards, independence, and the code of ethics.

B.2 The Profession in the Republika Srpska

42. **The RS Association of Accountants and Auditors has approximately 6,000 individual members, including 1,400 certified accountants and auditors, of which approximately 50 certified individual auditors are in public practice.** The balance of certified accountants and auditors work in industry, government, and education. In addition, the RS AAA includes approximately 3,000 associate members. Certified auditors apply to the Ministry of Finance for a license to operate as a sole practitioner or audit firm. The Ministry issues renewable licenses for two years based on an RS AAA certificate stating that the auditor is duly qualified and has complied with continuing professional education requirements (refer to paragraph 55 below).

43. **The profession is too small to conduct statutory audits required by law.** Statutory audit requirements (refer to paragraph 30 above) extend to approximately 650 enterprises in the RS, but there are only approximately 50 certified auditors organized as sole practitioners or audit firms. In spite of legal requirements, with a comparatively low ratio of auditors to needed audits, statutory audits are generally conducted in banks, insurance companies, and large companies only.

44. **The Law on Accounting recognizes the profession as largely self-regulated but subject to limited oversight by the Ministry of Finance.** The RS AAA is required by the Law to (a) enact accounting and auditing standards after approval by the Ministry of Finance; (b) interpret and provide guidance on those standards; (c) organize and conduct professional examinations; (d) organize and monitor continuing professional education; (e) develop a professional code of ethics for members; (f) control the quality of audit activity and members' professional conduct; (g) develop, if necessary, professional audit rules and techniques; and (h) certify and license accountants and auditors. The Ministry of Finance retains limited but effective authority over the profession through the biannual renewal of audit licenses and approval of accounting and auditing standards.

45. **Lack of resources constrains the activities of the RS AAA, which has so far been largely supported by bilateral aid agencies.** Professional dues levied by the RS AAA range from US\$5 to US\$50 per year, which is very low compared to similar professional association membership fees in EU Member States or accession countries. This fee shortfall hampers the quality and timeliness of translation, guidance, interpretation, professional examination, quality assurance, and other important activities.

46. **The RS AAA has adopted the IFAC Code of Ethics for Professional Accountants (November 2001 revision).** Compliance with ethics requirements lags behind, since the IFAC Code was only recently adopted, and business ethics remains a rather vague concept. The RS AAA has yet to develop guidance, organize training, and enforce these recently enacted requirements.

47. **The RS legislation relating to auditor's liability is poorly drafted and has never been tested.** Several issues exist concerning the current RS legislation governing auditors' activities:²⁵

²⁵ This report outlines the legal principles applicable to auditor's liability, but does not attempt to give anything more than an introduction to the issue. This report is not meant to give exhaustive rendition of the law nor legal advice to its readers.

- In cases where an audit engagement has not been conducted in accordance with legal requirements, the auditor or audit firm is subject to disciplinary sanctions by the Ministry of Finance, including permanent removal of the audit license.
- The Rules on the Audit of Financial Statements, passed in December 2000 and amended in October 2001, set out the auditor's duty to the audited company and its shareholders. The Rules include provisions pertaining to the auditor's civil liability, including a requirement to take out liability insurance. Lawyers contend that such liability extends to third parties (e.g., creditors, investors, or any person relying in good faith on the auditor's opinion). However, the low statutory cap on auditors' liability hampers the effectiveness of auditor liability as a driver of audit quality. The Rules on Auditing fix an arbitrary cap (approximately US\$15,000) on auditors' liability to the audited company.

The ROSC team is not aware of any disciplinary, civil, or criminal decision by the Ministry of Finance or RS courts against auditors to date.

C. Professional Education and Training

48. **The professional education requirements of the State Framework Law establish three categories of practitioners: certified accounting technician (CAT), certified management accountant (CMA), and certified auditor (CA).** All three groups will be tested and certified by the International Standards Commission or by the Ministry of Finance (refer to paragraph 35 above). Candidates must fulfill requirements for education, examination, and practical experience as determined by the Commission, in full accordance with IFAC standards and guidance.

49. **The State Framework Law requires participation of licensed auditors in continuing professional education (CPE).** In order to retain qualification, a licensed accountant or auditor will be required to undertake CPE for a minimum of 120 hours over a three-year period. The profession expects that CPE will form part of a broader national qualification and training program in Bosnia and Herzegovina consistent with recent IFAC International Standards on Education. Since the Independent Standards Commission has not yet been made fully operational, no measures have been taken as of yet.

C.1 Professional Education and Training in the Federation of BiH

50. **Several universities in BiH have undergone a considerable curriculum reform effort to improve the quality of academic education.** This has created "pockets of excellence" among BiH universities; however, the full fruits of such efforts will not be borne until at least 2004 or 2005, as the reform program was initiated only a few years ago.

51. **An auditor must have acquired appropriate higher education, obtained relevant practical experience, and passed the professional examination administered by the IAA.** The FBiH Accounting Law requires the following:

- ***To qualify as a trainee*** one must have a four-year university degree in economics.
- ***To qualify as an independent accountant*** one must have obtained one year of practical experience in accounting; and passed the examination that covers subjects such as accounting, business law, information technology, etc.
- ***To qualify as a professional auditor*** one must have attended courses organized by the IAA and passed the examination that covers subjects such as auditing, internal control, financial accounting, etc.

Due to transitional measures for the access to the profession, there is no evidence that all IAA licensed and certified practitioners have the proper qualification.

52. **Licensed auditors are encouraged, but not required, to participate in continuing professional education to maintain and improve their professional competence and to meet public expectations for quality work by the profession.** This issue should be resolved after the implementation of the State Framework Law, and the implementation of the new Independent Standards Commission (see paragraph 49).

C.2 Professional Education and Training in the Republika Srpska

53. **Academic and professional education curricula were adapted in 2001 in line with IFAC and UNCTAD requirements.** Their introduction was facilitated by substantial support from a bilateral aid agency. However, not all faculty members and instructors appear to be up-to-date with recent accounting trends. A major effort has been made to improve the quality of academic education and the skills of faculty. The fruit of the efforts realized should appear before the end of the current university year.

54. **An auditor must have acquired appropriate higher education, obtained relevant practical experience, and passed the professional examination administered by the RS AAA.** The RS Auditing rules require the following:

- **To qualify as a certified bookkeeper,** one must have obtained a high school certificate in economics. A certified bookkeeper is allowed to keep the accounting records and sign the financial statements of a small enterprise. If working in a medium- and large-size enterprise, a certified bookkeeper must be supervised by an independent accountant.
- **To qualify as an independent accountant,** one must have a three-year university degree in economics. Such qualification is required to be appointed chief accountant in a medium-sized enterprise. Appointment to chief accountant position in a large enterprise is allowed under the supervision of a certified accountant.
- **To qualify as a certified accountant,** one must have a four-year university degree in economics. Such qualification is required to be appointed chief accountant in a large enterprise.
- **To qualify as an auditor,** one must have a four-year university degree in economics. The RS AAA does not ensure that the practical experience candidates have gained is acceptable.²⁶

55. **Licensed auditors are required to participate in continuing professional education for a minimum of 30 hours per year, organized by the RS AAA, to maintain and improve their professional competence and to meet public expectations for quality work by the profession.**

D. Setting Accounting and Auditing Standards

56. **The State Framework Law introduces a countrywide standard-setter, the Independent Standards Commission.** The creation of a countrywide accounting and auditing standard-setter is a major step in the right direction, subject to adequate public oversight (refer to paragraph 35).

²⁶ International Education Standard (IES) 5, *Practical Experience Requirements*, suggests a number of ways to ensure that the practical experience candidates have gained is acceptable.

57. **The State Framework Law requires the use of IFRS by large enterprises as of 2005.** Large enterprises are defined in the RS and FBiH draft Implementing Laws as those with a total income for the year, including sales or value-added tax, exceeding KM1 million (US\$650,000), or which employ 50 persons or more. The State Framework Law does not distinguish between legal entity and consolidated financial statements. Therefore, the ROSC team assumes that a company would have to prepare both, according to IFRS.

D.1 Setting Accounting and Auditing Standards in the Federation of BiH

58. **The IAA is the accounting and auditing standard-setting body.** The IAA develops national accounting and auditing standards based on IFRS and ISA, although it has not established a due process to develop these standards.

59. **The FBiH translation of IFRS, although readily available, is outdated, incomplete, and inaccurate.** The 1998 IFRS volume was translated by the IAA and published in the Official Gazette as a handbook. It was endorsed as the FBiH accounting standards under the name Codex (refer to paragraph 10 above). However, the IAA translation dropped several standards²⁷ and all Interpretations of the Standing Interpretations Committee; removed several paragraphs deemed too complex for the local environment (e.g., contingencies); and significantly modified the IFRS Conceptual Framework. In 1999, IAS 30 through IAS 38 were translated, adapted, and adopted as national standards with modifications.²⁸ In total, 14 complete international standards and 17 international standards with adaptations have been adopted as national standards. While the ROSC team acknowledges that the written law tradition requires giving IFRS legal endorsement for their use in the FBiH, the current environment does not enable timely translation and adoption of new IFRS, amendments to existing standards, and interpretations. Also, adapting rather than adopting IFRS significantly impedes the transparency and reliability of financial statements.

60. **The FBiH standards on auditing follow the International Standards on Auditing as translated into local language in 1998.** Any ISA enacted by IFAC after 1998 and amendments to existing ISA since then are not applicable in the FBiH.

D.2 Setting Accounting and Auditing Standards in the Republika Srpska

61. **The RS AAA is the accounting and auditing standard setting body, but it is subject to the supervision of the Ministry of Finance.** The Law delegates to the RS AAA, for a transitional period ending in 2007, the authority to develop temporary accounting standards until IFRS can be implemented “in full.” The RS AAA develops accounting and auditing standards and submits the proposed standards to the Ministry of Finance for enactment. The standard setting process lacks adequate due process. The passage of the State Framework Law and the RS Implementing Law will result in the transfer of responsibilities relating to standards to the Independent Standards Commission.

62. **The RS translation of IFRS, although readily available, is outdated.** The 1999 IFRS volume was translated by the RS AAA and published in separate books. It was endorsed as the RS accounting

²⁷ Some important standards—IAS 14, *Segment Reporting*; IAS 27, *Presentation of Consolidated Financial Statements*; and IAS 36, *Impairment of Assets*—are not implemented in the FBiH.

²⁸ IAS 30, *Disclosures in the Financial Statements of Banks and Similar Financial Institutions*; IAS 31, *Financial Reporting of Interests in Joint Ventures*; ISA 32 *Financial Instruments: Disclosure and Presentation*; IAS 33 *Earnings Per Share*; IAS 34, *Interim Financial Reporting*; IAS 35, *Discontinuing Operations*; IAS 36, *Impairment of Assets*; IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*; and IAS 38, *Intangible Assets*.

standards. However, the RS AAA's translation dropped several standards, since only 16 accounting standards were enacted. The RS AAA adopted those standards that are important for SMEs, since SMEs account for the bulk of economic activity in the RS. In the event that a transaction is not covered by the 16 existing standards, accountants are required to refer to the relevant IFRS.

63. **RS standards on auditing follow the ISA in existence in 1999 when translated into local language.** The RS Accounting Law authorizes the RS AAA to translate and issue auditing standards in the RS. All ISA enacted by IFAC after 1999 and no amendments to existing ISA are applicable in the RS. A new version of IFAC standards and Code of Ethics was translated in 2003 and used for professional examination, but is not widely distributed to RS AAA members, due to lack of resources.

E. Enforcing Accounting and Auditing Standards

E.1 Enforcing Accounting and Auditing Standards in the Federation of BiH

64. **There is no effective mechanism for enforcing financial reporting requirements, except to a certain extent in banks.** Company directors have yet to change their cultural mindset. Their customary role was to delegate financial reporting to chief accountants; now they must take responsibility themselves for ensuring that financial statements are true and fair. The Government is mainly concerned with the prevention of tax evasion resulting from illegally established companies and undeclared cash transactions. Therefore, enforcing financial reporting requirements is perceived as less important. Compliance remains a voluntary matter in the absence of coercive or positive incentives. However, institutionalized enforcement mechanisms in the banking sector appear to be more effective.

65. **The FBiH lacks a sound quality assurance mechanism for statutory audit, which is fundamental for ensuring good audit quality.** Good audit quality implies adding credibility to published financial information and adding value and protection to shareholders, investors, creditors and other stakeholders. However, the FBiH has not implemented a system of quality assurance that is organized in a manner that is independent from the reviewed statutory auditors and audit firms. This does not conform to IFAC pronouncements and *acquis communautaire* requirements.

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66. **There is no effective mechanism for enforcing financial reporting requirements except to a certain extent in banks.** Company directors have yet to change their cultural mindset. Their customary role was to delegate financial reporting to chief accountants; now they must take responsibility themselves for ensuring that financial statements are true and fair. The Government is mainly concerned with the prevention of tax evasion resulting from illegally established companies and undeclared cash transactions. Therefore, enforcing financial reporting requirements is perceived as less important. Compliance remains a voluntary matter in the absence of coercive or positive incentives. However, institutionalized enforcement mechanisms in the banking sector appear to be more effective.

67. **The RS still lacks a sound quality assurance mechanism for the statutory audit, which is fundamental for ensuring good audit quality.** Good audit quality implies adding credibility to published financial information and adding value and protection to shareholders, investors, creditors and other stakeholders. However, the RS has not implemented a system of quality assurance that is organized in a manner that is independent from the reviewed statutory auditors and audit firms. This does not conform to IFAC pronouncements and *acquis communautaire* requirements. The RS AAA has begun to develop a new quality control system, and has planned new training activities on this subject before the end of 2004.

III. ACCOUNTING STANDARDS AS DESIGNED AND AS PRACTICED

68. **Accounting requirements and practices are on average of such poor quality that investors and other users cannot make a judgment from financial statements whether a company's securities are a sound investment; nor can the financial statements be relied on for other decision-making purposes.** The adoption of reliable accounting standards must be accompanied by recognition and reliance on the importance of transparency and disclosure by all stakeholders in the financial reporting system. Corporations should be convinced that disclosure is a benefit rather than a burden. In this respect, the lack of an articulated demand from actual or potential shareholders and other stakeholders remains the primary reason why companies are not interested in publishing extensive information.

A. Accounting Standards as Designed and as Practiced in the Federation of BiH

69. **FBiH accounting standards fall short of IFRS.** There are significant differences between current FBiH accounting standards and IFRS, which may have an adverse impact on the quality of financial statements. Selected differences include the following:

- **Conceptual framework.** The International Accounting Standards Board (IASB) framework sets out the concepts that underlie the preparation of general-purpose financial statements. FBiH accounting standards do not include important concepts of the IASB framework, such as the qualitative characteristics of financial statements (understandability, relevance, reliability and comparability) and the recognition that “management of an enterprise has the primary responsibility for the preparation and presentation of the financial statements of the enterprise.” The omission of certain key sections from the IASB framework may adversely affect the quality of financial statements in the FBiH.
- **Financial instruments.** IAS 39, *Financial Instruments: Recognition and Measurement*, which prescribes the accounting treatment for financial assets and liabilities (e.g., accounts receivables, loans), was not adopted in the FBiH.
- **Investment property.** IAS 40, *Investment Property*, which prescribes the accounting treatment for investment property and related disclosure requirements, was not adopted in the FBiH. Therefore, investment properties (e.g., real estate held in the investment portfolio of an insurance company) are still accounted for in conformity with IAS 25, *Accounting for Investments*, which was superseded by IAS 40 in the rest of the world. Under IAS 25, a company is permitted to choose from a variety of accounting treatments for investment property (i.e., depreciated cost, revaluation with depreciation, and cost less impairment).
- **Agriculture.** IAS 41, *Agriculture*, which imposes the evaluation at fair value for living stocks and biological products, was not adopted in FBiH.

70. **The ROSC team assessed the compliance gap by sampling five sets of financial statements that purport to be prepared in accordance with IFRS and 10 sets that purport to be prepared in accordance with FBiH accounting standards.**²⁹ For the sample assessment, the ROSC team selected 5 banks and 10 companies in the enterprise sector (listed and non-listed). While the banks purported to apply IFRS, none actually prepared full IFRS-based financial statements. The quality of financial statements in the enterprise sector was generally insufficient. Several issues emerged from the samples:

²⁹ The ROSC team used stratified random sampling to select the companies that were analyzed in this report. However, due to the sample's small size, it cannot be considered to be representative of all listed companies. Hence, the findings, although useful for illustrating potential problems in financial reporting, pertain to shortcomings found in the financial statements of specific companies. The findings are not meant to reflect systemic problems that would apply to listed companies in general.

- ***Some sampled financial statements did not include all elements that should have been produced.*** Five out of ten enterprise sector companies did not include notes to financial statements. Four financial statements were not accompanied by the audit report although the companies were listed and supposed to have a statutory auditor. None of the sampled financial statements presented any consolidated financial statements and no segment reporting was disclosed in any report, although some should have presented them. Such noncompliance prevented the reader from drawing any relevant conclusion on the basis of the sampled financial statements.
- ***Possible failures to recognize impairment losses on property, plant, and equipment may result in overstated assets.*** The majority of enterprises used the minimum depreciation rates set by the IAA without regard to the economic useful life of the assets and do not test these assets for impairment. Bankers corroborated this analysis and pointed to several instances where the carrying amounts of property, plant, and equipment in audited financial statements are overstated.
- ***Possible nondisclosure of related party transactions.*** While it is particularly difficult to assess the quality of related party disclosures, the ROSC team noted an instance where a listed company controlled by its parent provided only limited information regarding significant transactions with the parent.
- ***Noncompliance with requirements on the classification of compound instruments (convertible debt), hedge accounting, and the measurement of marketable securities and long-term investments is indicative of a need for capacity building in this area.*** IAS 39 has not been adopted in FBiH, and there is no FBiH accounting standard dealing with recognition and measurement of financial instruments. The ROSC team discussed these issues with management, auditors, and regulatory agencies, who acknowledge the need for capacity building in this area. Such noncompliance adversely impacted the transparency of bank financial statements in the sample.

B. Accounting Standards as Designed and as Practiced in the Republika Srpska

71. **The RS translation of IFRS falls short of current “full IFRS,” which may have an adverse impact on the quality of financial statements (see paragraph 59 above).** Selected differences include the following:

- ***Revaluation of intangible assets, investments, equity, property, plant, and equipment.*** Companies used until 2000 officially published revaluation coefficients that were based on changes in general price indices (e.g., 14 percent in 1999; 16.1 percent in 2000) to revalue intangible assets, investments, equity, property, plant, and equipment, a procedure that does not comply with IFRS. Observers note that such revaluation generally resulted in overstated assets and net equity. This system was officially abandoned in 2000, and should not be in practice, but the IFRS alternative system of reevaluation and devaluation introduced by IFRS has not yet replaced it.
- ***The RS translation does not mention deferred tax accounting.*** IAS 12, *Income Taxes*, requires that an enterprise recognize the amount of current and future tax related to events that have been recognized in financial accounting income. Consequently, deferred tax liabilities derived from situations where future taxable income will be greater than future financial accounting income due to temporary differences (e.g., due to differences between tax depreciation and book depreciation) are not reported in the RS. Conversely, deferred tax assets are not recorded either.

- **Financial Instruments.** IAS 39, *Financial Instruments: Recognition and Measurement*, which prescribes the accounting treatment for financial assets and liabilities (e.g., accounts receivables, loans), was not adopted in the RS.
- **Investment property.** IAS 40, *Investment Property*, which prescribes the accounting treatment for investment property and related disclosure requirements, was not adopted in the RS. Therefore, investment properties (for example, real estate held in the investment portfolio of an insurance company) are still accounted for in conformity with IAS 25, *Accounting for Investments*, which was superseded by IAS 40 in the rest of the world. Under IAS 25, a company is permitted to choose from a variety of accounting treatments for investment property (depreciated cost, revaluation with depreciation, and cost less impairment).
- **Agriculture.** IAS 41, *Agriculture*, which imposes the evaluation at fair value for living stocks and biological products, was not adopted in the RS.

72. **The ROSC team was unable to review an adequate sample of full financial statements in the RS.** Most sampled financial institutions and enterprise sector companies presented audited abridged financial statements, which did not include notes to the financial statements. While most included a balance sheet, income statement, cash flow statement and statement of changes in equity, several sampled companies failed to present a cash flow statement and statement of changes in equity. This is a significant departure from the RS accounting requirements.

IV. AUDITING STANDARDS AS DESIGNED AND AS PRACTICED

A. Auditing Standards as Designed and as Practiced in the Federation of BiH

73. **There are differences between the translation of ISA applicable in 1999 and current ISA.** These differences may have an adverse impact on audit quality. The differences stem from new ISA and amendments made to existing ISA since 1999, which were not endorsed in the FBiH. Selected differences include the following:

- **Fraud and error.** The revised ISA 240, *The Auditor's Responsibility to Consider Fraud and Error*, has not been endorsed in FBiH. The revised ISA 240 clarifies the role of auditors, management, and those charged with governance of an entity with respect to fraud and error in financial statements. A revision would be of particular interest in a marketplace that continues to provide an environment where the potential for fraud exists.
- **Communication of audit matters.** In 1999, IFAC issued ISA 260, *Communications of Audit Matters with those Charged with Governance*. The ISA establishes requirements and provides guidance on the communication of audit matters arising from the audit of financial statements between the auditor and those charged with governance of an entity (for example, the supervisory board). This standard may play an important role in making these persons more accountable throughout the financial reporting process.

74. **There is conflicting evidence about the quality of statutory audits.** From discussions conducted by the ROSC team with sole practitioners, small and large audit firms, and the IAA, selected problem areas surfaced that adversely impact the average quality of auditing practices in FBiH:

- **Lack of documentation.** Some auditors do not document matters that are important in providing evidence to support their audit opinion and evidence that the audit was carried out in accordance with applicable standards.

- **Fraud and error.** Responding to international corporate reporting scandals, the international standard on fraud and error has been reinforced by a recent amendment, which has not yet been reflected in FBiH auditing guidelines. More worrying is that few auditors appear to understand their responsibility to consider fraud in audits of financial statements.
- **Internal control systems.** Auditors tend to start with substantive testing but do not always seek to understand the accounting and internal control systems. As a result, auditors may not become aware of weaknesses in these systems. Consequently, they may fail to make management aware of material weaknesses in the design or operation of the accounting and internal control systems. This is a missed opportunity to enhance financial management in FBiH.
- **Related parties.** Strict application of the international standard on auditing related party transactions seems to give rise to tension between the auditor and management and may result in inadequate disclosure of related party transactions.
- **Lack of audit evidence.** Some auditors do not appear to systematically attend physical inventory counting even though inventory is material to the financial statements. In addition, some auditors do not appear to use external confirmations (e.g., from banks) even though circumstances may warrant it.

B. Auditing Standards as Designed and as Practiced in the Republic of Srpska

75. **There are differences between the translation of ISA applicable in the RS and current ISA. These differences may have an adverse impact on audit quality.** The differences stem from new ISA and amendments made to existing ISA since 1999, which were not endorsed in the RS. The standard gap and compliance gap in the RS are similar to the gaps in the FBiH described in paragraph 73 and 74 above). Although a complete updated version of IFAC ISAs and Code of Ethics was translated and published in 2004, it has not been yet distributed and enforced by lack of resources.

76. **The audit reports accompanying the sampled financial statements were not prepared in accordance with ISA 800, *The Auditor's Report on Special Purpose Audit Engagements*, which is a significant departure from ISA.** ISA 800 requires, among other things, that the auditor's report include the statement, "for a better understanding of the Company's financial position and the results of its operations for the period and of the scope of our audit, the summarized financial statements should be read in conjunction with the financial statements from which the summarized financial statements were derived and our audit report thereon." None of the sampled financial statements in paragraph 72 above complied with this ISA requirement.

77. **Although the ROSC team was unable to review an adequate sample of complete financial statements, the ROSC team found significant audit issues in the audited financial statements of a limited sample of economically significant companies, including banks.** The local member firm of an international audit firm network expressed unqualified audit opinions on the financial statements of two RS banks, both of which purported to comply with RS accounting regulations. The notes to the financial statements of one of the banks highlighted "major departures from IFRS," i.e., significant differences between RS accounting regulations and IFRS, whereas the notes to the financial statements of the second bank stated, "RS accounting regulations mostly comply with IFRS." Also, while it is particularly difficult to assess the quality of related party disclosures, the ROSC team noted that these two banks did not disclose any related party relationships or related party transactions. Finally, in a third instance, the local member firm of another international audit firm network expressed an unqualified audit opinion on a bank's financial statements without identifying the financial reporting framework. The audit purported to be conducted in accordance with ISA.

V. PERCEPTIONS ON THE QUALITY OF FINANCIAL REPORTING

78. **As primary users of financial statements, bankers indicated that audit quality needs to be enhanced and enforcement mechanisms strengthened to improve the quality of corporate financial reporting.** Investors, lenders, and other users place little reliance on the information contained in corporate financial statements. Most interviewees consider that bank financial statements are generally more reliable than those of companies in the commercial/industrial sector (few observers commented on insurance companies). In the commercial/industrial sector, interviewees generally consider the financial statements prepared by joint stock companies (audited) as more reliable than those prepared by limited liability companies (unaudited). Observers unanimously cited tax evasion and fraud as the core motivations behind accounting improprieties.

VI. POLICY RECOMMENDATIONS

79. **The recommendations of this ROSC accounting and auditing report are mutually supportive in some obvious ways.** Superb accounting standards are jeopardized from the outset if people do not understand how to translate the standards into a journal entry. Without attempting to provide a detailed tactical design for reform and specifics of conditions in Bosnia and Herzegovina, this ROSC auditing and accounting report sketches the select policy recommendations—consistent with the relevant portions of the *acquis communautaire*—that could enhance the quality of corporate financial reporting. This will contribute to promoting private sector growth and reducing volatility in several ways:

- Strengthening Bosnia and Herzegovina’s financial architecture and reducing the risk of financial market crises, and their associated negative economic impacts, including through increased transparency of the financial condition and performance of groups, which currently do not prepare consolidated financial statements;
- Contributing to foreign direct and portfolio investment and helping to mobilize domestic savings;
- Facilitating the access of smaller-scale corporate borrowers, including small and medium enterprises, to credit from the formal financial sector by lowering the barrier of high costs of information and borrowing;
- Improving the assessment and collection of taxes on corporate profits;
- Allowing investors to evaluate corporate prospects and make informed investment and voting decisions, which will result in a lower cost of capital and a better allocation of resources;
- Allowing shareholders and the public at large to assess management performance, thus influencing its behavior (financial reporting is also a building block of a market-based monitoring of companies); and
- Facilitating Bosnia and Herzegovina’s eventual integration into the European Union.

80. **As an immediate priority, the statutory framework should be reviewed and harmonized, albeit gradually, with the relevant portions of the *acquis communautaire*.** Accounting and auditing regulation should not be revised in a vacuum but rather in the context of a comprehensive review of the statutory framework pertaining to financial reporting. This requires amending relevant laws and legislation (company, banking and insurance, securities market, etc.) in order to establish a sound statutory and regulatory framework and establish the foundations for institutionalized enforcement of those enhanced requirements. The new State Framework Law adopted in June 2004 should be quickly

enforced in each Entity, through the two Implementing Laws which are already drafted, and through the effective creation of the Independent Standards Commission, the nomination of the International Special Adviser, and the election of seven professional members of the Commission. A budget should be attributed at State level and in each Entity for the creation and functioning of the Independent Standards Commission, and the creation of the quality control and oversight system. The statutory framework should be gradually amended, through the adoption of Implementing Laws and Regulations in each Entity, and in the District of Brcko, in order to enact the relevant portions of the *acquis communautaire*, and would include the following primary recommendations (refer to paragraphs 81 to 84 below):

81. While the ROSC team views the State Framework Law as directionally correct and endorses the Law as an important step forward, the ROSC team recommends that the RS and FBiH Implementing Laws and the Independent Standards Commission pay due attention to three issues of particular concern:

- **Capacity for implementing IFRS by 2005:** The ROSC team believes that the effective date of 2005 for applying IFRS is a tough challenge for most companies and such rapid implementation may result in noncompliance. Thus, the ROSC team insists that rapid capacity building is necessary, and the implementation of an effective enforcement mechanism for IFRS is crucial.
- **Application of IFRS to the financial statements of public interest entities, but not of SMEs:** BiH has rightly adopted IFRS and the Implementing Laws of the Entities use three criteria to define public accountability: (a) having securities listed; (b) the nature of the business (for example, banks and insurance companies); and (c) the size of the business (exceeds thresholds regarding total yearly income or number of people employed). The ROSC team is pleased to note that in both the RS and FBiH, entities for which there is no public interest (e.g., SMEs) are exempted from having to comply with IFRS.³⁰ However, the ROSC team recommends that the size thresholds be raised, as at present, they are not sufficiently high and would place an unnecessarily high reporting burden on entities for which there is no public interest.
- **Prescriptive accounting requirements for SMEs:** The ROSC team favors a prescriptive set of accounting requirements for SMEs, based on the Fourth and Seventh EU Company Law Directives, as opposed to placing the burden on SMEs to develop their own accounting standards, individually, per the RS and FBiH draft Implementing Laws.³¹

82. Increase the accountability of preparers of financial statements (refer to paragraphs 9 and 23 above). With a view to enhancing accountability, all company board members should be collectively responsible for the true and fair view of financial statements by law and in practice. The ROSC team recommends that the Company Law and its implementation (i.e., the judiciary) provide the right framework for companies to do business, by ensuring that criminal and civil liability provisions pertaining to directors conform with Company Law best practices.³²

³⁰ Per Articles 11.2 and 11.3 of the RS draft Implementing Law and FBiH draft Implementing Law, respectively.

³¹ Per Articles 11.2 and 11.3 of the RS draft Implementing Law and FBiH draft Implementing Law, respectively.

³² The High Level Group of Company Law Experts, which was set up by the European Commission in September 2001 to make recommendations on a modern regulatory framework in the EU for Company Law, recommended that the board should be collectively responsible for the probity of financial statements of the company. In a one-tier structure, this is a collective responsibility of both executive and non-executive directors, and in a two-tier structure, this is the collective responsibility of both the managing directors and the supervisory directors.

83. **Establish an effective system of public oversight that is aligned with the *acquis communautaire*.** The ROSC team recommends that BiH implement a system of public oversight that is aligned with the proposal for a new Eighth EU Company Law Directive, once it is adopted by the European Council and Parliament. This system should be headed by an independent body that is independent of the industry that it regulates and free from undue political pressure. This independent body should have ultimate responsibility for oversight of the approval and registration of statutory auditors and audit firms, adoption of standards on ethics, internal quality control of audit firms and auditing, and continuing education. This body should supervise the quality assurance system organized by the professional organizations but must have the right, where necessary, to conduct its own investigations on statutory auditors and audit firms. The body should have authority to (a) impose non-judicial, administrative sanctions against preparers of financial statements and auditors for violations, (b) file a civil case in court seeking judicial remedies for violations of regulations and laws, and (c) have the authority to refer matters to criminal authorities for criminal prosecution. The European Commission proposed to allow a minority of auditors to participate in the governance of the system of public oversight. The membership of the body should conform to the Directive's requirements.

84. **Ensure that the professional organizations formally endorse and follow their mandate to serve the public interest.** The accountancy profession's public consists of clients, credit grantors, governments, employers, employees, investors, the business and financial community, and others who rely on the objectivity and integrity of auditors to maintain the orderly functioning of commerce. The professional organization and the new Independent Standards Commission should formally recognize a distinguishing mark of the audit profession: the acceptance of its responsibility to the public.

85. **Ensure the quality of registered auditors, under the control of new Independent Standard Commission.** The ROSC team strongly recommends that the Independent Standards Commission and the professional bodies enforce the CPE requirements and implement an effective system for monitoring CPE attendance. Furthermore, the ROSC team recommends that the Independent Standards Commission and the professional bodies implement a system of quality assurance to ensure that auditors are subjected to strong disciplinary sanctions if they do not comply with CPE requirements, in order to preclude unqualified auditors from retaining their authorization to practice under the new system (refer to paragraph 37 above).

86. **Ensure that statutory audits are mandated only when there is a public interest requirement for the audit of financial statements (see paragraphs 17 and 30 above).** Public relevance may be determined by reference to practices such as those enacted in EU Member States to comply with the Fourth and Seventh EU Company Law Directives. Obviously, the Euro amounts for the thresholds set out in the Directives (balance sheet total, turnover, and number of employees) should be tailored to the BiH economy.

87. **Establish procedures for appointment, dismissal, and resignation of the statutory auditor or audit firm that ensure that the statutory auditor is independent from those who prepare the financial statements of the audited entity.** With regard to the dismissal and resignation of auditors, the legislature should introduce the principle that the statutory auditor can only resign or be dismissed if there is a significant reason why the statutory auditor cannot finalize the audit. The reasons for dismissal and resignation should be disclosed to the responsible oversight authorities.

88. **Take account of recent international scandals when strengthening auditing requirements.** For example, the principle that the group auditor bears full responsibility for the audit report in relation with the consolidated financial statements should be introduced. This principle implies that the group auditor needs to receive sufficient documentation of the review that may be performed by another auditor or audit firm.

89. **As a condition of using an international network name, local member firms of international audit firm networks should disclose sufficient information about the structure and operation of their respective networks and about their individual relationships with them.** This disclosure would enable an audit report user to assess the extent of reliance that can be placed on the implicit quality assertion that underlies the use of a common international network brand name. Such disclosures should describe the quality standards applied by the networks, the quality assurance for enforcement of standards, and details of how frequently the local firm is subject to network review. This would force the networks to exercise a much higher standard of care with respect to the quality of their member firms—since their procedures would be publicly transparent—and would ensure that quality weaknesses are addressed rapidly. The audit issues noted in paragraph 77 above call for the immediate adoption of these disclosure requirements.

90. **Enhance the auditor’s contribution to the supervisory process.** The banking and insurance supervisors should modernize the terms of reference of the statutory auditor’s contribution to the supervisory process, taking into account internationally accepted standards such as the Basel Committee on Banking Supervision and IFAC joint guidance on “The Relationship Between Banking Supervisor and Bank’s External Auditor.” Terms of reference should be developed in association with professional organizations. Moreover, regulators should extend accounting and auditing requirements beyond prudential requirements to ensure public disclosure of reliable and timely information that enables market participants and other users of that information to make an accurate assessment of a credit institution’s or insurance company’s financial condition and performance.³³ Toward that end, the recommended adoption of IFRS for the consolidated financial statements of *public interest entities*, including credit institutions and insurance companies, is paramount.³⁴

91. **Enhance financial transparency requirements.** BiH may want to draw on the requirements of the new EU Directive on harmonization of transparency requirements with regard to information about issuers whose securities are traded on a regulated market. In the medium- to long-term, these requirements should shorten the deadline for submission of *audited* annual financial statements. Among key requirements are the following:

- The final deadline for disclosing an annual financial report, including the statutory audit report, to the public should be no more than four months after fiscal year-end. The authorities should therefore ensure that the Law on Commercial Companies does not prevent timely disclosure, as would be the case if the annual financial report had to be the final version approved by shareholders in the annual general meeting.
- The half-yearly report should be upgraded to an interim report composed of a condensed set of financial statements to be established following IAS 34, *Interim Financial Reporting*, and a management report on the company’s activities. The half-yearly financial report should be published after two months after semester-end.

In the short-term, BiH should significantly enhance compliance with disclosure requirements for all legal entities with limited liability (see paragraphs 21 and 33 above), in line with the amended First EU

³³ This would also conform to the guiding principles of the third pillar, *Market Discipline*, under the New Accord set out by the Banking Committee on Banking Supervision. The third pillar aims to encourage market discipline by developing a set of disclosure requirements, which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes, and hence the capital adequacy of a credit institution.

³⁴ The ROSC team recognizes that BiH may want to delay adoption of IFRS for credit institutions and insurance companies until IAS 39 and insurance accounting standards are finalized. Based on the forthcoming mandatory use of IFRS in the European Union, this is expected to be completed by 2005.

Company Law Directive, in order to facilitate the granting and monitoring of credit to the private sector (e.g., banking intermediation, credit insurance) to preserve fair competition and to prevent company law from being abused for fraud, terrorism or other criminal activity.

92. **The legislature should not restrict management’s right to appoint as head of accounting a person that it deems appropriate.** The FBiH should remove the requirement in the Accounting Law that the person responsible for preparing financial statements hold an “independent accountant” license issued by the Institute of Accountants and Auditors (refer to paragraph 20 above). This requirement may adversely impact the business environment and foreign direct investment. Moreover, this requirement appears to be somewhat arcane in the context of modern corporate governance practices. The High Level Group of Company Law Experts, which was set up by the European Commission in September 2001 to make recommendations on a modern regulatory framework in the EU for company law, recommended that the board should be collectively responsible for the probity of financial statements of the company: in a one-tier structure, this is a collective responsibility of both executive and non-executive directors, and in a two-tier structure, this is the collective responsibility of both the managing directors and the supervisory directors. The head of the accounting function should work under the responsibility of management and the directors, who should be held accountable to select and hire an officer they deem capable.

93. **The Banking Agencies, Securities Commissions, and other institutions should enhance their financial reporting, monitoring, and enforcement arrangements.** Enforcement comprises several factors, including (a) clear accounting standards, (b) timely interpretations and implementation guidance, (c) statutory audit, (d) monitoring by supervisors, and (e) effective sanctions. Each of these must work efficiently: the system will be as strong as its weakest part in delivering strong investor and creditor protection. The Banking Agencies, Securities Commissions, and other institutions have a critical role in ensuring that banks, listed companies, insurance companies, and other *public interest entities* comply with accurate and consistent application of accounting standards in the financial and securities markets. Therefore the financial reporting enforcement role of these institutions should be enhanced as follows:

- **Monitoring objectives.** The ROSC team recommends that compliance with accounting requirements (IFRS for consolidated financial statements) by banks, listed companies, insurance companies, and other *public interest entities* should be formally adopted in these institutions’ monitoring objectives.
- **Enforcing compliance.** The issuer’s board of directors is responsible for the completeness, accuracy and truthfulness of the financial information. Statutory auditors act as a first external line of defense against misstatements by expressing their opinion on the financial information based on their audit. These Banking Agencies, Securities Commissions, and other designated institutions should monitor compliance of the financial information presented by banks, listed companies, insurance companies, and other *public interest entities* with accounting standards, and take appropriate measures in case of infringements discovered in the course of enforcement.
- **Necessary powers.** The necessary powers of the Banking Agencies, Securities Commissions, and other designated institutions should minimally include power to monitor financial information, require supplementary information from issuers and statutory auditors, and take measures consistent with the purposes of enforcement. These institutions should be responsible for setting up an appropriate due process of enforcement and its implementation. They should therefore be provided with resources sufficient to establish and carry out an effective monitoring system. This includes having professionally skilled staff that are experienced with IFRS and the legal implications of enforcement.

- **Issuers and documents.** Financial information should include annual and interim financial statements and reports, prepared on individual and consolidated basis, as well as prospectuses and equivalent documents.
- **Methods of enforcement.** For financial information other than prospectuses, ex-post enforcement is the normal procedure. For prospectuses, ex-ante approval is the normal procedure. Enforcement of all financial information is normally based on selection of issuers and documents to be examined. The preferred models for selecting financial information for enforcement purposes are mixed models whereby a risk-based approach is combined with a rotation or a sampling approach. Methods of enforcement on selected information cover a wide spectrum of possible checking procedures, ranging from pure formal checks to in-depth substantive in-nature checking. The level of risk should normally determine the intensity of the review to be performed by the enforcers.
- **Actions.** Where a material misstatement in the financial information is detected, the Banking Agencies, Securities Commissions, and other designated institutions should take appropriate actions to achieve appropriate disclosure and where relevant, public correction of the misstatement (in line with the requirements of IFRS). Non-material departures from the reporting framework will not normally trigger public correction even though they normally deserve an action as well (e.g., statement conveyed to the infringer). Actions should be effective, promptly enacted and proportional to the impact of the detected infringement.

94. **Enhance academic and professional education as well as training.** In adopting IFRS and ISA, BiH will set challenging and demanding objectives for itself. Education and training for preparers, auditors, and regulators must keep pace:

- **Enhance academic education for students, as well as training for instructors.** At the university level, an advisory board should review and update the accounting curriculum in order to incorporate all international accounting and auditing standards and practical-oriented teaching at the undergraduate university level. The ethical dimensions of business management, corporate finance, and accounting and auditing should be taught with case studies in undergraduate programs. Particular attention needs to be given to increasing students' critical thinking skills. To enhance the capacity of faculty to teach accounting and auditing courses with international components, universities may need to retool and expand the scope of existing programs.
- **Enhance professional education, as well as training for preparers, auditors, and regulators.** With regard to regulators, the staffs of the Banking Agencies, the Ministries of Finance, and the Securities Commission should be provided meaningful theoretical and practical training in order to enforce accounting, financial reporting, and auditing standards. Training for preparers, auditors, and regulators should encompass practical experience in the banking, insurance, and securities market; legal and compliance issues; and accounting, auditing and financial issues.
- **Continuing professional education.** The professional organizations and the Independent Standards Commission should make it a priority to adopt and enforce the IFAC standard on continuing professional education.
- **Enhance English language skills.** In the context of economic integration, the accounting and auditing profession should actively enhance its English language skills.

ACRONYMS AND ABBREVIATIONS

BiH	Bosnia and Herzegovina
EU	European Union
FBiH	Federation of Bosnia and Herzegovina
GDP	Gross domestic product
IAA	Institute of Accountants and Auditors
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
ISA	International Standards on Auditing
ROSC	Reports on the Observance of Standards and Codes
RS	Republika Srpska
RS AAA	RS Association of Accountants and Auditors
SME	Small- and medium-size enterprise
SRRiF-FBiH	Union of Accountants, Auditors, and Financial Workers of the FBiH
UNCTAD	United Nations Conference on Trade and Development

Appendix I: Policy Recommendations – Proposed Priority Levels

Action	Paragraph Number in the ROSC Report	Timing		
		Short-term (less than 1 year)	Medium-term (1 to 3 years)	Long-term (3 to 5 years)
1. All public interest entities should present consolidated financial statements in conformity with “full IFRS.”	Para. 81		✓	✓
2. The legislation should provide small- and medium-size enterprises and micro-enterprises with a reporting framework more adapted to their size.	Para. 81		✓	✓
3. Increase the accountability of preparers of financial statements.	Para. 82		✓	
4. Increase public oversight of accounting standard-setting and the audit profession.	Para. 83	✓	✓	
5. Ensure that the professional organizations formally endorse and follow their mandate to serve the public interest.	Para. 84	✓	✓	
6. Establish profession entry requirements that ensure the quality of licensed auditors.	Para. 85	✓		
7. Ensure that statutory audits are mandated only when there is a public interest requirement	Para. 86		✓	
8. Establish procedures for appointment, dismissal, and resignation of the statutory auditor or audit firm that ensure that the statutory auditor is independent from those who prepare the financial statements of the audited entity.	Para. 87		✓	
9. Take account of recent international scandals when strengthening auditing requirements.	Para. 88	✓		
10. As a condition of using an international network name, local member firms of international audit firm networks should disclose sufficient information about the structure and operation of their respective networks and about their individual relationships with them.	Para. 89		✓	
11. Enhance the auditor’s contribution to the supervisory process.	Para. 90		✓	✓
12. Enhance financial transparency requirements.	Para. 91		✓ ³⁵	✓ ³⁶
13. The legislature should not restrict management’s right to appoint as head of accounting a person that it deems appropriate.	Para. 92		✓	

³⁵ Refers to compliance with the First EU Company Law Directive.

³⁶ Refers to compliance with the Transparency Directive.

14.	The Banking Agencies, Securities Commissions, and other institutions should enhance their financial reporting, monitoring, and enforcement arrangements.	Para. 93		✓	✓
15.	Enhance academic and professional education as well as training.	Para. 94	✓	✓	✓