

REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC) Croatia

ACCOUNTING AND AUDITING

October, 2007

Contents

Executive Summary

- I. Introduction
- II. Institutional Framework
 - A. *Statutory Framework*
 - B. *The Profession*
 - B.1. *The Accounting Profession*
 - B.2. *The Audit Profession*
 - C. *Professional Education and Training*
 - D. *Setting Accounting and Auditing Standards*
 - E. *Enforcing Accounting and Auditing Standards*
- III. Accounting Standards as Practiced
 - A. *Real Sector Companies*
 - B. *Financial Sector Entities*
- IV. Auditing Standards as Designed and as Practiced
- V. Perceptions of the Quality of Financial Reporting
- VI. Policy Recommendations

EXECUTIVE SUMMARY

This report provides an updated assessment of accounting, financial reporting, and auditing requirements and practices within the enterprise and financial sectors in Croatia. 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.

Regulatory and Institutional Framework

Croatia has made considerable progress in developing its regulatory framework for corporate sector financial reporting and auditing since the publication of the first A&A ROSC in 2002 (see Table 1). The alignment of the revised regulatory framework with the *acquis communautaire* has been significantly improved and lays the basis for reinforcing the institutional capacity for financial reporting and auditing. However, not all requirements of the relevant *acquis* have been introduced and further work is needed to achieve full compliance. For example, the reporting layouts required by the accounting Directives have not been implemented. There are no requirements on annual management reports, the rules governing consolidated accounts are not fully covered, and the types of audit opinions and the responsibility of a group auditor are not fully addressed. In

The report was prepared by a team from the World Bank on the basis of the findings from a diagnostic review carried out from September 2006 through May 2007. The team was led by Mr. Erik van der Plaats, Senior Financial Management Specialist, World Bank; and included Mr. David Nagy, Corporate Financial Reporting Specialist, World Bank; and a team of consultants including Mr. David Cairns, Mr. Gerald Kogler, and Mr. Gerhard Grabner, as well as other various specialists.

addition, recent changes to the *acquis communautaire* on financial reporting, such as the amended Fourth, Seventh and Eighth Company Law Directives (June 2006), need to be incorporated. However, the government is committed to achieving full compliance with the relevant portions of the *acquis communautaire* in a very short timeframe.

According to the Accounting Act as of 2005, Croatia has replaced the required use of IFRS for the financial statements of all companies with a requirement that only large, listed and financial sector companies (Public Interest Entities, or PIEs) must apply IFRS. However, the IFRS translation process in Croatia was disrupted between 2000 and 2004, and the formal adoption of IFRS in the Official Gazette in December 2006 related to IFRS as at 2004, without supporting pronouncements such as IFRICs. As a result, Croatia mandates the use of a translation of out of date standards and therefore does not apply IFRS (since the standards are neither current nor complete). Narrowing the scope of required application of IFRS from all companies to PIEs implements one of the major recommendations from the previous A&A ROSC and is more proportionate to the institutional capacity for properly applying IFRS. All other companies may choose to use either IFRS or accounting standards to be issued by the Croatian Financial Reporting Council (FRC). However, at present the financial reporting requirements for Small and Medium-sized Enterprises (SMEs) are still the same as in 2002 and will only change once the FRC has issued the accounting standards for SMEs, based on IFRS and the EU Accounting Directives. The financial reporting framework in Croatia is not up-to-date and not complete and lacks alignment with the set of IFRS (and IFRICs) endorsed by the European Commission. Furthermore, differences between the Croatian financial reporting framework and extant IFRS may confuse foreign investors.

The Croatian institutional framework has undergone several important changes. However, further capacity building relating to monitoring, enforcing, and strengthening supervision (except for banks) is needed to ensure proper application of IFRS and national accounting standards. At the beginning of 2006, the Croatian Securities Commission, Insurance Companies Supervisory Authority and Agency for Supervision of Pension Funds and Insurance were merged into a single integrated regulator, the Croatian Financial Services Supervisory Agency (HANFA). This merger should help to avoid overlaps and supervisory gaps. In March 2007, the Varaždin Stock Exchange (VSE) was merged with the Zagreb Stock Exchange (ZSE), creating one single stock exchange in Croatia. The Financial Reporting Council (FRC) and the new Chamber of Auditors were established in 2006 on the basis of the new Accounting and Audit Acts.

Corporate Sector Financial Reporting and Auditing in Practice

Public availability of legally mandated financial statements for companies - other than banks - is limited. This seriously undermines the value added of the financial reporting function in the Croatian market economy and partially reflects a general lack of user demand for financial statements. Due to problems with obtaining financial statements, the ROSC team was not able to review as many financial statements as intended. Although the Accounting Act enacted in 2005 requires all joint stock companies to publish their financial statements, the current requirements on filing and publication are not fully in line with the requirements of the *acquis communautaire* (First, Fourth, and Seventh Company Law Directives and the Transparency Directive) and international best practices. Moreover, the new Accounting Act does not foresee sanctions for companies that do not comply with filing and publication obligations.

The financial statements reviewed as part of this assessment relate to the 2005 financial reporting year and therefore do not reflect the impact of the new Accounting Act or the IFRS adopted in December 2006. The reviewed financial statements of Croatian banks were generally of good

quality. This can largely be attributed to the intensive on- and off-site supervision by the Croatian National Bank (HNB) as well as the transfer of knowledge and expertise of foreign owned private banks. The quality of financial statements of insurance undertakings could not be assessed because of difficulties in obtaining these financial statements. The review of financial statements of real sector companies and of pension and investment funds showed a number of non-compliance issues.

Except for banks, there is at present no systematic enforcement of the quality of financial statements besides the statutory audit function. The Croatian Financial Services Supervisory Agency (HANFA) regulates and supervises listed companies and the non-banking financial sector, including insurance undertakings, leasing companies, pension fund management companies, and investment fund management companies. Since its establishment, HANFA has continuously strengthened its institutional capacity and should continue further strengthening its role to properly enforce financial reporting requirements.

Furthermore, there is no system of external quality assurance to ensure the quality of statutory audits in practice. The newly established Chamber of Auditors is currently developing an effective system of quality assurance. In addition, audit committees, which are required by the Audit Act for public interest entities, are expected to positively impact the audit quality in the future. The new Audit Act establishes public oversight of the Chamber of Auditors by the Ministry of Finance. Although the new EU Eighth Company Law Directive requires a system of oversight without making fixed rules on infrastructure, it may be difficult to meet some other requirements of the Directive, such as finding a majority of non-practitioners knowledgeable in the area of statutory audit.

Key Recommendations

This report concludes that Croatia should take further steps in order to achieve its goal of developing a robust financial reporting framework tailored to the needs of the Croatian market economy, and aligned with the *acquis communautaire*, international standards and best practices. While all the policy recommendations set forth in Table 2 and Section VI of this report are important, the following recommendations are key:

1. Make the publication of complete financial statements (including audit opinion and notes) of all public interest entities a reality so that financial reporting can play its essential role in the Croatian market economy. This will require further changes to the regulatory framework and the development of appropriate institutional capacity.
2. Establish a continuous and sustainable translation and adoption process for IFRS and IFRIC interpretations. National processes will be needed until EU membership is attained by Croatia, at which time the European Commission will endorse IFRS and IFRICs for the EU and take responsibility for their translation.
3. Introduce an effective system of external quality assurance subject to public oversight, to underpin public confidence in the audit function. This will require the building of capacity within the Chamber of Auditors, but any involvement of practicing auditors must not undermine the objectivity and public credibility of the quality assurance system.
4. Continue to strengthen the role and capacity of HANFA in enforcing the financial reporting requirements for listed companies, insurance undertakings, and investment and pension funds.

Next Steps

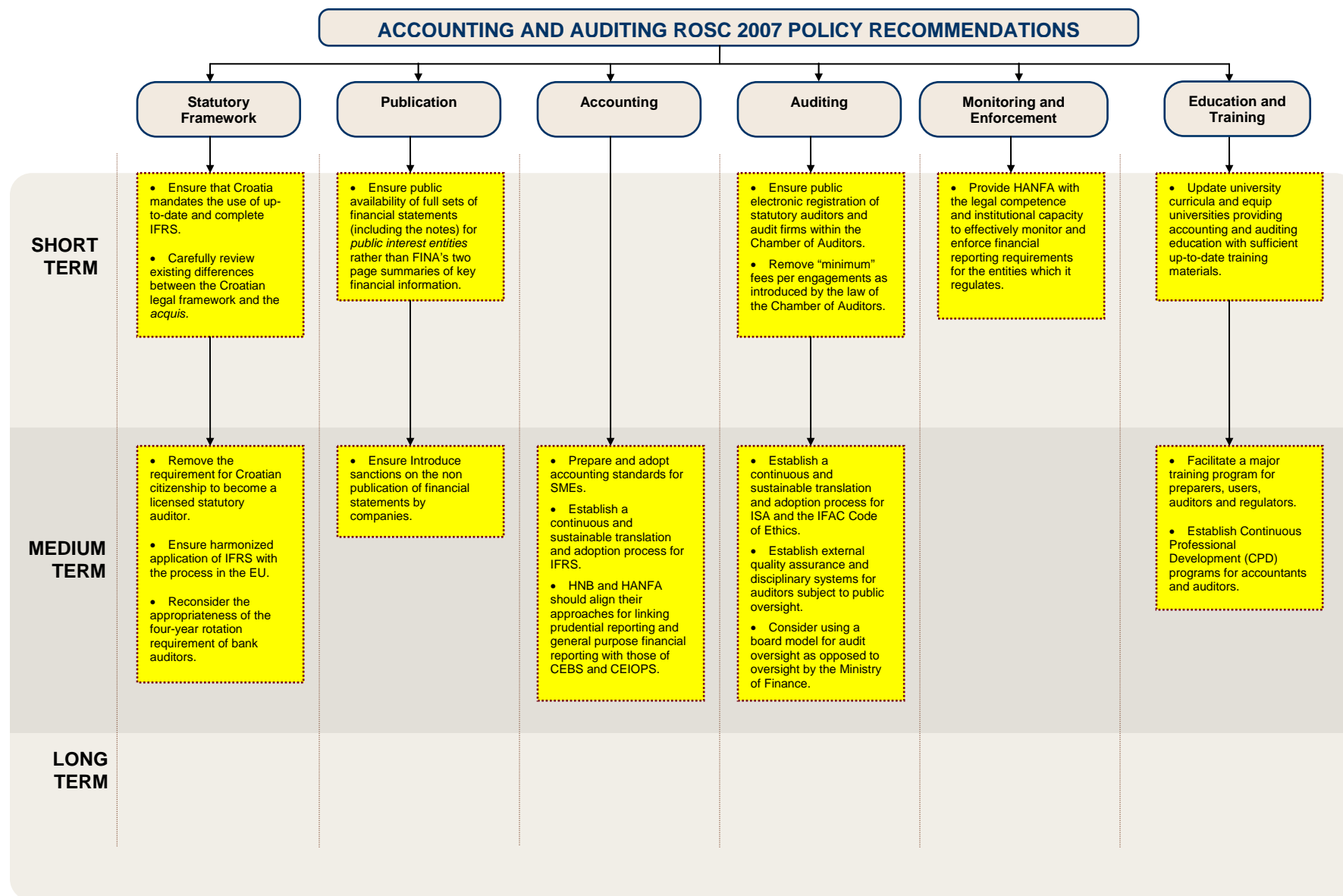
The ROSC policy recommendations made in this report will require an active role on the part of government and cooperation between key stakeholders including supervisors, the accounting and audit professions, and universities, gathered in the Croatian National Steering Committee (NSC) on corporate sector financial reporting. The NSC should advise government on the implementation of the recommendations.

Based on the successful experience of other countries, the NSC should develop a Country Strategy and a detailed Country Action Plan which clearly sets out key actions, allocates responsibilities for their implementation, and indicates the resources needed. The government and its development partners should work together to secure resources to achieve the common goal of enhancing the quality of financial reporting in Croatia. The World Bank is committed to supporting Croatia in this reform process.

Table 1: Progress since 2002 on Key Recommendations of the Previous A&A ROSC 2002

Key 2002 A&A ROSC Recommendations		Status as of May 2007
1	Establish a Croatian Financial Reporting Council (FRC).	Achieved
2	Require the use of full IAS/IFRS for public interest companies only – this should include (but should not be limited to) listed companies, banks, insurance undertakings, other financial institutions/intermediaries and other significant publicly and privately owned commercial entities.	Achieved
3	Require SMEs to use other financial reporting standards only as part of a harmonized EU and/or international approach.	In progress <i>(Croatian FRC has begun drafting accounting standards for SMEs.)</i>
4	Make necessary arrangements for continuous translation and timely publication of International Standards on Auditing (ISA) and the Code of Ethics for Professional Accountants.	In progress <i>(New Chamber of Auditors began translating ISA and translated the Code of Ethics for Professional Accountants in July 2007.)</i>
5	Rationalize the different requirements for the publication and filing of financial statements and financial information on the basis of a common financial reporting platform.	In progress <i>(Recent regulatory amendments but no progress in practice until now)</i>
6	Establish mechanisms within regulatory agencies to monitor the quality of audited financial statements of the entities under their supervision and to take appropriate actions against those companies, members of company management, audit firms, auditors and others who have failed to comply with accounting and auditing requirements.	In progress

Table 2: A&A ROSC 2007 Policy Recommendations



MAIN ABBREVIATIONS AND ACRONYMS

A&A	Accounting and Auditing
ACCA	Association of Chartered Certified Accountants
CESR	Committee of European Securities Regulators
CEBS	Committee of European Banking Supervisors
CEFTA	Central European Free Trade Association
CG	Corporate Governance
DG ELARG	European Commission Directorate General for Enlargement
DG MARKET	European Commission Directorate General for Internal Market and Services
HNB	Croatian National Bank
EBRD	European Bank for Reconstruction and Development
EU	European Union
FDI	Foreign Direct Investment
FINA	Croatian Financial Agency
FRC	Croatian Financial Reporting Council
FSAP	Financial Sector Assessment Program
GDP	Gross Domestic Product
HANFA	Croatian Financial Services Supervisory Agency
HRK	Croatian Kuna (1 HRK = 0.184686 U.S. dollars)
IAASB	International Auditing and Assurance Standards Board
IAS	International Accounting Standards (now IFRS)
IASB	International Accounting Standards Board
IDF	World Bank Institutional Development Fund
IES	International Education Standards for Professional Accountants
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
ISA	International Standards on Auditing
IMF	International Monetary Fund
IPA	Instrument for Pre-Accession
MoF	Ministry of Finance
NSC	National Steering Committee
OECD	Organization for Economic Cooperation and Development
ROSC	Report on the Observance of Standards and Codes
TEMPUS	Trans-European Mobility Scheme for University Studies
VSE	Varaždin Stock Exchange
ZSE	Zagreb Stock Exchange

I. INTRODUCTION

1. This assessment of accounting and auditing practices in Croatia is part of a joint initiative by the World Bank and International Monetary Fund (IMF) to prepare Reports on the Observance of Standards and Codes (ROSC)¹. The assessment focuses on the strengths and weaknesses of the accounting and auditing environment that influence the quality of corporate financial reporting, and includes a review of both statutory requirements and actual practice. It uses International Financial Reporting Standards (IFRS)² and International Standards on Auditing (ISA)³ as benchmarks and draws on international experience and best practices. This assessment is an update of the previous A&A ROSC⁴ conducted in Croatia in 2002.

2. The report has regard to European Union (EU) law (also known as the *acquis communautaire*). The relevance of the *acquis communautaire* for Croatia is twofold. First, and perhaps most importantly, it represents a high-quality model for the regulation of accounting and auditing with the ability to be applied to countries of differing characteristics. Second, the adoption of the *acquis communautaire* is instrumental for Croatian EU membership. In particular, this report benchmarks the Croatian regulatory framework and institutional capacity against the First, Second, Fourth, Seventh, and Eighth Company Law Directives, as well as the Transparency Directive, the IAS Regulation, and the Banks and Insurance Accounts Directives.

3. Croatia is an upper middle income country that became independent in 1991. It has a population of 4.4 million. Gross National Income (GNI) per capita was US\$ 8,060 as of 2006⁵ and Gross Domestic Product (GDP) per capita (PPP- Purchasing Power Parity) was US\$ 13,200⁶ as of 2006. Croatia is located along the eastern coast of the Adriatic Sea and borders Slovenia, Hungary, Serbia, Bosnia and Herzegovina and Montenegro; it also shares a maritime border with Italy. Croatia applied for EU membership in 2003. The EU granted Croatia official candidate status in June 2004, and accession negotiations commenced in October 2005. Croatia is a member of the World Bank Group (WB), the International Monetary Fund (IMF), the European Bank for Reconstruction and Development (EBRD), the World Trade Organisation (WTO), and the Central European Free Trade Association (CEFTA)⁷ among others.

4. Croatia and the EU have completed the initial accession screening process, and currently Croatia has 14 out of 33 *acquis communautaire* chapters opened for accession

1 For more information, please see www.worldbank.org/ifa/rosc_aa.html

2 International Financial Reporting Standards are issued by the International Accounting Standards Board (IASB), an independent accounting standard-setter based in London, United Kingdom. The IASB announced in April 2001 that its accounting standards would be designated "International Financial Reporting Standards" (IFRS). Also in April 2001, the IASB announced that it would adopt all of the International Accounting Standards (IAS) issued by the International Accounting Standards Committee (IASC). Within this report, the term IFRS encompasses both IFRS and IAS as well as the related interpretations.

3 International Standards on Auditing (ISA) are the standards issued by the International Auditing and Assurance Standards Board of the International Federation of Accountants (IFAC).

4 The 2002 A&A ROSC is available at http://www.worldbank.org/ifa/Croatia%20ROSC_0602.pdf

5 Source, World Bank

6 Source, CIA, The World Fact Book

7 After almost eight months of negotiations, the CEFTA 2006 Agreement was signed on December 19, 2006 among governments of Albania, Bulgaria, Bosnia and Herzegovina, Croatia, Montenegro, the Republic of Moldova, Romania, Serbia and The Former Yugoslav Republic (FYR) of Macedonia, as well as UNMIK/Kosovo. With this step, the former network of 32 bilateral trade agreements was replaced with one, which will bring the needed trade liberalization and administrative simplification to the SEE region.

negotiations; two are temporarily closed. The ambitious negotiation agenda calls for the closing of more than half of the 33 chapters during the 2007 calendar year. The European Commission concluded in its *Croatia 2006 Progress Report*, published on November 8, 2006, that Croatia can be regarded as a functioning market economy. The European Commission's 2006 Progress Report highlighted that Croatia has made further progress towards meeting the political and economic criteria for membership as well as aligning with the *acquis communautaire*. However, the progress report concluded that state intervention in the economy remained significant. Little progress has been made in implementing privatization plans and in enterprise restructuring. The development of the private sector has been hampered by deficiencies in public administration and the judiciary, and difficulties in enforcement of property and creditor rights."⁸

5. In 2006, the country had 1,100 bank branches and total banking assets equivalent to 121 percent of GDP in 2006 – about twice the rate of most other countries and entities in South East Europe. The five largest banks account for approximately three quarters of banking assets. While the number of banks decreased from 60 in 1998 to 33 in 2006, a strengthening of some second tier banks slightly eroded the market share of the top five banks. After the 1998 banking crisis and years of restructuring, the sector is now growing rapidly. Between 2000 and 2006 loans to the private sector increased from 36 to 72 percent of GDP while deposits rose from 32 to 67 percent of GDP. The Croatian National Bank (HNB) had to introduce some regulatory restrictions to control bank's foreign indebtedness, due to the fact that banks tended to fund their domestic lending by borrowing abroad in order to exploit the interest rate spread between the Euro zone and Croatia.

6. Foreign banks hold 91 percent of all banking assets in Croatia. The market leader, Zagrebacka Banka, is majority-owned by Unicredito. The number two in the market, Privredna Banka Zagreb (PBZ), is a subsidiary of Banka Intesa. Erste Bank Croatia is the number three with a ten percent market share and plans further expansion. Other big EU players are the subsidiaries of Austria's Raiffeisen International and Hypo Alpe-Adria Bank. Société Générale owns Croatia's fifth largest bank, Société Générale - Splitska Banka.

7. The insurance sector accounts for 6 percent of total financial assets, the highest in the region. With premium income equivalent to 3.2 percent of GDP, the Croatian insurance market is at a level of development similar to that in the new EU Member States. The sector has recorded average growth rates of 10 percent in recent years. Half of the 20 insurance undertakings and 2 reinsurance undertakings are majority foreign-owned, accounting for a third of premium income. With 10 of the insurance firms having less than one percent market share, further consolidation can be expected. 24 percent of premium income relates to life insurance, which indicates the relative maturity of Croatia's insurance sector.

8. A new pension system with compulsory and voluntary private components was introduced in 2002. By 2004, pension funds managed half a billion EUR of investments for a total of 1.1 million policy holders. 70 percent of funds were held by just two funds, AZ and Raiffeisen. This should in due course drive the development of capital markets. Another category of institutional investors emerged from the voucher privatization in the late 1990s, when the vast majority of vouchers were entrusted to privatization investment funds.

9. While exports of services (in particular tourism and transport) recorded strong growth, this was not enough to outweigh the rise in merchandise imports that was spurred by high public investments. The high external account deficit in turn has pushed up the external debt.

⁸ See DG ENLARGEMENT European Commission

Despite significant inflows of foreign direct investment, Croatia's external debt, presented in Euro terms, rose from 61.4 percent of GDP in 2000 to 85.3 percent in 2006.⁹ Net foreign direct investment (FDI) inflows increased to 7.4 percent of GDP in 2006 (up from 3.9 percent in 2005). The main FDI transactions were reinvested earnings and recapitalizations of several banks and the acquisition of the pharmaceutical producer Pliva and the oil and gas company INA. The biggest investors were Austria, the Netherlands, France, Germany and Switzerland. FDI was directed to financial intermediation, manufacture of chemicals and chemical products, food and beverages production, postal services and telecoms. Full-year FDI estimates for 2007 suggest a modest rise.¹⁰

10. The 2006 EBRD Transition Indicators suggest that the private sector accounts for about 60% of the economy in Croatia, which is below any of the "new EU8+2"¹¹ Member States. Despite some recent efforts, there is still a large number of public and state-owned enterprises that remains to be privatized, and direct state aid to the enterprise sector is high. To lower the cost of doing business, the Government launched the so-called HITROREZ¹² ("the regulatory guillotine") in September 2006, which aims to cut down redundant and business-unfriendly legislation by 40% by July 2007. This alone could bring savings to the private sector, according to some estimates to the tune of 3-7% of GDP.

II. INSTITUTIONAL FRAMEWORK¹³

A. Statutory Framework

11. **The development of Croatian Companies Act was influenced by the German model, and is largely aligned with the *acquis communautaire*.**¹⁴ The 2006 Croatia Progress Report by the European Commission concluded that Croatia has made a good progress to align its regulatory framework related to accounting and auditing with the *acquis communautaire*. In the area of company law, existing legislation is largely aligned with the *acquis*, however, "... monitoring and enforcement of corporate sector compliance still requires continued efforts."

12. **The Companies Act regulates business activities in Croatia.** The Companies Act recognizes the following types of entities (i) limited liability companies, (ii) joint stock companies, and (iii) partnerships. In addition, the Companies Act also recognizes (iv) business associations, (v) branch offices, (vi) co-operative enterprises, and (vii) civil partnerships. The Act defines rules and requirements on formation, functioning and dissolution of the various types of entities. For limited liability companies and joint stock companies the Act defines the rights and obligations of shareholders, and the responsibilities and liabilities of the company and its different organs such as the management board, the supervisory board and the general meeting of shareholders:

⁹ Source: World Bank Living Standards Assessment of Croatia, 2006, Croatian Central Bank

¹⁰ Source: World Bank Regular Economic Report, January 2008. For more information, please see: http://siteresources.worldbank.org/INTECA/Resources/EU8+2_CroatiaSupplement.pdf

¹¹ The term "EU-8+2" refers to the following EU Member States: Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia [EU8]; as well as Bulgaria and Romania [+EU2].

¹² For more information, please see www.hitrorez.hr

¹³ This report outlines the legal principles applicable with regard to accounting, auditing and financial reporting and does not attempt to give anything more than an introduction to the issues. This report is not meant to be an exhaustive rendition of the law nor is it legal advice to those reading it.

¹⁴ Source 2006 Croatia Progress Report by the European Commission: http://ec.europa.eu/enlargement/pdf/key_documents/2006/nov/hr_sec_1385_en.pdf

- A *joint stock company*, “*d.d.*”, is a company whose shareholders participate in the company’s capital, which is divided into shares. A joint stock company has its own legal personality, fixed share capital, and an incorporated organization which consists of three levels: shareholders' meetings, a supervisory board and a management board. Shareholders are not legally responsible for a joint stock company's liabilities. The minimum share capital required for establishing a joint stock company is HRK 200,000 (approximately EUR 27,000 or US\$ 37,000).
- A *limited liability company*, “*d.o.o.*”, implies a limited personal liability of the shareholder up to the amount of the invested capital. The management board of limited liability companies consists of one or more directors.

As of December 2006, there were 1,511 joint stock companies and 60,951 limited liability companies in Croatia.

13. The following table provides an overview of the *general* legal basis for important elements of financial reporting and auditing by legal persons in Croatia:

Main elements	Legal basis
Preparation of financial statements and applicable financial reporting framework (recognition and measurement)	Article 18 Accounting Act states that: 1) all large and all listed enterprises shall prepare financial statements in accordance with IAS/IFRS* (issued in the official Gazette); and 2) all other entities may choose between using IFRS* or financial reporting standards (to be) issued by the Financial Reporting Council (FRC).
Presentation of the financial statements (disclosure, lay-outs)	Article 18 Accounting Act states that enterprises shall prepare financial statements in accordance with IAS/IFRS* or financial reporting standards (to be) issued by the Financial Reporting Council (FRC).
Components of financial statements (balance sheet, income statement, cash flow statement, changes in equity and management report)	Article 15 of the Accounting Act defines financial statements as balance sheet, profit and loss account, cash flow statement, statement on changes in equity and notes on the annual accounts. There is no explicit requirement for a management report as required by the <i>acquis communautaire</i> .
Responsibility for the preparation of financial statements	Companies Act articles 300a (joint stock companies) and 428 (limited liability companies) stipulate that the management board shall be responsible for the preparation of the company’s financial statements.
Statutory audit of financial statements	Article 6 Audit Act: joint stock companies and limited liability companies above a certain size, as well as all banks and other financial institutions, shall have their annual financial statements audited.
Adoption of financial statements	Companies Act article 300e: the general meeting of shareholders of the company and, when delegated by the shareholders, the supervisory and management boards shall adopt the financial statements (and decide on the distribution of profits).
Publication of financial statements	Accounting Act article 20: joint stock companies shall publish financial reports.
Sanctions on fraudulent financial reporting	Article 21 of the Accounting Act: representatives of companies can be fined up to HRK 50,000 and entities up to HRK 500,000 for the

* Croatia mandates the use of a translation of out of date standards and therefore does not apply IFRS (since the standards are neither current nor complete).

	preparation of financial statements that do not give a true and fair view with the intent to obtain financial advantage. Entities can be fined up to HRK 500,000 for the preparation of financial statements based on invalid documentation.
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14. **The introduction in 2005 of a new Accounting Act (Official gazette No 146/05) and new Audit Act (Official gazette No 146/05) with the objective of improving the quality of financial reporting and auditing in Croatia also improved the alignment with the *acquis communautaire* and international standards and practices.** These laws are a major step forward. However, further reform is needed in some areas to achieve full compliance of the statutory framework for financial reporting and auditing with the *acquis communautaire* and to align with international best practice. For example, the reporting formats of the EU Fourth Company Law, Banks and Insurance Accounts Directives are not fully required, consolidated accounts are not fully covered in the Accounting Act, and the types of audit opinions and the responsibility of the group auditor are not addressed. In addition, ensuring a dynamic alignment with the “emerging” *acquis* requires implementation of recently adopted amendments such as those to the Fourth and Seventh Company Law Directives adopted in June 2006 (issuance of corporate governance statements, disclosures on related parties and off-balance sheet arrangements) and to the Eighth Company Law Directive on statutory audit adopted in May 2006.

15. **The following table provides an overview of the general legal basis for elements of financial reporting and auditing for each type of legal entity as at May 2007:**

Type of entity	Financial reporting framework for individual financial statements	Financial reporting standards for consolidated financial statements	Statutory audit (required by law)	Filing and publication of financial statements ¹⁵
Limited Liability Companies (LLCs)	If large then IFRS*; otherwise IFRS* or SME standards (to be published)	If large then IFRS*; otherwise consolidation criteria not specifically addressed.	LLCs with turnover over HRK 30 million are subject to annual audit.	Yes: FINA
Joint Stock Companies	If large then IFRS*; otherwise IFRS* or SME standards (to be published)	IFRS*	Annual audit	Yes: Newspapers, ZSE, FINA
Listed companies	IFRS*	IFRS*	Annual audit	Yes: Newspapers, ZSE, FINA
Banks	IFRS*	IFRS*	Annual audit	Yes: website, HNB, FINA
Insurance undertakings	IFRS*	IFRS*	Annual audit	Yes: HANFA, FINA
Investment funds	IFRS*	IFRS*	Annual audit	Yes: HANFA, FINA

¹⁵ Financial statements for the banking sector are easily accessible on the websites of banks. Only some of the real sector financial statements selected for review as part of this assessment were available via the internet. It was not possible to obtain a single set of financial statements from HANFA or FINA. According to HANFA representatives, financial statements submitted to HANFA are not publicly available, and are only for the use of the supervisory authority.

* Croatia mandates the use of a translation of out of date standards and therefore does not apply IFRS (since the standards are neither current nor complete).

16. **The authorities responsible for ensuring stability in the financial sector (including financial reporting) are the Croatian National Bank (HNB), the Croatian Financial Services Supervisory Agency (HANFA), and the Department for Financial Systems of the Ministry of Finance of the Republic of Croatia (MoF).** The functioning of the Croatian financial system also largely depends on the activities of many other public and private institutions such as the State Agency for Deposit Insurance and Bank Rehabilitation (DAB), the Central Depository Agency (SDA), the Financial Agency (FINA), the Central Registry of Insured Persons (Regos), the Croatian Bank for Reconstruction and Development (HBOR), the Zagreb Money Market (TNZ), the Zagreb Stock Exchange (ZSE) and many others. The Croatian Banking Association (HUB) and the Banking Association with the Croatian Chamber of Economy (HGK) represent the interests of the banking sector¹⁶, while the Croatian Insurance Bureau and the Insurance Association with the Croatian Chamber of Economy (HGK) represent the interests of the insurance sector.

17. **At the beginning of 2006, non-bank supervision was consolidated into a single institution, the Croatian Financial Services Supervisory Agency (HANFA).** The Croatian Securities Commission, Insurance Companies Supervisory Authority, and Agency for Supervision of Pension Funds and Insurance have been merged to create HANFA, a single integrated regulator, with the goal of avoiding overlaps and supervisory gaps. In addition to regulating securities, HANFA regulates non-banking financial intermediaries including insurance undertakings, leasing companies, pension fund management companies, and investment fund management companies. HANFA is also responsible for regulating and supervising the business operations of auxiliary financial institutions such as brokerage companies, investment consulting companies, regulated stock markets, and insurance underwriters, etc. HANFA is responsible for developing and implementing financial reporting requirements for non-banking financial institutions and monitoring compliance with the accounting, financial reporting, and statutory audit requirements.

18. **Although the Accounting Act (146/2005) requires the publication of (full) financial statements for joint stock companies, in practice many companies do not make their full financial statements available to the public.** The difficulties of the ROSC team in obtaining financial statements are consistent with a USAID-funded survey¹⁷ of leading Croatian companies from April 2007. The survey found that availability of financial statements of the surveyed companies has grown from 40% in 2004 to 51% in 2006. Although there is an improvement indicated, it appears that the economic environment in Croatia does not utilize the notion of financial transparency and the benefits of market discipline for monitoring the economic performance of companies.

19. **Over the past year, HANFA and ZSE have worked jointly to prepare the Croatian Corporate Governance Code.** According to the Code, companies should present their financial statements on their website. Furthermore, the annual report should be published in the English language, in addition to Croatian. If properly applied, the Code would constitute a major step forward for the efficiency of the Croatian capital market. The Corporate Governance Code is to be applied on a “comply or explain” basis in line with international practice. This may underpin market discipline on the publication of full financial statements, but does not constitute an enforceable obligation. The upcoming World Bank Corporate Governance ROSC will assess the Corporate Governance Code in more detail.

¹⁶ For more information, please see www.hnb.hr

¹⁷ For more information, please see www.pfsprogram.org/activities_pfs_see_croatia.php

20. **FINA (“financial agency”) publishes standardized summary financial statements of all companies. These are not full financial statements and do not include an audit report.** FINA has been operating since January 2002 as a successor of the Institute for Payment Transactions (ZAP), or before that, the “Social Accounting Service”. The Social Accounting Service, which enjoyed the exclusive right in the former Republic of Yugoslavia to perform payment transactions within the country, was transformed into the ZAP in 1993. At the beginning of 2002, the Law on Financial Agency was promulgated, and FINA, owned by the State, has inherited the rights, obligations and assets of the former Institute for Payment Transactions. FINA has more than 5,000 employees and an extensive business network of 177 business units. According to the Law on Financial Agency, all joint stock and limited liability companies are required to submit quarterly and annual returns of financial information to FINA. The information should be prepared in accordance with the Accounting Act and should, therefore, comply with IFRS*. However, FINA only maintains records of two page summaries of key financial figures (without the audit report and notes), which do not constitute the financial statements required by law.

21. **In March 2007, the Croatian capital market was unified, and the Varaždin Stock Exchange (VSE) was merged into the Zagreb Stock Exchange (ZSE).** The market capitalization of the ZSE has grown to a total of 295 billion Kuna (of which 251 billion are in shares and 43 billion are in bonds). It now has a total of 426 listed securities. ZSE makes the key financial figures of listed companies available on its website¹⁸; however these figures do not constitute IFRS* financial statements.

22. **Ensuring public availability of full financial statements is not common practice in Croatia.** The low level of availability of published full financial statements reflects the lack of a clear legal basis for publication, insufficient enforcement and the absence of appropriate sanctions on complete and timely filing and publication of financial statements by companies. Furthermore, as of January 2007, the *acquis communautaire* has required electronic filing of financial statements. Croatia will need to rapidly address this issue and bring filing requirements in line with the EU First, Fourth, and Seventh Company Law and Transparency Directives, which require electronic filing of full financial statements. The 2002 ROSC indicated concerns that companies are often required to submit the same information in different returns to multiple agencies. Unfortunately, little or no progress appears to have been made in this respect, and companies are still submitting their financial statements to multiple agencies. According to the recent amendments to the Croatian Court Register Act adopted on March 30, 2007, Croatia requires financial statements to be filed with the Court Register as per the First Company Law Directive. However these amendments state that "financial documents shall be submitted to the Court Register via the Financial Agency (FINA)." At present, companies file only short one or two page summaries of key financial information with FINA, rather than their full financial statements, and the reliability of these summary figures is not confirmed by any audit report. If FINA is to act as an electronic conduit to the Court Register, for the filing by companies of their legally-required (audited) financial statements, it must have the capacity for handling full financial statements, which it currently lacks. Given that the requirement for filing was amended only as of the end of March, it was not possible to determine the level of compliance with the new arrangements.

* Croatia mandates the use of a translation of out of date standards and therefore does not apply IFRS (since the standards are neither current nor complete).

¹⁸ ZSE website: <http://www.zse.hr/finreports.php?sessionId=fd7219c275a76592953812eaff480bfb>

23. **In Croatia, there is no enforcement of the requirement to file financial statements with the Court Register, which is contrary to the amended EU First Company Law Directive.** This lack of enforcement partially reflects the generally low demand for financial reports. Many companies appears to be owner-managed with very little or no bank loans and therefore are not exposed to a broader public interest. Parent undertakings of Croatian subsidiaries have their own information channels and do not need to rely on general purpose financial reporting.

24. **Although the introduction of a new legal framework for financial reporting in 2005 significantly improved alignment with the *acquis communautaire*, the framework still falls short of full compliance.** Croatian financial reporting practice has emerged from a combination of practices, including tax-oriented financial reporting, the required use of IFRS as at 2000 for all companies, and traditional publication of summary financial statements (FINA). The mandatory application of IFRS* is appropriate for Public Interest Entities. However, simply requiring the use of IFRS* does not meet all of requirements of the EU accounting Directives on issues other than measurement, recognition and disclosure such as responsibility for the preparation of accounts, reporting formats, annual management reports, and publication requirements. The Croatian regulatory framework should fully include these additional *acquis communautaire* requirements.

25. **The Croatian government is determined to undertake the necessary changes to the regulatory framework on financial reporting so as to achieve full compliance with the *acquis communautaire*.** The ROSC team identified a number of areas where further alignment is needed. For example, despite requirements on the preparation of consolidated accounts in the Companies Act, the Banking Law and the Insurance Act, the Accounting Act barely covers the preparation of consolidated financial statements. For example, the Accounting Act does not include the criteria of the Seventh Company Law Directive determining whether or not to consolidate subsidiaries and defining the scope of consolidation for financial reporting, does not include specific disclosure requirements on consolidated subsidiary undertakings, and does not require management to prepare a consolidated annual management report. In addition, the (electronic) publication of full individual and consolidated financial statements is not clearly required for joint stock companies, not required for limited liability companies and there are no defined sanctions for the non-publication of financial statements.

26. **The Accounting Act of 2005 distinguishes between large, medium and small enterprises and limits the mandatory use of IFRS* to “Public Interest Entities”.** Limiting the mandatory use of IFRS* is an important policy change and implements a major recommendation of the ROSC 2002. It also addresses comments made by the European Commission in its 2006 progress report: “[Croatia] requires a broader application of the IFRS* than foreseen in Article 4 of the IAS Regulation, as it applies to all large entities, as well as financial institutions and entities whose securities are listed. Enforcement of accounting requirements needs to be monitored.” Croatia has replaced the requirement to use IFRS* for the financial statements of all companies with a new requirement that only large, listed and financial sector companies are required to follow IFRS*. All other companies have an option to use IFRS* or accounting standards to be issued by the Financial Reporting Council. However, at present the financial reporting requirements for SMEs are still the same as in 2002 and will only change once the FRC has issued the accounting standards for SMEs, based on IFRS and the EU Accounting Directives.

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27. **The Accounting Act defines companies - in accordance with the criteria of the EU accounting Directives - as small, medium and large companies for the purpose of financial reporting as follows:**

- Small if they do not exceed two of the following three conditions: (i) assets totaling 27 million HRK; (ii) revenue of 54 million HRK; (iii) 50 employees.
- Medium-sized if they exceed two of the three conditions for small entities, but do not exceed two of the following three conditions: (i) assets totaling 108 million HRK; (ii) revenue of 216 million HRK; (iii) 250 employees.
- Large if they exceed at least two of the following three conditions: (i) assets totaling 108 million HRK; (ii) revenue of 216 million HRK; (iii) 250 employees. According to the Accounting law all banks, housing savings banks, insurance companies, leasing companies, investment funds, and investment funds are considered large.

28. **The Croatian National Bank (HNB) is responsible for the development and implementation of financial reporting requirements applicable to the banking sector.** The Law on the HNB of April 20, 2001 and the Croatian Banking Law of July 17, 2003, as well as various legal “Decisions”, form the key banking legislation. According to the Banking Law, banks are obliged to prepare and publish annual financial statements in accordance with the Accounting Act and IFRS*. Annual financial statements and consolidated annual financial statements must be audited by certified auditors. Banks are obliged to submit audited annual financial statements and audited consolidated financial statements of a banking group to the HNB. In addition, certain prudential reporting requirements are set out by the HNB. Whilst aiming at the protection of deposit holders, these prudential reporting requirements do not always fully comply with measurement principles laid out in IFRS, particularly with regard to loan loss provisioning.

29. **As specified in the Accounting Act, the Financial Reporting Council (FRC) is an expert body of nine members appointed by the Government which is obliged to approve IFRS* and enact financial reporting standards for entities which do not use IFRS*.** The national legislation prescribes that the FRC should also “interpret” IFRS*. Since Croatia is determined to join the European Union, the national legislation should not prescribe that the FRC “interpret” IFRS*, rather it should seek to ensure consistent application of IFRS*. Any decision on the application of IFRS* for listed companies should not contradict IFRICs and be checked against CESR efforts to ensure harmonized application of IFRS in the EU. The FRC has begun drafting accounting standards for SMEs. Croatia has decided to develop accounting standards for SMEs which will be based on a combination of IFRS as of 2000 (used in Croatia until 2005) and the EU Fourth Company Law Directive. The FRC intends to apply the exemption options available in the *acquis communautaire* relating to the preparation, presentation, publication and audit of financial statements.

30. **The Audit Act is broadly aligned with the *acquis communautaire* and enhances the institutional framework for statutory audit.** When preparing the Audit Act, the proposals for amendments to the Eighth Company Law Directive and other Commission recommendations were taken into account. As a consequence, many requirements of the amended EU Eighth Company Law Directive (2006/43/EC) have been addressed in the Audit Act. However, for assessing full compliance with the amended Eighth Directive, the (to be) adopted bylaws of the

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Chamber of Auditors and the (to be established) systems of quality assurance and public oversight need to be considered.

31. **The overall education and training requirements in the Audit Act are aligned with the amended Eighth Company Law Directive, but a description of the subject matters of theoretical knowledge is not included in the Act.** The Directive's ownership and management requirements for audit firms are included in the Act, and individual auditors and audit firms shall be registered by the Chamber of Auditors (although minimum registration information and electronic registration are not defined). On auditor independence, auditors and audit firms are prohibited from providing additional services to the audited entity, and may not have business or other relationships with audited entities. All public interest entities shall have audit committees with tasks as defined in the amended Eighth Company Law Directive. The Chamber of Auditors shall establish a system of quality assurance¹⁹ with full time inspectors and public oversight²⁰, which shall be carried out by the Ministry of Finance. However, some issues, such as the annual disclosure requirements on audit firms of public interest entities, and the type of audit opinions have not been addressed or are addressed in less detail.

32. **The Audit Act provides some further safeguards on audit quality in addition to the requirements of the amended Eighth Company Law Directive.** For example, an individual auditor or an audit firm employing only one licensed auditor is prohibited from auditing listed companies, banks, insurance undertakings, as well as other financial sector companies and large (turnover greater than HRK 40 million) joint stock and limited liability companies. Also there is a specific legal requirement that the auditor shall have comprehensive audit working papers supporting the audit opinion.

33. **The Audit Act introduced more proportionate audit requirements by providing audit exemptions for small companies.** The Audit Act states that financial statements of all joint stock companies, limited partnerships, and limited liability companies with the total annual revenue of which exceeds HRK 30,000,000 (approx. EUR 4,100,000) shall be subject to annual audit, as well as the financial statements of connected companies, regardless of their size, if their controlling company is subject to audit. The latter requirement goes beyond the extant *acquis communautaire* and may be disproportionate. This requirement should be reconsidered in the light of adopting the forthcoming ISA 600 on group audits. Banks, insurance companies, investment funds, retirement insurance undertakings, and other companies are also subject to audit according to special regulations. Furthermore, the Audit Act requires that consolidated financial statements should be subject to annual audit. Limited liability companies and limited partnerships with an annual revenue of less than HRK 30,000,000 (approximately EUR 4,100,000) shall be subject to audit in accordance with their own rules (however according to the Fourth and Seventh Company Law Directives, the audit requirement is not defined by turnover thresholds alone). Statutory audits shall be conducted by audit firms or auditors licensed by the Croatian Chamber of Auditors.

34. **Statutory auditors shall be appointed by the general meeting of shareholders.** In the case of public interest entities, the audit committee shall recommend an independent auditor to the general meeting. The Audit Act also prescribes that the contract with the statutory

¹⁹ Each Member State shall establish system of quality assurance covering all statutory auditors and audit firms in compliance with the functional criteria of the new Eighth Company Law Directive.

²⁰ According to the new Eighth Company Law Directive, each Member States must establish an effective system of public oversight. This system is to be governed by non-practitioners knowledgeable us areas relevant to statutory audit and will subject all statutory auditors and audit firms to public oversight.

auditor can only be cancelled on justified grounds and that differences of opinion on accounting treatments with the management board is not a justified ground.

35. **The Audit Act establishes public oversight of the Chamber of Auditors with the Ministry of Finance.** The recently amended Eighth Directive requires a system of oversight but does not provide fixed rules on the oversight structure. However, it may be difficult to meet some other requirements of the Directive, such as finding a majority of non-practitioners knowledgeable in the area of statutory audit to exercise. In addition, it may be better to have a non-governmental oversight board to ensure a broader public interest; Recital 9 of the Directive could be read in that sense. Finally, an independent board model would lessen (unnecessary) political influence.

36. **The Banking Act requires the rotation of bank auditors every four years. Many banks in Croatia are part of foreign banking groups, thus this four year requirement could present an issue for Croatian banks with foreign ownership.** Croatian policymakers may wish to reconsider the four year rotation requirement of bank auditors. Mandatory rotation of the audit firm is possible, but not required by the new Eighth Directive because the uncertainty of the benefits. Whilst mandatory rotation of audit firms may support the independence of the auditor, it comes at cost of losing collective audit experience every four years, which may adversely impact audit quality. In addition, the rotation requirement could create some inefficiency for the audit of Croatian subsidiaries of international banks when the group auditor belongs to a different network than the local audit firm.

37. **The Code of Ethics for Professional Accountants was translated and adopted in early July 2007.** However, ethical requirements are not effectively enforced by the new Chamber of Auditors as its system of external quality assurance of auditors has not yet been established. Furthermore, the translation of ISA has not yet been completed. Croatia should establish a continuous and sustainable translation process and proper adoption of ISA (which may be mandatory following membership of the European Union if the European Commission adopts ISA).

38. **The Chamber of Auditors' first by-law sets minimum audit engagement fees based on the size of the audited companies.** The Chamber of Auditors claims that the pricing regime restricts price manipulation and protects the integrity of the auditors. However, the minimum engagement fee has given rise to criticisms from many audit firms, both large and small. The initial minimum engagement fee was EUR 5,000. Smaller firms objected to this minimum fee as a high audit fee creates disadvantages for them, since most companies would rather use larger, better known audit firms. The local member firms of major international networks claim that a smaller firm will not provide the same level of audit quality although the smaller firm will still be paid as much as the larger firm. The AZTN, the Croatian Competition Authority, has recently called for amendments to be made to the Audit Act to eliminate fixed tariffs and to permit price competition and the minimum engagement fee has been recently decreased. However, the ROSC team still suggested removing "minimum" fees per engagements in the new Audit Act.

39. **Financial reporting in Croatia originated from company law requirements specific to sectors and is not focused on publicly disclosing the ("true") economic performance and financial position of the company.** In the Croatian company law context financial statements are primarily used by the management and supervisory boards and the general meeting of shareholders of the company for deciding on profit distribution and maintaining minimum capital for protection of creditors' rights. The Companies Act, the Banking

Law and the Insurance Act have some reporting deadlines for submitting financial statements to the supervisory board and supervisors but are basically silent on the publication of full financial statements to the public at large. This lack of transparency on reporting the “real” economic value and financial position of the company to potential investors and other stakeholders such as employees undermines the efficiency of the capital market and limits market discipline on companies.

40. **The Accounting Act requires joint stock companies to publish full financial statements. However, it does not detail how, where and by when the financial statements should be published and does not define sanctions resulting from non-publication.** The requirements for publication of full financial statements and management reports in Croatia are not fully aligned with the *acquis communautaire*. Under the *acquis*, large limited liability companies are also required to publish full financial statements and management reports. Member States can limit the mandatory requirement for publication of financial statements in the case of small companies to solely require an abridged balance sheet and, in the case of medium-sized companies, to require an abridged balance sheet and profit and loss account. Furthermore, the Transparency Directive requires publication of financial statements, as well as management and audit reports in full. In addition the amended First Directive requires effective and dissuasive sanctions resulting from the non-publication of financial statements.

41. **The Audit and Accounting Acts do not make references to other laws which deal with similar issues; this complicates the understanding of the legal basis for financial reporting.** Examples include requirements for the publication of financial statements (also dealt with in the Banking Law, the Insurance Acts and in the Companies Act), the appointment of statutory auditors (also dealt with in the Companies Act), and regulations governing consolidated financial statements (also dealt with in the Banking Law, the Insurance Acts and in the Companies Act). A lack of references between the various Laws and Acts does not only complicate the proper understanding of the legal basis but also risks inconsistencies between the various laws, undermining legal certainty. It is also unclear why the size criteria in the Audit Act (Article 6-3) and the Accounting Act (Article 17-1) differ since they are identical in the *acquis communautaire*.

42. **Financial information on insurance undertakings was not readily available.** It was not possible to obtain a single full set of financial statements from HANFA or FINA. Although financial statements were requested directly from several insurance undertakings, the ROSC team received only one set of financial statements.

B. The Profession

B.1. The Accounting Profession

43. **The Croatian Association of Accountants and Financial Experts has approximately 30,000 members and is full member of IFAC.** IFAC requires that its members, both associate and full, make their best efforts to comply with IFAC’s Statements of Membership Obligations (SMOs)²¹. IFAC is currently running a member body compliance program identifying the level of compliance of the member bodies with the SMOs. The Croatian

²¹ IFAC SMOs are designed to provide clear benchmarks to current and potential IFAC member organizations to assist them in ensuring high quality performance by accountants worldwide. SMOs cover quality assurance, education standards, auditing standards, ethics, investigation and discipline, etc. For additional information, refer to www.ifac.org/Compliance/index.php.

Association of Accountants and Financial Experts is participating in the member body compliance program. However, many of the 30,000 members of the Association have not obtained qualifications compliant with IFAC's education requirements for professional accountants, as set out in IFAC's International Education Standards.

44. **The main challenge faced by the accounting profession in Croatia is a lack of adequate skills.** Although Croatia required IFRS* for all companies several years ago, many members of the profession struggle to understand and implement the requirements of IFRS*. Bookkeeping and financial reporting are often conducted according to the taxation-based rules commonly used in the past. It is particularly difficult for the 'older generation' accountants to switch from the previous, strictly regulated tax-oriented environment to the principles-based accounting standards, which require much judgment and use of accounting estimates.

45. **Educating accountants who work at the majority of Croatian companies is key to improving the practical application of IFRS* and the forthcoming standards for SMEs.** While the level of understanding of modern accounting concepts of newly qualified accountants may be higher than that of current accounting practitioners, the established accountants should be also given an opportunity to improve their theoretical and practical skills.

B.2. The Audit Profession

46. **In Croatia, the statutory audit profession has developed on the basis of an initial phase of automatic "grandfathering".** In 1993, auditors were temporarily licensed for 2 years on the basis of experience, then had to take an examination in order to be licensed permanently. Since then, entry to the audit profession has only been possible through taking an examination or, by completing a post graduate program on accounting and auditing. Prior to 2002, the MoF recognized two professional organizations of auditors, the Croatian Association of Auditors (HUR) and "Benedikt Kotruljevic". "Benedikt Kotruljevic" had issued approximately 100 audit licenses which were recognized by HUR after "Benedikt" became defunct. All statutory auditors were re-licensed automatically when the new Chamber of Auditors was established in 2006.

47. **Against this background of grandfathering and in the absence of a system of Continuous Professional Development, some auditors may not be up-to-date and hence there would be merits in a re-licensing program for auditors.** Initiating re-licensing may be demanding and difficult to organize. Another effective way of ensuring that all statutory auditors meet adequate quality standards would be the rapid introduction of an effective quality assurance program by the Chamber of Auditors with withdrawal of licenses in case of unacceptable audit quality.

48. **In 2006 the new Chamber of Auditors was established as a professional body with public authority to issue bylaws and licenses.** The Chamber has a governing board of 11 members with one member appointed by the MoF and the other 10 members, who are audit practitioners, appointed by the Assembly. The Chamber of Auditors is overseen by the MoF. The Chamber's main responsibilities as defined by the Audit Act include:

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- Determining the program for audit examinations and organizing Continuing Professional Development (CPD), issuing audit licenses and maintaining the register of licensed auditors and audit firms;
- Translation, adoption and interpretation of International Standards on Auditing and professional ethical standards; and
- Ensuring the quality of audits carried out by certified auditors and audit firms in order to assess whether audits were conducted in accordance with the legal framework, ISA, and other rules of the auditing profession.

49. **Currently, Croatia has approximately 960 certified auditors and 250 audit firms, including local member firms of major international networks.** Minimum competency requirements for membership of the audit profession are determined by the new Audit Act. Candidates must:

- Hold a university degree;
- Have a minimum of three years of audit experience under the supervision of a certified auditor;
- Have passed the examination for auditor certification;
- Be fluent in Croatian language, both spoken and written;
- Be a Croatian citizen²²; and
- Provide evidence of no prior conviction for criminal acts against payment transactions safety and operations.

50. **To comply with the requirements of the *acquis communautaire*, the necessity of Croatian citizenship to become an auditor should be reconsidered.** Moreover, the linguistic requirements in the Croatian Audit Act are also contrary to the *acquis*, in particular the references to the separate language tests.

51. **The Chamber of Auditors is in the process of developing a long-term business plan, which sets out the revenues and resources required to carry out its responsibilities.** The business plan is likely to require the implementation of a coordinated capacity-building program, as well as the recruitment of personnel with appropriate accounting and auditing qualifications and experience. Currently, the Chamber of Auditors does not have the appropriate staff to carry out its responsibilities. The Chamber of Auditors has an elected President and Vice-President and also has two full time administrative staff positions.

52. **There is currently no systematic quality assurance to detect and correct poor audit quality in practice and to allow for an improvement of audit quality in general.** The absence of a system of quality assurance is a serious concern, in particular for auditors of public interest entities because statutory audit constitutes currently the most important element of enforcing the proper preparation of financial statements. According to the Audit Act, the Chamber of Auditors is responsible for audit quality control. Under the Act, all auditors and audit companies should fully comply with the audit regulations by March 18, 2007. However, since the Chamber was only established in March 2006, the preparations for monitoring audit quality are still in progress. External quality assurance should be implemented urgently so as to identify poor audit quality and maintain the public trust in the audit function. The absence of a system of external quality control may be partly mitigated for some auditors by systems of internal quality

²² Not in line with the *acquis communautaire*.

control e.g. in local member firms of major international networks, but internal quality control cannot be a substitute for external quality assurance which covers all auditors and audit firms.

53. **Annual transparency reporting by statutory auditors of public interest entities should be introduced, as this is required by the new EU Eighth Company Law Directive.** Given the significance of public interest entities to the economy, stricter requirements are necessary for their auditors, including public provision of information by the auditors who conduct such audits. Transparency reporting by these audit firms would facilitate additional monitoring and supervision and also enhance public confidence in the statutory audits of public interest entities. Information to be provided on an annual basis by the audit firm should include: description of the legal structure and ownership; details of membership of a network of audit firms; description of the internal quality control system; information regarding the fees earned for statutory audits, other assurance services, tax advisory services and other non-audit services; basis for partner remuneration; and other information

C. Professional Education and Training

54. **Professional accounting education and training in accountancy and auditing in Croatia is needed by all participants in the corporate financial reporting process.** Different levels and types of competence are required by different participants: preparers of financial statements need a good working knowledge of the standards to which they must prepare accounts; bookkeepers need knowledge of only the basics of the accounting system they use; auditors need a higher level of knowledge to cover auditing standards and techniques in addition to accounting standards; regulators need specific knowledge of the law and regulations relating to financial reporting in their field; and taxation officers need to know both the taxation regulations and the interaction between the taxation regulations and accounting principles used to prepare financial statements. Education and training in accountancy are delivered at two stages – at the higher education level and at professional level once accountants have begun working.

55. **An example of university-level education in the area of accounting and auditing is the Faculty of Economics and Business of the University of Zagreb.** It provides several training courses in accounting and auditing, ranging from the basic to advanced levels.²³ Accounting is a subject of study during the first semester of the second year, and auditing is a subject during the first semester of the fourth year. In addition, optional courses are provided in specialist areas such as accounting of commerce and tourism, international accounting, accounting for SMEs, and non-profit accounting. The number of students studying accounting and auditing is steadily growing. In 2006/2007, the number of students of accounting and auditing programs at the University of Zagreb was 390, compared with 220 in 2005/2006. The continuous increase of students has been achieved through the work of Faculty of Economics and Business of the University of Zagreb and is also due to an increase in the perceived attractiveness of entering the profession by students. Students at the University of Zagreb can continue postgraduate studies in the area of management accounting and internal audit. University professors base the curriculum and accounting exams on IFRS from 2004. The curriculum at the Faculty of Economics of the University of Zagreb, as well as other leading universities in Croatia may wish to further up-date the curriculum in order to ensure the coverage of up to date IFRS* and IFRICs.

²³ For more information, please visit: www.efzg.hr/default.aspx?id=6502

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56. **The new established Croatian Chamber of Auditors administers the training and examination system for those seeking access to the auditing profession.** The structure and procedures of the auditing examination are determined by the bylaw on examination recently adopted by the Chamber of Auditors. In the past, postgraduate students who completed the postgraduate program in accounting and auditing automatically been certified as auditors by the HUR, a previous association, and did not have to pass the HUR examination. This is no longer possible under the new Audit Act and was non-compliant with the *acquis communautaire*. The current requirements as defined in the Audit Act require an audit examination and practical training. This is largely compliant with the *acquis communautaire* except that the subject matters of theoretical knowledge covered by the examination have not been defined.

57. **There are important changes needed to the education, training and certification of professional accountants and auditors in Croatia.** The current education and qualifications available are not highly regarded by some employers and employees of auditing firms. Reasons cited included a lack of translated IFRS* material and outdated IFRS training materials. A small number of Croatians have taken English-language qualifications. The majority of them are employed in the local member firms of major international networks, leading banks and large companies. Accountants and auditors should also be encouraged to maintain and further improve their theoretical knowledge and practical skills through programs of Continuing Professional Development (CPD).

58. **At present, professional courses available in Croatian are scarce and have little or no market recognition.** English language qualifications are inaccessible to many due to cost and language constraints. Measures are needed to stimulate and improve the provision of local language accounting education and training in Croatia. Professional organizations should be encouraged to work more closely with universities and business schools to enhance the quality of the accounting and auditing education provided; where possible syllabi should be coordinated so that exemptions from basic accountancy qualifications are available to students who have majored in accountancy. The availability of such exemptions reduces the length of time required to complete subsequent professional qualifications, and thus increases training capacity. In addition, there is a major need to enhance the resources available to university faculties teaching accounting, both in terms of updating the skills and knowledge of faculty staff and in the provision of textbooks, training materials and reference materials such as local-language copies of IFRS*, ISAs and the forthcoming Croatian standards for SMEs.

59. **Participants in the financial reporting process need to be encouraged to gain the education and training they need to meet requirements made of them in their role.** This covers preparers in all sizes of entity, regulators, auditors and even taxation officers; in almost all cases, this means updating their skills at least to a basic level of modern accounting. This basic level of accounting knowledge would cover simple financial and management accounting and relevant law, taxation and other regulations. The Croatian government, regulators, professional bodies and education providers should work together to decide on appropriate target educational standards and qualifications suitable for rapidly expanding Croatian accounting capacity.

D. Setting Accounting and Auditing Standards

60. **The translation of IFRS* and ISA is not an ongoing and sustained effort.** The current process does not allow for ongoing translation of IFRS* and ISA into the Croatian

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language as they are amended. Rather, translations have been updated every few years. As a result, individual accountants, auditors and audit firms that lack English language skills are not in a position to apply the latest changes as they are published by the IASB (for IFRS) and IAASB (for ISA). While this situation is not uncommon in non-English speaking countries, it is a hurdle that must be overcome to allow effective implementation of IFRS*. Ongoing translation of IFRS* and ISA will also facilitate the education and training of the preparers, users and auditors of financial statements.

61. **The Croatian Association of Accountants and Financial Employees translated the IFRS 2004 edition.** From 2000 until the translation of IFRS as at 2004 there was no up-to-date translation of IFRS. IFRS were significantly amended during this period. The translated version of IFRS as at 2004 was published in December 2006 in the Official Gazette and has been publicly available in Croatian language on the internet since then. The government has received a waiver of copyright from the IASCF for the publication of the “bare standards”. Prior to this, IFRS were not published in the Official Gazette and were not publicly available on the internet. The current translation process of IFRS* is still disruptive and not up to date. In addition, supporting information such as IFRICs have not been translated and published.

62. **Several reporting requirements for banks are included in the Banking Act, in particular, the Act states that banks shall prepare and publish their annual reports in accordance with the Accounting Act and IFRS*.** In addition to the duties stipulated by the Companies Act, the Banking Act requires banks to keep business books and other books, to keep business documentation, to prepare bookkeeping documents, and to prepare financial and other statements in accordance with accounting regulations and standards. The basis for the preparation of financial statements of the financial sector is unclear as there is some overlap and contradiction between IFRS and the different requirements of supervisors. An example of this relates to requirements for loan loss provisioning by the HNB which may not comply with IFRS. In addition, HANFA indicated that measurement requirements for prudential reporting might contradict the measurement principles of IFRS. The HNB and HANFA should base their approaches to linking prudential reporting and general purpose (IFRS) financial reporting on the EU approaches such as the “COREP” and “FINREP” IFRS-based prudential reporting by banks as developed by the Committee of European Banking Supervisors (CEBS).

E. Enforcing Accounting and Auditing Standards

63. **The good quality of the audited financial statements of banks can be attributed to HNB supervision, and the transfer of foreign knowledge to Croatian banks.** Although the HNB places reliance on the audit opinion of the bank’s auditor for ensuring the correct application of IFRS* for general purpose financial reporting, the HNB enforces the application of IFRS in the context of ensuring proper prudential reporting through on- and off-site inspections. Moreover, regular on-site inspections may help to identify poor external audit quality of bank auditors. There is a high level of foreign ownership in Croatian banks, which also implies a transfer of foreign knowledge and know-how to Croatian banks. The prudential regulation and banking supervision division of the HNB employs approximately 92 professionals, however most are economists (78). Its enforcement capacity seems to be adequate for the current state of development, but institutional strengthening will be needed as the market matures.

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64. **No mechanism currently exists for enforcing compliance with financial reporting requirements in the real sector companies.** Section III of this report notes several areas of non-compliance with IFRS*. A proper and rigorous enforcement regime for financial reporting is key to establishing and maintaining the quality of financial reporting and to underpinning investors' confidence in financial markets.²⁴ The existing monitoring and enforcement mechanisms pertaining to financial reporting for the non-banking sector should be further strengthened. Although the recent Accounting Act and Audit Acts do establish several sanctions for non-compliance with their requirements, there were no reported cases of enforcement by FINA, ZSE or HANFA. Systematic enforcement of financial reporting standards should be addressed, as there is over-reliance on effective auditing for ensuring the proper application of financial reporting standards. In particular, HANFA will need to build additional IFRS capacity to become an effective enforcer of high-quality financial information. HANFA has more than 104 staff, but lacks staff with adequate IFRS* knowledge.

65. **There were no restrictions on trading exercised as punitive actions for incorrect application of IFRS* in the last three years.** HANFA should continue to strengthen its capacity for monitoring and enforcing the proper application of IFRS*. In the past, the VSE has not had mechanisms for enforcing proper financial reporting and auditing of listed companies. VSE published submitted reports on the internet, but did not control the quality of the financial reporting. In the event of noncompliance, the ZSE is empowered to suspend further trading of the company's shares. Fines and other penalties are also described in the Accounting Act and range from HRK 10,000 to HRK 500,000. In practice, these penalties have not been applied.

66. **There is no effective enforcement mechanism of the requirement to file full sets of financial statements with the Court Register.** This is contrary to the amended EU First Company Law Directive and reflects the general lack of user demand for financial reports.

III. ACCOUNTING STANDARDS AS PRACTICED

67. **The ROSC team reviewed a sample of financial statements prepared in accordance with IFRS*.** The financial statements selected were for the financial year 2005. This implies that the old regime ("IFRS 2000") applied to the sample and not the new regime "IFRS 2004". However, some entities (in particular banks) followed up-to-date IFRS as part of the group accounting policy without preparing two sets of financial statements. The ROSC team used judgmental sampling to select the financial statements. However, due to the small sample size, the outcome cannot be considered representative for all Croatian companies, particularly in the non-banking financial sector where only one financial statement of insurance, pension and investment entities were reviewed. Hence, the findings, although useful for indicating potential systemic problems in financial reporting, will pertain only to shortcomings found in the financial statements of specific companies. It should be noted that the sample included financial statements for the financial year 2005 which means that the new Accounting (and Audit) Act were not yet in force. This means that financial statements should have been prepared using "IFRS 2000" and not the "IFRS 2004" adopted in December 2006. As noted earlier, however, neither "IFRS 2000" nor "IFRS 2004" could be considered as properly IFRS compliant as at the 2005 financial year balance sheet date.

²⁴ Recital 16 of EC Regulation 1606/2002, otherwise known as the IAS Regulation

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The compliance gap:

68. **To assess the compliance gap, 15 sets of audited financial statements were reviewed by the ROSC team.** This included 5 banks, 7 real sector companies, one insurance undertaking, one investment fund, and one pension fund. 14 audit reports were unqualified and 1 was qualified. The results of the review are set out below.

A. Real Sector Companies

69. **The financial statements of the seven real sector companies were prepared in accordance with IFRS* and were audited in accordance with ISA.** The financial statements appeared generally to be of a reasonable quality, but much of the wording of accounting policies and notes appears to be standard wording, possibly drawn from model financial statements made available by the audit firms. Several companies disclosed accounting policies for events and transactions which they did not have. This may raise doubts about the understanding of IFRS* and financial statements.

70. **The following areas of non-compliance with standards by real sector companies were identified:**

- *IAS 1, Presentation of Financial Statements.* The consolidated income statement shows “net financial expenses”. IAS 1 does not permit the offsetting of income and expenses in this way.
- *IFRS 3, Business Combinations.* In one sampled company, provisions had not been recognised by the acquirees. Therefore, their recognition of acquired liabilities is prohibited by IFRS 3. In the review of a second sampled company, the financial statements did not comply with the requirements of IFRS 3 relating to the recognition of restructuring provisions and goodwill.
- *IAS 16, Property, Plant and Equipment.* One sampled company disposed of a property which was carried at a revalued amount. On the disposal, the company cancelled the revaluation reserve in equity by crediting property. As a result, the profit on sale is the difference between the sale proceeds and the cost of the property. This does not comply with IAS 16. IAS 16 does not permit the reversal of the revaluation. It requires that the profit on sale should be calculated as the difference between the sale proceeds and the carrying amount based on the revalued amount. The audit opinion is correctly qualified on this matter.
- *IAS 27, Consolidated and separate financial statements.* In some cases, “non-consolidation” was noted, which does not appear to comply with IAS 27 (which requires consolidation up until the date of disposal).

71. **In addition to the specific non-compliance issues noted in the above paragraph, the review noted minor compliance issues relating to the measurement of loans receivable (IAS 39), capitalisation of development costs (IAS 38) and discontinued operations (IFRS 5).** None of the issues of non-compliance noted in the review appeared sufficiently serious so as to materially affect the usefulness of the financial statements. This view was shared by companies’ auditors as six out of the seven audit opinions on the financial statements were unqualified with respect to compliance with IFRS* and other matters.

B. Financial Sector Entities

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72. **The quality of the financial statements of banks was of a relatively high standard even when compared to international peers.** All of the five sets of banks' financial statements included in the review sample had unqualified audit opinion. However, two audit opinions did not refer to IFRS* compliance but rather to statutory compliance. In practice, the financial statements of all banks are audited by the local member firms of major international audit firm networks.

73. **Banks are required to calculate provisions for potential loan losses in accordance with requirements of the HNB, which suggests that the actual provisions recorded are not in line with impairment principles under IAS 39.** The HNB rule requires banks to calculate impairment within a range of 0.85 – 1.20 percent of the precise defined sum of total assets. This methodology may be adequate for regulatory/prudential requirements, but it does not comply with IAS 39, which requires that the allowance for loan losses be calculated as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate. Banks use these regulations not only for prudential reporting but also in preparing their general purpose financial statements.

74. **The HNB's representatives expressed their strong concerns about a potential non-compliance issue with the Bank Accounts Directive.** The lay-out of the financial statements under IFRS* is not fully aligned with the presentation lay-out of the Bank Accounts Directive.

75. **The financial statements of the financial sector entities do show some evidence of non-compliance:**

- In some of the financial statements the description of the basis of preparation (IAS 1) is missing or inadequate;
- Examples of the use of “unconsolidated financial statements” are unclear;
- Foreign currency differences on “available for sale” financial instruments do not appear to be in line with IAS 21, *Effects of changes in foreign exchange rates*;
- Inadequate information was provided regarding leases; and
- There were missing disclosures on the reporting of provisions.

76. **Accounting policies to describe the classification of investments and the accounting treatment of fair value gains and losses were generally not disclosed as required by IAS 39.** Certain disclosure requirements of IAS 39 were not completely fulfilled, including:

- Missing details and explanations of sensitivity analysis on financial instruments;
- Unwinding of non-performing loan provisions; and
- Inconsistent application of the effective interest method.

77. **Only one set of financial statements of an insurance undertaking was obtained.** Overall, the financial statements were of good quality. The insurance undertaking reviewed is a subsidiary of an international group and will have additional internal reporting requirements. The most important IFRS* for insurance entities is IFRS 4, which contains detailed disclosure requirements. The following areas of non-compliance were noted:

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- While the company provided extensive information on insurance business, some qualitative requirements were not adequately disclosed, e.g. changes in assumption and influences on insurance liabilities/payments
- For non-insurance activities, including investments activities, a number of disclosures were missing in the areas of deferred tax, pension benefits and financial instruments

While overall the company's financial statements were in-line with IFRS*, not all measurement appeared to be compliant with IFRS* and that there is still significant room for improvement on disclosures required by IFRS*.

78. **HANFA's representatives expressed their strong concerns about a potential non-compliance issue with the Insurance Accounts Directive.** The lay-out of the financial statements under IFRS* is not fully aligned with the presentation lay-out of the Insurance Accounts Directive.

79. **The quality of sampled financial statements of the pension and investment funds showed a number of possible non-compliance issues.** In some instances, users of these financial statements would be unable to make an informed decision or, or worse, could be misled in the decision-making process. Examples of possible non-compliance noted include:

- The financial statements of the reviewed investment fund indicated potentially questionable accounting treatments. In several instances, investments were classified as held to maturity under IAS 39. Although this classification might be appropriate for pension funds in the current growth situation, such treatments in "normal" investment funds appear unlikely to be in line with the principles set out for classification under IAS 39.
- The audit opinion on the reviewed pension fund financial statements did not refer to the specific financial reporting framework applied.

IV. AUDITING STANDARDS AS DESIGNED AND AS PRACTISED

80. **According to the Audit Act, the Croatian Chamber of Auditors is responsible for the translation and publication of ISA.** The translation of new and amended ISA is in progress and the Chamber is planning to finalize the translation and publish the full set of ISA in the Official Gazette in 2007. Due to the fact that the full set of ISA will become officially effective only after they are published in the Official Gazette, there are currently no auditing standards in effect in Croatia. The current translation of the Code of Ethics is based on the 2005 IFAC handbook. The Chamber of Auditors plans to translate and publish the Code of Ethics for Professional Accountants issued by IFAC in the 2007 calendar year. After the publication of ISA and the Code of Ethics, the ISA and Code will become effective in the Republic of Croatia.

81. **In several instances the audit opinions in the sampled financial statements of financial sector entities referred to statutory requirements rather than to IFRS in their audit opinion.** This is likely to be due to the fact that the financial statements of public interest entities were not fully compliant with up-to-date IFRS, but rather with the Croatian statutory requirements which fall short of requiring compliance with up-to-date IFRS.

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V. PERCEPTION OF THE QUALITY OF FINANCIAL REPORTING

82. **There is a general perception that corporate financial reporting should rather satisfy the needs of tax authorities rather than the needs of other users, including investors and creditors.** The 2002 Croatian Accounting and Auditing ROSC highlighted the need for meaningful use of financial statements for market-oriented decision making but, in practice, this has not significantly changed.

83. **Many preparers and users of financial statements believe that the Croatian statutory framework requires compliance with IFRS*.** However, as indicated throughout this report, Croatia mandates the use of out of date standards. As a result, Croatia does not apply IFRS, due to the fact that it is using non-complete and out of date standards.

84. **There is very limited availability of published financial statements in Croatia.** The current requirements on filing and publication of financial statements are not in line with international best practice in this area. The overall transparency and disclosure levels of Croatian corporate and non-banking sectors are still not satisfactory and, in general, bankers and other potential users of financial information do not feel they can “trust” the financial statements by potential borrowers. Moreover, Croatia does not properly enforce the requirement to file financial statements, which is contrary to the amended First Company Law Directive.

85. **Stakeholders believe that general purpose financial statements prepared under IFRS* should meet investor, supervisory and tax requirements at the same time.** However, the different purposes of financial reporting and the differentiation of these purposes in line with the size or character of companies do not allow this. This “one size fits all” view leads sometimes to conflicting financial reporting requirements which may be worsened now that the FRC and the supervisory bodies have been empowered to “interpret” IFRS* and to regulate the form and contents of the IFRS* financial reports. The ROSC team strongly recommends distinguishing different reporting/filing purposes. It appears unlikely that prudential reporting and general purpose reporting requirements (applying potentially volatile IFRS measurement principles) can be fulfilled using a single set of accounting policies.

86. **There are sensitive relationships between the local member firms of major international networks and other audit firms.** Until now, the local member firms of major international networks have financed the Chamber of Auditors, because the funding is largely based on a share of member firms’ audit fee turnover. However, the local member firms of major international networks do not have a representative in the governing Board of the Chamber and in addition have limited voting rights in the Assembly. Each audit firm has one vote in the Assembly regardless of the number of auditors it employs.

87. **Stakeholders in Croatia expressed a desire for the simplification of laws governing financial reporting with respect to SMEs.** In this context, the FRC has begun the process of drafting accounting standards for SMEs. Furthermore, stakeholders would prefer to submit financial reports to one centralized register rather than to various institutions, such as State Bureau of Statistics, HANFA, Croatian National Bank, and tax authorities.

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VI. POLICY RECOMMENDATIONS

88. **Croatia has recently introduced a more proportionate regulatory and institutional framework for financial reporting and auditing, but the challenge is now to build and strengthen suitable institutions to properly implement and enforce all *acquis communautaire* requirements related to financial reporting and auditing.** The recommendations of this ROSC are interrelated and mutually supportive and are also designed to collectively improve the corporate financial reporting environment in Croatia. Critical success factors for implementation include leadership from the highest levels of government, capitalizing on current desire for change and balancing of the incentives and disincentives for compliance with the financial reporting requirements. This report recommends that policymakers or other key stakeholders:

89. **Statutory Framework**

- Ensure that Croatia mandates the use of up-to-date and complete IFRS.
- Carefully review existing differences between the Croatian legal framework and the *acquis communautaire* with a view to implementing and enforcing full compliance with the *acquis communautaire*²⁵.
- Ensure harmonized application of IFRS with the process in the EU.
- Remove the requirement for Croatian citizenship to become a licensed statutory auditor.
- Reconsider the appropriateness of the four-year rotation requirement of bank auditors.
- Update legislation to clearly outline the authority of regulatory bodies to enforce accounting and auditing standards and to review the range of sanctions currently available to deter non-compliance.

90. **Publication**

- Ensure public availability of full sets of financial statements (including the notes) for *public interest entities*²⁶ rather than FINA's two page summaries of key financial information.
- Introduce sanctions on the non publication of financial statements by companies.

91. **Accounting**

- Prepare and adopt accounting standards for SMEs.
- Establish a continuous and sustainable translation and adoption process for IFRS*.
- HNB and HANFA should align their approaches for linking prudential reporting and general purpose financial reporting with those of CEBS and CEIOPS.

92. **Auditing**

- Establish a continuous and sustainable translation and adoption process for ISA and the IFAC Code of Ethics.
- Establish external quality assurance and disciplinary systems for auditors subject to public oversight.

²⁵ Refer to *Corporate Sector Accounting and Auditing within the Acquis Communautaire*, by the World Bank, March 2007.

²⁶ The equivalent requirements exist in EU Member States as set forth in the Fourth and Seventh EU Company Law Directives, and the Transparency Directive.

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- Ensure public electronic registration of statutory auditors and audit firms within the Chamber of Auditors.
- Remove “minimum” fees per engagements as introduced by the law of the Chamber of Auditors.
- Consider using a board model for audit oversight as opposed to oversight by the Ministry of Finance.

93. **Monitoring and Enforcement**

- HANFA should continue to strengthen its institutional capacity to effectively monitor and enforce financial reporting requirements for the entities which it regulates.

94. **Education and Training**

- Update university curricula and equip universities providing accounting and auditing education with sufficient up-to-date training materials.
 - Facilitate a major training program for preparers, users, auditors and regulators.
 - Establish Continuous Professional Development (CPD) programs for accountants and auditors.
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