

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

ACCOUNTING AND AUDITING

June 15, 2006

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Executive Summary

This report provides an assessment of accounting, financial reporting, and auditing requirements and practices within the enterprise and financial sectors in Kosovo. The report uses International Financial Reporting Standards (IFRS) and International Standards on Auditing (ISA), and draws on international experience and good practices in the field of accounting and audit regulation, including in European Union (EU) Member States, to assess the quality of financial information and to make policy recommendations.

Kosovo has an estimated population of 2 million and a gross domestic product (GDP) per capita of EUR 1,105 as of 2005. Kosovo was placed under temporary United Nations (UN) administration following the 1999 conflict, and its economy has begun to recover, recording positive growth since 2000. In November 2005, the UN appointed a Special Envoy for Kosovo with a mandate to initiate negotiations on the final status of Kosovo between the Government of Serbia and representatives of the Provisional Institutions of Self-Government (PISG) in Kosovo. These negotiations started in March, 2006, and are ongoing at the time of writing (June 2006). When concluded, these negotiations are expected to remove the uncertainty surrounding Kosovo's political status. This should contribute significantly to increased foreign direct investment.

Privately-owned enterprises make up the majority of the enterprise sector, both by number and economic output. Two classes make up the public enterprise sector in Kosovo: Publicly-Owned Enterprises (POEs) and Socially-Owned Enterprises (SOEs). Currently, 23 POEs and an estimated 400 to 500 SOEs exist in Kosovo. The United Nations Mission in Kosovo (UNMIK) established the Kosovo Trust Agency (KTA) in 2002 as an autonomous agency to continue UNMIK's regulation and management of all POEs and SOEs. Though the KTA has privatized a number of SOEs since 2003, no POEs have been privatized to date.

The banking sector plays a very limited role in the economy's financing, consisting primarily of retained earnings and informal, family-generated funding. Seed financing as an intermediate level of borrowing is also lacking. However, loans to the private sector are rapidly increasing—from 10 percent of GDP in 2003 to 23 percent of GDP in 2005. As of 2005, seven banks were operating in

This report was prepared by a team from the World Bank on the basis of the findings from a diagnostic review carried out in Kosovo in February 2006. The staff team was led by Seda Aroyamak (ECSPS) and comprised David Cairns (Visiting Professor, London School of Economics), Liam Coughlan (Associate Consultant, HELM Corporation), Gerhard Grabner, (Senior Manager, Ernst & Young Austria) and Vito Intini (ECSPF). The review was conducted through a participatory process involving various stakeholders and was led by the authorities.

Kosovo, two of which are majority-owned by foreign banks and make up 66 percent of total banking assets.

As of the end of 2005, the non-banking financial sector consisted of eight licensed insurance companies, four of which are domestic and four of which are of foreign origin. Furthermore, six licensed supplementary pension funds were in existence by the end of 2005 with a recorded 4,197 participants. As yet, there is no capital market present in Kosovo.

The Statutory Framework, including applicable Accounting and Auditing Standards

UNMIK Regulation 2001/30 on the Establishment of the Kosovo Board on Standards for Financial Reporting (KBSFR) and a Regime for Financial Reporting in Business Organizations (“the Law on Financial Reporting”) establishes the regulatory structure for accounting and auditing in Kosovo. The structure is appropriate but is not working effectively. Limited technical and financial resources have resulted, with institutional weaknesses in several areas. There is a desire to address the existing weaknesses. The proposed amendments to the Law aim to improve the existing framework through strengthening the oversight of the accounting and audit profession and clarifying further the roles and responsibilities of the regulatory institutions. These improvements are unlikely to work unless the institutional weaknesses described below are dealt with.

The Law requires the KBSFR to issue Kosovo Accounting Standards (KAS) that comply with IFRS after taking into consideration the business environment in Kosovo.

The Law requires all corporations (except “small corporations”), POEs, and SOEs to prepare their financial statements in conformity with KAS or IFRS. Applying simplified standards for smaller enterprises is a logical approach. However, adoption of a three-tiered financial reporting structure with *public interest entities* (PIEs) eventually applying IFRS; SMEs applying simplified financial reporting requirements; and micro enterprises continuing to apply tax-based rules would remove the problem of applying KAS or IFRS in relatively small organizations for which they were not designed or intended. The Law is in the process of being amended (hereinafter Draft Law) and this would provide an opportunity to address this issue.

Corporations (other than small corporations), POEs, and SOEs are required submit their (audited) financial statements to the business registry and the Ministry of Economy and Finance. However, the financial statements filed with the business registry are not publicly available. This may hinder the decision making abilities of stakeholders and may also inhibit the market incentive for greater compliance with accounting and audit requirements.

Banks and insurance companies are required to prepare financial statements in compliance with IFRS and the accounting requirements set forth by the Banking and Payments Authority of Kosovo (BPK). The recognition and measurement principles as well as the disclosure requirements set out by the BPK differ from “full IFRS.” Compliance with BPK requirements takes precedence, which precludes successful implementation of IFRS in the banking and insurance sectors.

The Law requires the KBSFR to issue auditing standards in conformity with ISA after taking into account the business and economic environment in Kosovo. In 2002, the KBSFR published an Administrative Decision in Albanian, which made application of ISA mandatory for licensed auditors carrying out statutory audits. The ISA adopted in 2002 were the 1999 Albanian language

translation of ISA. No subsequent review or updates have been carried out or mandated by the KBSFR.

The Law requires the financial statements of all corporations (other than small corporations), POEs and SOEs to be audited. The scope of statutory audit requirements is too broad, considering the stage of development of the audit profession in Kosovo and the rationale for such a requirement mandated by statute. The Draft Law provides an opportunity to address this issue.

The Accounting and Audit Profession

The accounting and audit profession in Kosovo is at a very early stage of its development. Under the framework established by Law on Financial Reporting in 2001, the two leading institutions in the area of accounting and auditing are the KBSFR and the Society of Certified Accountants and Auditors in Kosovo (SCAAK). The Law requires licensing of auditors by the KBSFR. However, the KBSFR does not yet have in place a formal mechanism to ensure that the licensed auditors possess the education, experience, qualifications and knowledge of ethical and professional standards to discharge the role of independent auditor. Other than for 11 grandfathered auditors, the KBSFR relies on the professional examinations organized by SCAAK. A further 40 individual licenses have been issued in accordance with this process (see below).

SCAAK is the only professional accounting and auditing body in Kosovo. However, the Law does not require auditors to remain members of SCAAK once they have passed their professional examination. Consequently, SCAAK is unable to monitor compliance by all licensed auditors with the Law and its membership obligations. While SCAAK has managed to set up some of the fundamental pillars of the accountancy profession (e.g., education) since its establishment, it lacks the authority, capacity, and resources to expand its role and foster greater audit quality.

Professional Education and Training

University curricula on offer do not provide an adequate basis for professional education and training for accountants and auditors. The curriculum has not been updated and there is an acute shortage of modern educational materials in the local languages.

SCAAK has established a certification program that complies with the Law on Financial Reporting. However, it falls short of the requirements of the new Eighth EU Company Law Directive with respect to statutory auditors (refer to Paragraph 32 below) and International Education Standards (IESs) with respect to accounting technicians and certified accountants. The SCAAK certification program, for which SCAAK has developed training materials, comprises three qualifications:

- Accounting Technician (as of June 15, 2006, there were 198 accounting technicians),
- Certified Accountant (as of June 15, 2006, there are 98 certified accountants), and

- Auditor (as of June 15, 2006, there are 75 licensed auditors). The Law states that an applicant must be a “certified accountant,” and pass two examinations in auditing administered by SCAAK.

As of mid-June 2006 there were also around 1,500 accounting and auditing students registered with SCAAK.

Among the areas of noncompliance with IES and the *acquis communautaire*, accountants and auditors are not required to take part in programs of continuing professional developments (CPD). Consequently, there is no established mechanism to ensure that accountants and auditors maintain (or increase) their theoretical knowledge, professional skills and values at (to) a sufficiently high level.

Monitoring and Enforcement

No mechanism currently exists for enforcing compliance with accounting and financial reporting requirements by business organizations. The KBSFR does not have any enforcement powers and, apart for the activities of the BPK with respect to the financial statements of banks and insurance undertakings, there are no other authorities with such powers.

The priorities of the BPK have been directed towards prudential regulation and supervision rather than the enforcement of accounting standards to be applied to general purpose financial statements. Also, the BPK has limited capacity to enforce KAS (or IFRS) in the general purpose financial statements of banks and insurance undertakings. Consequently, the BPK has developed a policy of relying on audit firms with international affiliations for the audit of banks and insurance undertakings.

No mechanism currently exists for monitoring and enforcing auditing standards and other audit requirements. The KBSFR does not have any enforcement powers and there are no other authorities with such powers. SCAAK has not established a quality review scheme for auditors, although a disciplinary committee has been formed to consider complaints. However, SCAAK's efforts are partly undermined by the absence of a requirement for auditors to be members of SCAAK.

Accounting Standard Gap and Compliance Gap Analysis

In October 2001 the KBSFR issued 19 KAS which were simplified versions of the equivalent IFRS at that time. However, since donor support was not prolonged and a sustainable standard setting process had not been established, the KBSFR has been unable to update the KAS as changes in IFRS were made by the IASB and Kosovo's economy developed.

Differences between KAS and IFRS that may have a significant impact on the financial statements of corporations, including POEs and SOEs, include the following:

- Impairment of assets may not be recognized
- Liabilities for employment benefits may be understated.
- KAS do not deal with consolidated financial statements.
- KAS have not been updated for other new and revised IFRS, including revisions to IAS, issued by the IASB since 2001. These new and revised standards may have a material effect on the financial statements of some business organizations in Kosovo.

The difficulties faced by business organizations operating in Kosovo, including POEs, are so significant that they bring into question the reliability of IFRS financial statements and, therefore,

whether they can, and do, comply with IFRS (e.g., uncertainties about the ownership or carrying amounts of assets). These issues are compounded by widespread noncompliance with IFRS requirements where compliance should be possible (e.g., non-recognizing the impairment of assets). The KAS financial statements reviewed by the ROSC team were generally very brief and many did not appear to comply with KAS.

Auditing Standard Gap and Compliance Gap Analysis

The significant differences between National Standards on Auditing (NSA) and ISA are due to late and poor translation of ISA. The delay in incorporating new ISA and amendments to existing ISA since 1999 results in a significant standard gap. However, the issues arising from this delay are of less concern than the issues resulting from the lack of understanding and proper usage of NSA. The problems identified with regard to the practice of NSA are at a much basic level than the problems associated with outdated and incomplete standards. For example, problems with the objective of an audit, audit risk assessment, basic audit procedures, and other such common problems are independent of inconsistent terminology between two advanced standards or a delay in incorporating the latest changes. The major challenges facing Kosovo are to upgrade the education regarding ISA, and to encourage and enforce implementation of the basic principles contained in the standards.

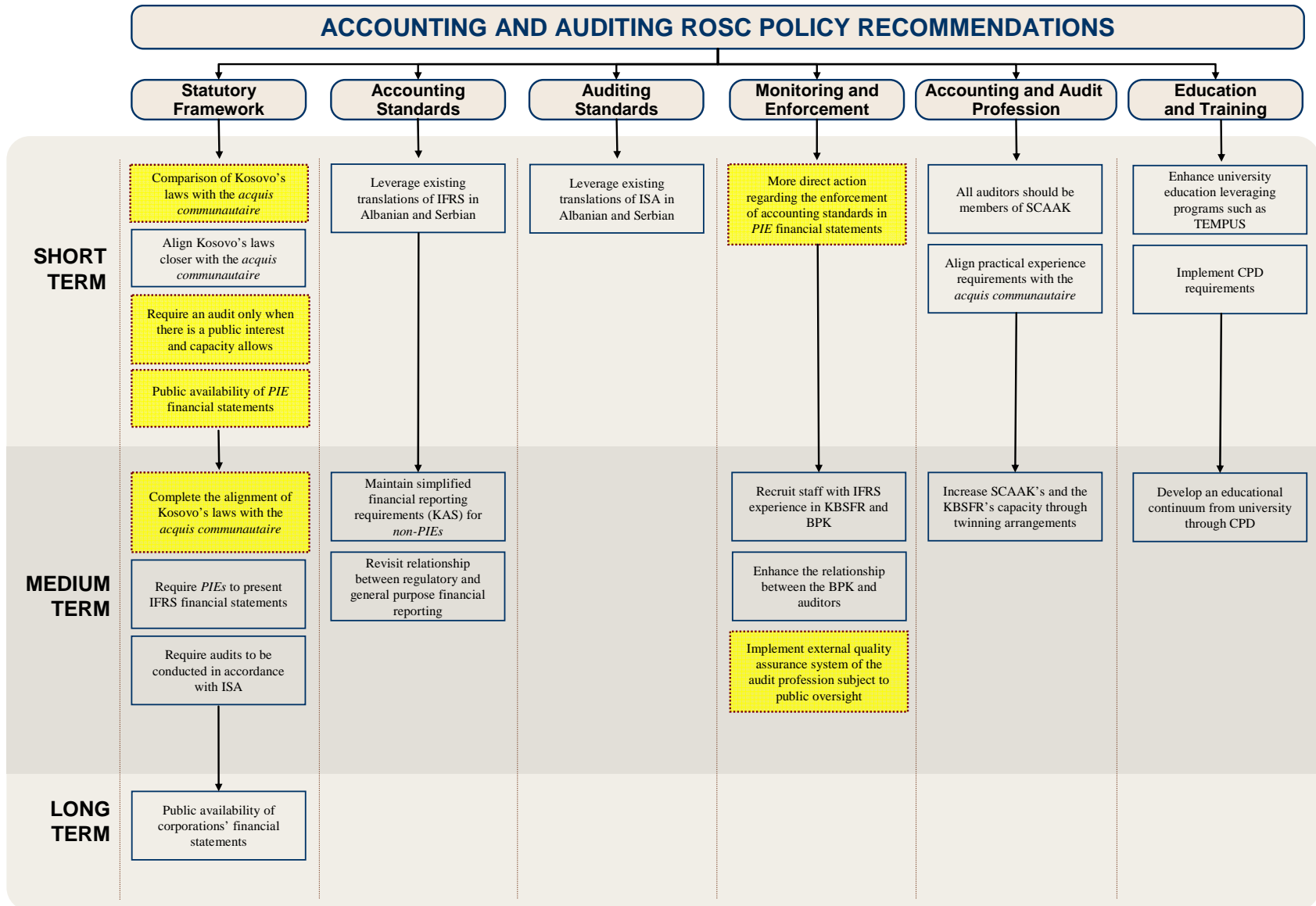
Main Recommendations


While all the policy recommendations set forth in Section VI of this report are important, the ROSC team has identified a number of recommendations that it considers to be “critical success factors” owing to their extreme importance for financial system stability, economic growth (including mobilization of investment capital) and the fight against corruption. These critical recommendations, explained below and sequenced in Figure 1, fall under the six major pillars of the accounting and auditing infrastructure. Each of these, in turn, plays a major role in shaping the overall accounting and auditing culture and environment:

- **Enhance the proposed amendments to the Law on Financial Reporting to align the Law closer to the *acquis communautaire* (short to medium term):** Kosovo should phase in the introduction of the *acquis*’ requirements, including those of the new Eighth EU Company Law Directive, in such a manner as to ensure that the institutional framework is capable to support their implementation:
- **Require audits only when there is public interest and capacity allows (short term):** The number of entities subject to a statutory audit requirement should be commensurate with the number of available qualified auditors. Policymakers should phase in statutory audit requirements with a view to ensuring that they do not overburden Kosovo’s audit capacity.
- **Require that audited financial statements of *public interest entities* (short term) and other corporations (longer term) be available to the public:** Requiring the public availability of the full set of financial statements, including notes, is important for several reasons. First, public availability of financial statements protects third parties (including creditors, suppliers, employees, etc.), as it reduces the asymmetry of information between firms and third parties. Second, it helps to protect the public from potential negative economic impact; this would be relevant, for example, in the case of economically significant companies, where their actions and/or demise could have a significant negative impact on the local economy. Finally, it promotes improved allocative efficiency, both within firms and in the economy, as managers and investors would be better able to distinguish between good and bad investment opportunities and business operations.
- **Take more direct action with regard to the monitoring and enforcement of accounting and reporting standards by *public interest entities* (short term):** While a review of the

financial information of these enterprises showed very significant obstacles to compliance with IFRS, which are beyond their control, the review noted widespread non-compliance with IFRS requirements resulting from lack of capacity or willingness to comply on the part of preparers.

- **Establish and implement external quality assurance of the audit profession and disciplinary systems, subject to public oversight (medium to long term):** The KBSFR should have the authority and capacity to oversee SCAAK. SCAAK should establish a quality assurance system for the audit profession. The KBSFR should ensure that the quality assurance system is, in fact and appearance, an exercise with sufficient public integrity. The results of the external quality assurance system should feed into the Continuing Professional Development program and/or the disciplinary system, as appropriate.



 critical success factors

MAIN ABBREVIATIONS AND ACRONYMS

ACCA	Association of Chartered Certified Accountants (United Kingdom)
BPK	Banking and Payments Authority of Kosovo
CESR	Committee of European Securities Regulators
EDCOM	Education Committee of IFAC (now IAESB)
EEA	European Economic Area
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IAASB	International Auditing and Assurance Standards Board
IAESB	International Accounting Education Standards Board (formerly EDCOM)
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IASCF	International Accounting Standards Committee Foundation
IEKA	Institute of Authorized Chartered Auditors (Albania)
IES	International Education Standard
IFAC	International Federation of Accountants
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IPSAS	International Public Sector Accounting Standards
ISA	International Standards on Auditing
KAS	Kosovo Accounting Standards
KBSFR	Kosovo Board on Standards for Financial Reporting
KTA	Kosovo Trust Authority
MEF	Ministry of Economy and Finance
NSA	National Standards on Auditing
PIE	Public Interest Entity
PISG	Provisional Institutions of Self-Government
POE	Publicly-Owned Enterprise
ROSC	Reports on the Observance and Standards of Codes
SCAAK	Society of Certified Auditors in Kosovo
SEEPAD	South East Europe Partnership for Accountancy Development
SFRY	Socialist Federal Republic of Yugoslavia
SME	Small and Medium-sized Enterprise
SMO	Statement of Membership Obligation
SOE	Socially-Owned Enterprise
SSA	Stabilization and Association Agreement
TEMPUS	Trans-European Mobility Scheme for University Studies
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNMIK	United Nations Mission in Kosovo
UNSCR	United Nations Security Council Resolution

I. INTRODUCTION

1. This assessment of accounting and auditing practices in Kosovo is part of a joint initiative of the World Bank and International Monetary Fund (IMF) to prepare Reports on the Observance of Standards and Codes (ROSC). The assessment focuses on the strengths and weaknesses of the accounting and auditing environment that influence the quality of corporate financial reporting and involves a review of both mandatory requirements and actual practice. It uses International Financial Reporting Standards (IFRS)¹ and International Standards on Auditing (ISA)² as benchmarks and draws on international experience and good practices in the field of accounting and auditing regulation. The assessment also has regard to the relevant requirements of EU law, the *acquis communautaire*.³

2. Following the end of the Kosovo war of 1999, United Nations Security Council Resolution (UNSCR) 1244 placed Kosovo under temporary United Nations (UN) administration. Since then Kosovo has developed and continues to develop instruments and institutions necessary to implement an independent economic policy. The economy inherited in 1999 had been damaged by poor economic policies, broken external trade and financial links, international sanctions, a lack of investment and ethnic conflict. The macroeconomic data indicate that there has been recovery of economic activity and positive growth since 2000.⁴ Kosovo has an estimated population of 2 million as of 2005. The gross domestic product (GDP) per capita is estimated as EUR 1,105 as of 2005. The use of the euro as the de facto local currency has eliminated exchange rate volatility and stabilized inflation at a low level.

3. In November, 2005, the UN appointed a Special Envoy for Kosovo, former President Ahtisaari of Finland, with a mandate to initiate negotiations on the final status of Kosovo between the Government of Serbia and representatives of the Provisional Institutions of Self-Government (PISG) in Kosovo. These negotiations started in March, 2006, and are ongoing at the time of writing (June 2006). Until Kosovo's final status is clarified and new legislation is passed and enforced, the investment Kosovo needs in order to provide jobs for its population, which is one of the youngest and fastest growing in Europe, will be hampered.

4. There are currently three basic classes of enterprises in Kosovo: privately-owned enterprises, which make up the majority of the enterprise sector by number and share of output; Publicly-Owned Enterprises (POEs); and Socially-Owned Enterprises (SOEs). The distinction between POEs and SOEs – which together comprise the public enterprise sector – is a feature of the pre-March 23, 1989 Socialist Federal Republic of Yugoslavia (SFRY) commercial legal

¹ 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.

² International Standards on Auditing (ISA) are the standards issued by the International Auditing and Assurance Standards Board of the International Federation of Accountants (IFAC).

³ The relevance of the *acquis communautaire* for Kosovo is twofold. First, and perhaps most importantly, because it represents a high-quality model for the regulation of accounting and auditing, which may be applied to countries of differing characteristics. Second, the adoption of the *acquis communautaire*, as it pertains to accounting and auditing, would be instrumental to further Kosovo's keen interest in deepening economic association with the EU.

⁴ Refer to Kosovo Economic Memorandum, World Bank, May 2004.

regime that was reinstated in Kosovo by UNMIK in December, 1999.⁵ Under that regime, POEs corresponded roughly to state-owned enterprises in other socialist countries, but social ownership was a concept unique to the SFRY, in which enterprises were owned neither by the state, nor by employees, but by “society.”

5. There are currently 23 POEs⁶ and an estimated 400 to 500 SOEs in Kosovo. POEs include large entities operating in key sectors of the economy (e.g., utilities, telecommunication). The exact number of SOEs is a matter of uncertainty because of the current difficulty of determining enterprise ownership status. Of those enterprises that were classified as SOEs before March 23, 1989, a significant number underwent ownership transformations – typically privatizations or mergers with other enterprises – during the 1990s. According to current UNMIK regulations, such enterprises are nevertheless deemed still to be independent SOEs if these transformations were either in contravention of applicable law, or discriminatory. The process of investigating whether these two conditions hold for individual enterprises is ongoing.⁷

6. The regulation and management of all POEs and SOEs are currently powers reserved to UNMIK. After a period during which UNMIK itself exercised these powers, the Kosovo Trust Agency (KTA) was established in 2002 as an autonomous agency to which they were delegated. The KTA has also been responsible for a process of privatizing SOEs that was initiated in 2003. POEs are not included in this process; and none have been privatized to date.

7. This report assesses the quality of financial reporting by POEs and SOEs and makes recommendations for improvement. High quality financial reporting would provide policy-makers with more reliable financial information to address the fiscal burden associated with POEs and SOEs, including (i) transfers from the budget (equivalent to 3.2 percent of GDP over the period 2000-05, i.e. EUR 460 million), (ii) loans from the budget,⁸ (iii) transfers from international donors (EUR 610 million over the period 2000-04), and (iv) the non-payment of taxes (EUR 30.4 million). This report also covers the role of financial reporting in the context of the ongoing privatization of SOEs and of the assessment of management performance in POEs.

8. The banking sector plays a very limited role in the financing of the Kosovo economy. The main sources of financing for Kosovar enterprises are retained earnings and informal, family-generated funding. A significant level of seed financing as an intermediate level of borrowing is also lacking. However, loans to the private sector increased rapidly from 10% of GDP in 2003 to 23% of GDP in 2005. The local banks remain very liquid, with a deposit-to-loan ratio of 181% by the end of 2004, pointing to a sufficiently strong refinancing base for further expansion of their loans’ portfolio. At the end of 2005 there were seven banks operating in Kosovo. Two of these, whose majority shares are owned by foreign banks, made up 66% of the market assets.

⁵ UNMIK Regulation 1999/24. The legal definition of POEs and SOEs is given in the Law on Enterprises of the SFRY 77/88.

⁶ These 23 POEs are Kosovo Electricity Corporation, Post and Telecommunication of Kosovo, UNMIK railways, Pristina airport, two district heating enterprises (in Gjakova and Pristina), and 17 water, waste and irrigation enterprises.

⁷ Refer to Public Expenditure and Institutional Review, Volume II, World Bank, June 2006.

⁸ POEs face difficulties in accessing commercial finance as a result of, among others, unreliable financial performance. To address this market failure the PISG and UNMIK began inter-governmental lending to two enterprises in 2005 of EUR 10 million and EUR 12 million to Kosovo Electricity Corporation and Pristina Airport respectively. The terms and conditions of these loans were not on a commercial basis.

9. As of the end of 2005, eight licensed insurance companies have operations in Kosovo, four of which are domestic and four of which are of foreign origin. Furthermore, six licensed supplementary pension funds were in existence by the end of 2005 with a recorded 4,197 participants. As yet, no capital market exists in Kosovo.

10. Kosovo attracted EUR 66 million of foreign direct investment (FDI) in 2005, equivalent to 3 percent of GDP. Although this represented a substantial increase compared to previous years, sizeable FDI inflows that could fuel sustained economic growth are lacking. As of 2004, 593 companies in Kosovo are under either foreign or mixed ownership. Additionally, more than 90% of this foreign investment flows to enterprises with 10 or less employees.

11. Developing a solid private sector that can attract foreign direct investment is a major focus of Kosovo's economic agenda. The reform efforts, which were made on the legislative front with the new Law on Foreign Investment establishing an Investment Promotion Agency, are further enhanced by Kosovo's participation in the European Charter for Small Enterprises. This charter sets forth a framework for promoting small enterprises in Europe, recognizing them as key drivers of economic growth. Within the charter's goals is the achievement of a "regulatory, fiscal and administrative framework conducive to entrepreneurial activity and [the improvement of] the status of entrepreneurs".

II. INSTITUTIONAL FRAMEWORK⁹

A. Statutory Framework

12. **This report addresses financial reporting by corporations (i.e. companies in which shareholders have limited liability) as well as by POEs and SOEs (refer to Paragraph 7 above).** The formation and regulation of business entities in Kosovo is governed by UNMIK Regulation 2001/6 (2001) on Business Organizations ("the Law on Business Organizations"), which sets out that a business organization may be established as a personal business enterprise, a general or a limited partnership, or a corporation. A corporation may be incorporated as a joint stock company or a limited liability company:

- A joint stock company is a corporation, which may have any number of shareholders as well as different classes of shareholders. A joint stock company may conduct a public offering of its shares and the owner(s) may transfer his/her (their) shares without the approval of other shareholders or the company. The minimum initial capital of a joint stock company must be at least EUR 25,000.

The general meeting of shareholders is the ultimate governing body of a joint stock company. The board of directors is responsible for ensuring compliance with applicable laws and accounting standards. The board is also responsible for the preparation and presentation of the annual report, which must include the financial statements of the joint stock company together with the auditor's report.

- A limited liability company is a corporation, the shares of which are distributed only to its founders or among other pre-determined persons. The number of shareholders in a limited liability company is limited to 50. A limited liability company cannot conduct a public offering of its shares. Unless otherwise provided by the charter or by laws, a shareholder of a limited liability company who wishes to sell his shares first

⁹ 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.

offers them to the other shareholders and could only sell his shares to the third parties with the approval of the company.

The ultimate governing body of a limited liability company is also a general meeting of its shareholders. Unless there are less than 20 shareholders, a limited liability company also appoints a board of directors.

The banking and insurance laws require banks and insurance companies to be incorporated as joint stock companies. Because of the nature of their activities, this report regards these financial institutions as *public interest entities*.

As of the date of this report there are approximately 90 joint stock companies and 2,100 limited liability companies registered with the business registry.

13. The Kosovo Board on Standards of Financial Reporting (KBSFR) has the authority to regulate accounting and auditing in Kosovo. However, the KBSFR has so far lacked the capacity to exercise its regulatory authority, which resulted in significant implementation issues. UNMIK Regulation 2001/30 (2001) on the Establishment of the KBSFR and a Regime for Financial Reporting in Business Organizations (“the Law on Financial Reporting”) establishes the framework for accounting and auditing in Kosovo. The KBSFR is responsible for:

- determining the accounting and auditing standards;
- setting out the accounting and auditing requirements for the financial statements of business organizations including corporations established under the Law on Business Organizations, SOEs, and POEs;
- establishing and issuing standards for accountant and auditor professional training leading to the certification of accountants and the licensing of auditors; and
- issuing and reviewing audit licenses.

However, even though UNMIK Regulation 2001/30 laid out a basic regulatory structure, the KBSFR has been unable to exercise its authority, as mentioned above.

14. Since the Law on Financial Reporting is in the process of being amended, there is a window of opportunity to align it closer to the *acquis communautaire* while avoiding imposing on the business and regulatory community requirements which are not warranted from a cost/benefit point of view. Recognizing the areas for improvement in the current regulatory framework, the Ministry of Economy and Finance (MEF) is considering amendments to the Law on Financial Reporting that would strengthen the oversight of the accounting profession and further clarify the roles and responsibilities of the KBSFR. Specifically, this provides an opportunity to use the exemptions provided for in the *acquis communautaire* to avoid imposing an irrelevant financial reporting and statutory audit burden on small and medium-sized enterprises (SMEs) while mandating and enforcing stricter financial reporting by *public interest entities*. In Kosovo, these would likely include financial institutions and POEs. Section VI – Policy Recommendations elaborates on these introductory comments.

15. While this report concurs that small enterprises should be subject to simplified financial reporting requirements, the current thresholds (total assets and turnover) are not an adequate proxy for categorizing enterprises. The Law on Financial Reporting requires all corporations (except “small corporations”),¹⁰ POEs, and SOEs to prepare their financial statements in conformity with Kosovo Accounting Standards (KAS) issued by the KBSFR or IFRS. This report takes the view that a three-tiered financial reporting structure should be adopted

¹⁰ “Small corporations” are defined as corporations which have an annual turnover of less than EUR 100,000 and total assets of less than EUR 50,000.

with *public interest entities*¹¹ (PIEs) eventually applying IFRS, SMEs applying simplified financial reporting requirements, and micro enterprises continuing to apply tax based rules.¹² Such an approach would remove the problem of applying KAS or IFRS in organizations for which they were not designed or intended. In categorizing enterprises as large, SMEs, or micro enterprises, a combination of indicators (e.g., annual turnover, total balance sheet, and workforce) should be used. In addition, the level of the current threshold should be increased. The authorities have an opportunity to address this issue in revising the Law on Financial Reporting.

16. **The scope of statutory audit requirements is too broad in Kosovo considering the stage of development of the audit profession.** The Law on Financial Reporting requires that the financial statements of all corporations which have an annual turnover or total assets greater than EUR 250,000, POEs and SOEs be audited in accordance with auditing standards published by KBSFR (refer to Paragraph 43 below). The scope of these statutory audit requirements has three unintended consequences:

- It results in an imbalance between the demand for audit resulting from statutory audit requirements and the availability of qualified statutory auditors. The number of entities for which a statutory audit is required should be commensurate with the number of available auditors and consistent with the audit profession’s current stage of development.
- It imposes a statutory audit burden on companies whose size or activities do not warrant such an audit, i.e. there is no public interest in mandating such an audit.
- It adversely impacts (perceived) audit quality, since experience shows that quality is greater when limited resources are focused on ensuring compliance by a small number of larger entities.¹³ Also, there are inherent limitations on the ability to perform a proper audit of many smaller entities because of the ability of owner/managers to override internal controls.

The authorities have an opportunity to address this issue in revising the Law on Financial Reporting, leveraging the exemptions set out in the Fourth EU Company Law Directive.

17. **Shareholders appoint the statutory auditor from the auditors licensed by the KBSFR.** Additional requirements apply to the audit of the financial statements of banks and insurance undertakings (refer to Paragraph 22 below). Unlike in certain EU Member States, the Law on Financial Reporting does not include any termination mechanisms that could provide additional safeguards to auditor’s independence. Hence, a statutory auditor may resign or be dismissed to avoid an audit qualification.

18. **The Law on Financial Reporting and KAS set out the components of an entity’s financial statements. These are summarized in the table below:**

Type of Organization	Balance sheet	Income Statement	Cash Flow Statement	Statement of Changes in Equity	Notes	Audit Report	Refer to Paragraph
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¹¹ Within this report the term *public interest entity* is used to refer to those entities in which the general public has an interest by virtue of the nature of their business (e.g., financial institutions), their size, or their range of stakeholders (e.g., publicly-traded companies).

¹² Such a tiered structure is consistent with the approach of many EU Member States and with the approach proposed by United Nations Conference on Trade and Development (UNCTAD); details of which can be found at www.unctad.org/en/docs/itete20035_en.pdf.

¹³ Refer to *Implementation of International Accounting and Auditing Standards: Lessons Learned from the World Bank’s Accounting and Auditing ROSC Program*, Hegarty, Gielen, Hirata Barros, World Bank, September 2004.

Corporations (except small corporations and banks and insurance undertakings)	Yes	Yes	Yes	Yes	Yes	Yes	15
Small corporations	Yes	Yes	No	No	No	No	15
POEs	Yes	Yes	Yes	Yes	Yes	Yes	15
SOEs	Yes	Yes	Yes	Yes	Yes	Yes	15
Banks	Yes	Yes	Yes	Yes	Yes	Yes	20
Insurance undertakings	Yes	Yes	Yes	Yes	Yes	Yes	20

19. **Audited financial statements are not readily and publicly available.** The Law on Financial Reporting requires that all corporations (other than small corporations), POEs,¹⁴ and SOEs submit their (audited) financial statements to the business registry and the MEF. On the one hand, the level of compliance as determined by the business registry is approximately 50 percent, which results in part from ineffective disincentives to noncompliance (e.g., the sanction mechanism). On the other hand, (audited) financial statements filed with the business registry are not publicly available. The consequences of this non-availability are as follows:

- Stakeholders other than shareholders (e.g., trade creditors, lenders, etc.) may not have access to (audited) financial statements, which may hinder their decision-making ability. Research shows that this may hinder resource allocation, cross-border trade, and creditor protection.¹⁵
- It inhibits market incentives for greater compliance with accounting and audit requirements. In the absence of market demand for financial information, preparers and auditors have less incentive to apply the capacity that is required to prepare quality financial statements and carry out a proper audit.

In addition, these requirements fall short of the Fourth and Seventh EU Company Law Directives, which require most companies with limited liability to make their audited (consolidated) financial statements available to the public through a business registry system or its equivalent. As discussed in Section VI, this report favors making (audited) financial statements available but recommends that this requirement be phased in so as to avoid that misleading financial statements have yet a broader diffusion.

20. **Banks and insurance undertakings are required to prepare their financial statements in accordance with “IFRS and the accounting requirements set forth by the Banking and Payments Authority of Kosovo (BPK),” which results in conflicting requirements, falling short of “full IFRS.”** UNMIK Regulation 1999/21 on Bank Licensing, Supervision and Regulation (the “Law on Banks”) and UNMIK Regulation 2001/25 on the Licensing, Supervision and Regulation of Insurance Undertakings and Insurance Intermediaries (the “Law on Insurance”) require banks and insurance undertakings to present their financial statements in conformity with IFRS and other accounting requirements set out by the BPK. The BPK sets out recognition and measurement principles as well as disclosure requirements which differ from “full IFRS” (e.g., with respect to the measurement of loan impairment). Hence, even though the Law on Banks and the Law on Insurance make direct reference to IFRS, compliance with BPK requirements takes precedence (refer to Paragraph 42 below). This precludes successful implementation of IFRS in the banking and insurance sector. While preparers may have the option of voluntarily preparing additional financial statements in which full compliance with IFRS can be achieved, this has negative cost implications and also raises uncertainties

¹⁴ The KTA makes the audited financial statements of POEs available on its web site.

¹⁵ Refer to *A Cross-Country Analysis on the Impact of Public Disclosure of Financial Statements for Non-Listed Firms*, Gielen, Hirata Barros, World Bank, August 2006 (*to be released*).

among users as to which are the “real” figures. In addition, financial statements prepared and audited on a voluntary basis typically would fall outside the scope of Kosovo’s regulatory regime, thereby reducing the reliance users could place on them. Section VI – Policy Recommendations proposes a generally accepted model to reconcile the priorities of financial sector regulators and other users of financial statements, including shareholders.

21. **The Law on Banks requires bank financial statements to be published and to be provided to the public upon request.** A bank is required to publish in a national newspaper its audited financial statement and the auditor’s opinion within four months of the year end. The Law is silent as regards the notes to the financial statements. A bank is also required to publish an annual report and make it available to public upon request.

22. **The appointment of a bank or insurance undertaking statutory auditor is subject to BPK’s approval.** The approval by the BPK is based on the following conditions:

- The audit firm must have been duly licensed by the KBSFR and be a member of Society of Certified Accountants and Auditors in Kosovo (SCAAK). A foreign audit firm is eligible for the conduct of a statutory audit in Kosovo if it is duly licensed in an EU or European Economic Area (EEA) Member State.
- The approval is granted for a given financial institution’s audit in a given year, i.e. an audit firm may be approved as the auditor of several financial institutions but it is necessary for a separate approval to be granted to a firm for the audit of each financial institution for a financial year.
- The audit firm must provide the BPK with (1) an audit program for the audit of the financial institution and (2) a description of the use of resources in the audit mission.

In practice, the financial statements of all banks and insurance undertakings are audited by the local member firms of major international audit firm networks or their member firms in EU or EEA Member States. While this report confirms that audit quality is generally above average in the banking and insurance sector, the report was unable to conclude as to what the actual influence of this “ex ante” approval process on audit quality is in these two sectors, since many other factors also influence the relative greater quality of audit in the banking and insurance sectors.

B. The Profession

23. **The accounting and audit profession in Kosovo is at a very early stage of its development.** The Federal Ministry of Finance in the former SFRY governed the approval of programs for professional certification, the organization of examinations and issue of certificates, and also maintained a register of audit firms and certified auditors. Since the implementation of UNSCR 1244 following the end of the war in 1999, the Law on Financial Reporting established a new framework for audit regulation in Kosovo. Under this new framework, the two leading institutions in the area of accounting and auditing are the KBSFR and SCAAK, which were established in 2001. However, the Financial Reporting Law does not require licensed auditors to be members of SCAAK. In the absence of such a requirement, the KBSFR is the only institution which has the authority to regulate and monitor the audit profession.

24. **As discussed in Paragraph 13 above, the KBSFR has not yet developed the capacity to carry out its mandate.** As yet there is no formal mechanism designed to protect the public interest through ensuring that licensed auditors possess the education, experience, qualifications and knowledge of ethical and professional standards to discharge the role of independent auditor. Although the Law on Financial Reporting provides for funding of the KBSFR through the

Kosovo consolidated budget, it appears that the level of funding is inadequate for the discharge of the KBSFR's responsibilities. For example, the KBSFR has not carried out the triannual review of certification and licensing procedures, as required by the Law on Financial Reporting. In addition the KBSFR is required to provide technical guidance and information to business organizations concerning applicable accounting and auditing standards, though the KBSFR has not as yet developed the technical capacity to discharge this role as the majority of the KBSFR's technical employees are accounting students.

25. **The KBSFR has recognized SCAAK as Kosovo's professional accountancy body.** In the relatively short period since its establishment in 2001, SCAAK has established a qualification program for accountants that is in accordance with the requirements of the Law on Financial Reporting and has become an associate member of IFAC.

26. **With just 173 members, comprising 75 auditors and 98 certified accountants as of June 15, 2006, SCAAK lacks the capacity to generate sufficient revenues from membership subscriptions in the short to medium term to put in place the systems and structures implied by IFAC Statements of Membership Obligations (SMOs).**¹⁶ The level of annual subscription is quite low and collection rates remain low, and SCAAK relies upon training fees paid by students to fund its operation and development. Though public and private sector employers have expressed support for services provided by SCAAK and the need for the development of a cadre of skilled accounting technicians and accountants, the lack of a tradition of external auditing in Kosovo and the wider region, and the legacy of a culture of control, has contributed to a general lack of awareness in the business and wider community of the potential benefits of the audit, and the potential importance of the role of a well qualified accountant in the economic development of Kosovo.

27. **In spite of its limited resources and short history, SCAAK has completed the short-term recommendations published by IFAC in its Member Body Toolkit, which provides guidance and advice on establishing and developing a professional accountancy body.**¹⁷ The Toolkit sets out short, medium and longer term priorities for new professional accountancy bodies. SCAAK should now focus upon the medium and longer term priorities which are:

- Provision of Continuing Professional Development (CPD) and training,
- Regulation and monitoring of members in public practice, and
- Establishment of disciplinary procedures.

28. **As evidenced by the large size of the expatriate accounting community, there is a shortage of qualified Kosovar accountants and auditors who could serve the needs of Kosovo's growing economy.** The current pool of auditors is not even sufficient to cover the needs of non-governmental organizations (which are required to submit audited financial statements to their donors), financial institutions (which are required to submit audited financial statements to the BPK), and POEs (which are required to have audited financial statements in accordance with the requirements of the KTA). This lack of qualified auditors, which is compounded by unreasonably far-reaching statutory audit requirements (refer to Paragraph 16

¹⁶ SCAAK is an associate member of IFAC and is required to comply with the seven SMOs, which are benchmarks used for assisting IFAC members in ensuring high quality performance of their individual members.

¹⁷ This good practice guidance covers the roles and responsibilities of a professional accountancy body, education and examination and capacity development. It is available at www.ifac.org/DevelopingNations.

above), results in widespread non-compliance with those statutory audit requirements by private sector firms and SOEs. Two international audit firm networks have offices in Kosovo. These firms, along with the Macedonian offices of the other international audit firm networks, dominate the market for the statutory audit of financial institutions and POEs.

C. Professional Education and Training

29. **The curriculum at the Faculty of Economics of the University of Pristina and the equivalent on offer at private universities in Kosovo do not provide an adequate basis for professional education and training for accountants and auditors.** The finance, banking and accounting subjects that are available to students comprise a single semester course in rules-based financial accounting, a single semester elective course in introductory management accounting, a single semester elective in auditing and several theoretical courses in financial management. The curriculum has not been updated and there is an acute shortage of modern educational materials in the local languages. The demand for university education is robust however. For example, in 2005 the University of Pristina received 50 percent more valid applications than places for its courses in all subjects.

30. **As discussed in Paragraph 13 above, the KBSFR is responsible for, *inter alia*, the licensing of auditors.** Though there is no reference in the Law on Financial Reporting to persons who held certificates or licenses issued under the former SFRY regulations, the KBSFR was permitted to issue audit licenses for a 12 month transitional period to persons who possessed a minimum of three years' relevant accounting experience and passed examinations in two auditing related subjects. A total of 11 individual audit licenses were issued by the KBSFR during the transition period, and since then a further 40 individual licenses have been issued in accordance with the provisions of the Law on Financial Reporting. The Law states that an applicant must be a "certified accountant," and must pass two examinations in auditing administered by a professional auditing body, i.e. SCAAK (refer to the following Paragraph for a description of SCAAK's system). There is no requirement that an auditor remains a member of the professional auditing body.

31. **SCAAK has established a certification program that complies with the Law on Financial Reporting. However, it falls short of the requirements of the new Eighth EU Company Law Directive with respect to statutory auditors (refer to Paragraph 32 below) and International Education Standards (IESs) with respect to accounting technicians and certified accountants.**¹⁸ The SCAAK certification program, for which SCAAK has developed training materials, comprises three qualifications as follows:

Qualification	Entry Requirement	Exam Requirement	Experience Requirement
Accounting Technician (as of June 15, 2006, there were 198 accounting technicians)	<ul style="list-style-type: none"> • Same as for admission to University diploma 	<ul style="list-style-type: none"> • Financial accounting 1 • Cost accounting • Management information systems • Financial accounting 2 • Commercial law 	One year of accounting experience
Certified Accountant (as of June 15, 2006, there were 98 certified accountants)	<ul style="list-style-type: none"> • A University degree in any discipline, and • Completed accounting technician 	<ul style="list-style-type: none"> • Financial accounting 3 • Financial accounting 4 • Introduction to auditing • Ethics 	Proof of at least three years of accounting experience

¹⁸ IESs are issued by IFAC's International Accounting Education Standards Board (IAESB).

	examinations	<ul style="list-style-type: none"> • Business case Study 	
Auditor (as of June 15, 2006, there were 75 licensed auditors, including 11 “grandfathered” auditors)	<ul style="list-style-type: none"> • A University degree in any discipline • Completed certified accountant stage 	<ul style="list-style-type: none"> • Advanced auditing 1 • Advanced auditing 2 	Proof of at least three years of accounting experience

The SCAAK curriculum for accounting technicians, certified accountants and auditors was established in 2001 and has attracted nearly 2000 applicants, indicating a strong demand for professional training. The Law on Financial Reporting proposes two important amendments, which would enhance the system of approval of statutory auditors in Kosovo, i.e.:

- Future auditors would be required to complete a period of at least three years under a licensed auditor. This requirement is consistent with the *acquis* requirement regarding practical training. Under the *acquis*, at least two thirds of such practical training shall be completed with a statutory auditor or audit firm approved in any EU Member State.
- All licensed auditors would be required to remain members in good standing of a professional auditing body. This requirement is consistent with the *acquis* requirement for a statutory auditor to be of “good repute.”

Despite the shortcomings noted below with respect to compliance with IESs, SCAAK’s achievements in the relatively short period since its establishment attest to its willingness and determination to improve the Kosovar accountancy profession.

32. The SCAAK program does not address the following core topics identified in the Eighth EU Company Law Directive with respect to the professional education requirement for statutory auditors:

- IFRS;
- legal requirements and standards relating to the preparation of legal entity and consolidated financial statements;
- risk management and internal control;
- auditing and professional skills (the existing courses are limited in scope);
- legal requirements and professional standards relating to statutory audit and statutory auditors;
- ISA; and
- professional ethics and independence.

These core topics are particularly important in light of the weaknesses in university education noted in Paragraph 29 above. They are indispensable to meet the required breadth and depth of competence that auditors should apply to meet the developing needs of the business community.

33. The SCAAK entry requirements to the program of professional education for accountants and auditors is in compliance with IES 1, *Entry requirements to a program of professional education*, but the content of the professional accounting education program falls short of complying with IES 2, *Content of Professional Education Programs*. The major weaknesses include financial accounting programs, which have been developed in accordance with KAS. Consequently there is no coverage of “full IFRS.” In addition, auditing is not taught and examined based on “full ISA”, but based on an outdated Albanian translation (refer to Paragraph 43 below). Coverage of management accounting is also weak. Though accountants are perceived in the economy as compliance workers, their potential as management accountants capable of adding value to enterprises through the application of business planning, budgeting,

control, decision-making and strategic management can be enhanced if further attention is given to management accounting subjects in the professional education program.¹⁹

34. **SCAAK has not implemented a system of pre-approval, monitoring or effective control of the quality of experience obtained by accountants and auditors, which is a requirement of IES 5, *Practical Experience Requirements*.** As discussed in Paragraph 31 above, the proposed amendments to the Law on Financial Reporting will address this issue in line with the spirit of the new Eighth EU Company Law Directive.

35. **The examination policies of SCAAK were modeled, in part, on the Examination Administration Advisory document provided by IFAC, and meet the requirements of IES 6, *Assessment of Professional Capabilities and Competence*.** SCAAK has implemented measures to provide anonymity for candidates, to ensure that persons engaged in providing the courses are not involved in the setting or administration of examinations, and to protect the integrity of the examination process. There is scope for further improvement in examinations, for example, the introduction of standard examination formats and rubric, detailed and consistent marking schemes, an annual examination timetable and a structure that will further reduce threats to examination security and integrity. For example, given the relatively small pool of potential tutors and examiners, the procedures for maintaining anonymity of candidates and independence of examiners remain a risk area.

36. **Accountants and auditors are not required to take part in programs of continuing professional development (CPD).** This is a particularly important area for improvement in order to ensure that accountants and auditors maintain (or increase) their theoretical knowledge, professional skills and values at (to) a sufficiently high level. IES 7, *Continuing Professional Development* has introduced a CPD requirement for all accountants and auditors.²⁰ The authorities are planning to address this issue in revising the Law on Financial Reporting. The introduction of CPD will provide an opportunity for the profession to identify and address specific knowledge and skills gaps and thus improve audit quality through mandatory CPD in respect of statutory auditors. The introduction of CPD for accountants in business provides a similar opportunity.

37. **There is a small number of students studying for the qualification issued by the U.K. Association of Chartered Certified Accountants (ACCA).** The ACCA English language professional accounting qualification is promoted by a number of POEs managed or advised by expatriate staff, as well as by the member firms of international audit firm networks for those employees who have sufficient English language skills. The ACCA program offers Kosovo an opportunity to replace eventually the more expensive internationally qualified foreign accountants with similarly qualified Kosovars, though this option is limited to students with the requisite English language skills to study the program, and an employer capable of providing encouragement, mentoring, financial support and professional experience.

D. Setting Accounting and Auditing Standards

¹⁹ Further enhancements are also required to align SCAAK's system with IES 3, *Professional Skills* and IES 4, *Professional Values, ethics and attitudes*. Specifically, though the program does cover ethics as a separate subject, which meets the spirit of the requirement of IES 4, the version upon which the course is based is an outdated version of the IFAC Code of Ethics which falls short of the current IFAC requirements, especially as they relate to the independence requirement.

²⁰ The new Eight EU Company Law Directive has also introduced this requirement for auditors.

38. **While the Law on Financial Reporting requires the KBSFR to issue Kosovo Accounting Standards which comply with IFRS, after taking into consideration the business environment in Kosovo, the current structure and resources of the KBSFR are inadequate to enable the Board to comply fully with its mandate.** The Law on Financial Reporting states that the KBSFR must determine which IFRS apply after taking into consideration the business environment in Kosovo. The KBSFR issued 19 KAS in October 2001 which are simplified versions of the equivalent IFRS applicable at that time. However, since donor support was not prolonged, and a sustainable standard setting procedure was not established, the KBSFR has been unable to update KAS as changes in IFRS were made by the IASB and Kosovo's economy developed.

39. **The current staffing of KBSFR's secretariat is inadequate to allow the KBSFR to regulate accounting and auditing effectively.** The KBSFR has seven board members, of which one is nominated by the BPK and the remaining six are nominated by the Ministry of Economy and Finance. The Law on Financial Reporting requires that the members nominated by the Ministry be from the business community and the Department of Economics of the University of Pristina. In 2005, the Board met on a monthly basis but its discussions centered on the licensing of auditors (one of its responsibilities as discussed in Paragraph 13 above) rather than accounting standard setting. The KBSFR has offices within the Ministry. The Board's secretariat employs seven staff members who do not hold any accounting or audit qualification.²¹ In addition, these issues are unlikely to be addressed in the short- to medium-term, since the KBSFR may be unable to retain its staff members once they are duly qualified. Among other factors, the Board secretariat's inability to hire (and retain) qualified personnel is a consequence of the applicable salary scale, which is below market rates.

40. **The Draft Law would significantly enhance KBSFR's structure, governance, and resources.** However, it would greatly benefit from a twinning program or an equivalent arrangement to "import" institutional capacity and to mitigate the risk of regulatory capture. The Draft Law foresees the nomination of the Board members by the Government and their appointment by the National Assembly. The composition of the Board would be one member from the BPK, two members who are professional accountants, two members from the business community, one member from universities and one member from MEF. The Draft Law also proposes KBSFR to have an annual appropriation from the Kosovo consolidated budget.

41. **The requirement to enact KAS in the Albanian and Serbian languages requires a coordinated approach with the Albanian and Serbian standard setting authorities and with the International Accounting Standards Committee Foundation (IASCF), which is currently lacking.** The Law requires the standards issued by the KBSFR to be published and disseminated in Albanian, English, and Serbian with the English version to prevail in the event of conflict. However, the work of the KBSFR is hampered by the lack of a current Albanian translation of IFRS.²² Furthermore, the KBSFR has yet to assess with the IASCF how best to handle translation and copyright issues arising from the development of KAS, which are largely based on IFRS.

42. **The BPK enacts accounting requirements for banks and insurance undertakings, which meet the BPK's prudential objectives but are not always consistent with "full IFRS."**

²¹ Among the seven staff members, five are attending courses organized by SCAAK to become certified accountants.

²² Refer to Report on the Observance of Standards and Codes, Accounting and Auditing, Albania, June 2006.

Obtaining financial information from banks and insurance companies is of paramount importance in the prudential supervision role of the BPK. This may justify giving the BPK the authority to demand that banks prepare their prudential returns using certain measurement principles. However, an issue arises when the Law mandates simultaneous compliance with both IFRS and BPK requirements in the same set of financial statements, since IFRS and BPK requirements differ as regards certain measurement principles (e.g., measurement of loan impairment, valuation of certain assets held in an insurance undertaking's portfolio of investment). The existing standard setting arrangements in the banking and insurance sectors result in uncertainty and may mislead users as to what financial reporting standards actually apply.

43. **The Law on Financial Reporting requires the KBSFR to issue auditing standards in conformity with ISA after taking into account the business and economic environment in Kosovo.** The KBSFR is also required to publish and disseminate them widely in Albanian, English, and Serbian. In 2002, the KBSFR published an Administrative Decision in Albanian, which made application of ISA mandatory for licensed auditors carrying out audits in accordance with the requirements of the Law on Financial Reporting. The ISA adopted in 2002 were the 1999 Albanian language translation of ISA, which has been made available to individual auditors and the KBSFR by the Albanian Institute of Authorized Chartered Auditors (IEKA). No subsequent review or updates have been carried out or mandated by the KBSFR. The KBSFR does not have an ISA translation process of its own, and it did not have any contact with IFAC on ISA translation policy.²³

E. Enforcing Accounting and Auditing Standards

44. **No mechanism currently exists for enforcing compliance with accounting and financial reporting requirements by business organizations.** The KBSFR does not have any enforcement powers²⁴ and, apart for the activities of the BPK with respect to the financial statements of banks and insurance undertakings, there are no other authorities with such powers. Section III of this report notes that there is widespread non-compliance with both IFRS and KAS. It also emphasizes the lack of an effective audit pillar to report on compliance with accounting standards. The proposed amendments to the Law on Financial Reporting would require the KBSFR to enforce compliance with financial reporting requirements, investigate non-compliance and impose appropriate sanctions. While monitoring and enforcement are of paramount importance, these amendments would require a fundamental change in KBSFR's institutional capacity in order to be implemented.

45. **The BPK has not prioritized the monitoring and enforcement of compliance with KAS in the general purpose financial statements issued by banks and insurance undertakings.** The Law on Banks and the Law on Insurance state that the BPK has the authority to supervise banks and insurance undertakings, respectively. However, the priorities of the BPK have been directed towards prudential regulation and supervision rather than the enforcement of accounting standards to be applied to general purpose financial statements. While this establishes a regular review of compliance with applicable regulations, misstatements and errors in general purpose financial statements may remain undetected or may not become known to the public unless prudential considerations warrant.

²³ Refer to "Translation of Standards and Guidance Issued by the International Federation of Accountants," Policy Statement, September 2004.

²⁴ Currently, the KBSFR does not have access to the audited financial statements of corporations.

46. **The BPK has limited capacity to enforce KAS (or IFRS) in the general purpose financial statements of banks and insurance undertakings.** There are currently 17 members of staff in the Insurance Supervision Department and 11 members of staff in the Banking Supervision Department. While they review the statutory financial statements presented by banks and insurance undertakings, the staff only has introductory to intermediate knowledge of the more complex accounting requirements under KAS and IFRS. Consequently, the BPK has developed a policy of relying on audit firms with international affiliations for the audit of banks and insurance undertakings. While such reliance is understandable as a stop-gap measure, it poses two issues in the context of Kosovo:

- It is not supported by an adequate system of external quality assurance subject to public oversight. Consequently, audit firms are essentially not monitored and there is little assurance regarding the quality of their audits other than the reliance on their reputation.
- It does not allow the BPK to increase institutional capacity, since the expertise resides in the audit firms and a mechanism to transfer such expertise is lacking. Based on the fact that a majority of the banking sector is foreign-owned (which tends to lead to increasingly complex instruments being introduced), there is an urgent need to address this issue.

47. **No mechanism currently exists for monitoring and enforcing auditing standards and other audit requirements.** The KBSFR does not have any enforcement powers and there are no other authorities with such powers. SCAAK has not established a quality review scheme for auditors, although a disciplinary committee has been formed to consider complaints. So far this Committee has not dealt with any complaint about auditors. Its activities have been limited to a small number of cases of breaches of examination rules by students. In addition, SCAAK's efforts are partly in vain in the absence of a requirement for auditors to be members of SCAAK. The proposed amendments to the Law on Financial Reporting would empower the KBSFR to investigate non-compliance with the Law and would provide for a system of fines. However, the amendments do not set out how the enforcement mechanism will operate and do not clarify who is responsible for imposing sanctions in cases of non-compliance.

III. ACCOUNTING STANDARDS AS DESIGNED AND AS PRACTICED

48. **The purpose of this section is to perform the accounting *standard gap* analysis and *compliance gap* analysis.** The *standard gap* analysis compares KAS with IFRS in order to identify significant differences, which may adversely impact the reliability of KAS-based financial statements of corporations, including POEs and SOEs. The *compliance gap* analysis focuses on the compliance of the statutory and voluntary/contractual (e.g., required by a lender) financial statements with KAS and IFRS, respectively, in order to identify any shortcomings in the accounting standard monitoring and enforcement pillars in Kosovo.

49. **The review of KAS identified significant differences between KAS and IFRS.** KAS are simplified versions of the equivalent IFRS as at October 2001. Differences between KAS and IFRS that may have a significant impact on the financial statements of corporations, including POEs and SOEs, include:

- ***Impairment of assets may not be recognized.*** There is no KAS equivalent to IAS 36, *Impairment of Assets* which may lead to the overstatement of property, plant and equipment and other non-current assets. The severe difficulties faced by business organizations operating in Kosovo mean that it is likely that many organizations have impaired assets and, therefore, that the carrying amounts of those assets may be overstated.

- ***Liabilities for employment benefits may be understated.*** There is no KAS equivalent to IAS 19, *Employee Benefits* which may lead to the understatement of employee benefit liabilities. While pension schemes based on defined benefits are non-existent for the majority of companies in Kosovo, a few POEs have such plans and/or other one-off retirement payments or other long-term employee benefits.
- ***There is no KAS equivalent of IAS 41, Agriculture.*** Agricultural enterprises apply a transaction-based model and, therefore, do not report any income from biological assets until sale.
- ***KAS do not deal with consolidated financial statements.*** There are no KAS equivalents of IAS 27, *Consolidated and Separate Financial Statements*, IAS 28, *Investments in Associates*, IAS 31, *Interests in Joint Ventures*, IFRS, 3 *Business Combinations* and those parts of IAS 21, *Effects of Changes in Foreign Exchange Rates* which deal with foreign operations. This has two effects. First, a business organization with one or more subsidiaries is not required to publish consolidated financial statements. Second, there is no guidance in KAS for those business organizations, if any, that voluntarily prepare consolidated financial statements.
- ***KAS have not been updated for other new and revised IFRS, including revisions to IAS, issued by the IASB since 2001.*** There are no KAS equivalents of IFRS 4, *Insurance Contracts*, IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*, and IFRS 6, *Exploration for and Evaluation of Mineral Resources*. These standards may have a material effect on the financial statements of some business organizations in Kosovo. KAS have not been revised for revisions to IAS 1, IAS 2, IAS 8, IAS 10, IAS 16, IAS 24, IAS 32, and IAS 39, which may have material effects on the financial statements of some business organizations in Kosovo.

50. **There are specific differences between IFRS and Kosovo accounting requirements pertaining to banks.** Based on the balance sheet structure of the banks operating in Kosovo, the difference between KAS and IFRS that is likely to have the most significant impact relates to the measurement of loan losses. The BPK requires banks to calculate the impairment of loans and receivables on the basis of a provisioning matrix that specifies fixed provisioning rates for the number of days a loan has been classified as non-performing. The results may differ from the impairment of loans and receivables determined in accordance with IAS 39, *Financial Instruments: Recognition and Measurement*. IAS 39 determines the allowance as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the financial asset's original effective interest rate.

51. **The ROSC assessed the compliance gap by sampling:**

- Seven sets of audited financial statements which purport to be prepared in accordance with IFRS. For the sample review, the ROSC team selected six POEs and one bank (refer to Paragraphs 52 to 54 below).
- Two sets of audited financial statements of banks which purport to be prepared in accordance with KAS (refer to Paragraph 55 below).
- One set of audited financial statements of an insurance company which purport to be prepared in accordance with KAS.
- 15 sets of financial statements of other corporations which purport to be prepared in accordance with KAS (refer to Paragraph 56 below).

52. **The difficulties faced by business organizations operating in Kosovo, including POEs, are so significant that they bring into question the reliability of the financial**

statements and, therefore, whether they can, and do, comply with IFRS. As a result of these difficulties, the auditors refer in their audit reports to significant scope limitations and disclaim their opinions on five of the six sets of financial statements. The scope limitations deal with such matters as:

- the lack of appropriate records, ledgers, reconciliations and controls;
- the lack of contracts or agreements with some customers, suppliers, governments and other parties to the contracts or agreements;
- uncertainties about the ownership or carrying amounts of assets;
- uncertainties about the existence and measurement of liabilities; and
- the lack of determination of taxation liabilities.

53. In addition to the problems caused by the severe difficulties of operating in Kosovo, the IFRS financial statements of each of the POEs include several additional areas of potential non-compliance with IFRS which could have a further material effect on the reliability of those financial statements:

- In one POE, property, plant and equipment was accounted for using the revaluation model but has not been revalued since December 31, 2002. Furthermore, the revaluation of land was based on a fixed amount of EUR 2.5 per square meter irrespective of its location or use. Therefore, the balance sheet amounts of the property, plant and equipment probably do not reflect up-to-date fair values as required by IAS 16.
- Another POE has not recognized a liability for the unfunded portion of the pension obligations as required by IAS 19 and a deferred tax asset for temporary differences as required by IAS 12. Furthermore, some revenue has been recognized on a cash basis, rather than an accrual basis as required by IAS 18.
- One POE uses the diminishing balance method for depreciation which may not comply with IAS 16. Also, it does not account for or disclose the balance and transactions on a bank account and fails to make the disclosures required by IAS 24 for a management contract.
- One POE recognizes rental income on a cash basis which may not comply with IAS 17, does not account for employee benefit costs financed by UNMIK which may not comply with IAS 19 and IAS 20, and fails to record accounting software, implementation and training costs provided by government grant which may not comply with IAS 20.
- Another POE has not written off inventories which have been consumed or determined bad debts based on information about customers. Consequently, inventories, receivables and profits are likely to be materially overstated.
- Finally, one POE has not reduced the carrying amount of inventories for obsolete and slow moving items and has not estimated the net realizable value of inventories. Consequently, inventories and profits are likely to be materially overstated.

54. The IFRS financial statements of POEs often include a considerable amount of standard wording, which may not deal adequately with the events and circumstances of a particular enterprise. The standard wording is usually drawn from model financial statements provided by the audit firms. In several cases, the standard wording includes accounting policies for events and transactions which are not relevant to the enterprises concerned. According to some, the use of standard wording reflects the lack of knowledge and understanding of IFRS and

IFRS financial statements among accountants. The audit firms assert that they assist only as far as is ethically possible.

55. **The financial statements of two banks purport to comply with KAS but the lack of some records and documentation question the reliability of the financial statements.** The audit reports include scope limitations referring to the lack of:

- a reconciliation of differences with respect to inter-branch account balances;
- subsidiary ledger details for amounts due to customers;
- supporting documentation/reconciliations for accrued interest and other payables;
- fixed assets records for tax purposes; and
- supporting documentation for tax expense and tax liability.

56. **The KAS financial statements of other corporations were generally very brief and many did not appear to comply with KAS.** In many cases the financial statements consisted of a single page although others did appear to comply with KAS. Examples of missing information from financial statements include:

- balance sheet;
- cash flow statement;
- statement of changes in equity;
- statement of accounting policies used; and
- comparative information.

IV. AUDITING STANDARDS AS DESIGNED AND AS PRACTICED

57. **The purpose of this section is to perform the auditing *standard gap* analysis and *compliance gap* analysis.** The *standard gap* analysis compares National Standards on Auditing (NSA) in Kosovo with ISA in order to identify significant differences, which may adversely impact the reliability of the audits of financial statements of corporations, POEs, and SOEs. The *compliance gap* analysis focuses on the compliance of the statutory and voluntary/contractual (e.g., required by a lender) audits of financial statements with NSA or ISA.

58. **The significant differences between NSA and ISA are due to late and poor translation of ISA.** As discussed in Paragraph 43 above, the Law on Financial Reporting requires the KBSFR to issue auditing standards in conformity with ISA. In 2002, the KBSFR published an Administrative Decision in Albanian, which made application of the 1999 Albanian language translation of ISA mandatory. The delay in incorporating new ISA and amendments to existing ISA since 1999 results in a significant standard gap. However, the issues arising from this delay are of less concern than the issues resulting from the lack of understanding and proper usage of NSA. The problems identified with regard to the practice of NSA are at a more basic level than the problems associated with outdated and incomplete standards. For example, problems with the objective of an audit, audit risk assessment, basic audit procedures, and other such common problems are independent of inconsistent terminology between two advanced standards or a delay in incorporating the latest changes. The major challenge facing Kosovo is in education regarding ISA and in encouraging and enforcing implementation of the basic principles contained in the standards.

59. **The proposed amendments to the Law on Financial Reporting *envisage* a continuation of the role of the KBSFR as an auditing standard setter.** However, the

authorities have an opportunity to shift the allocation of scarce resources within the KBSFR in order to focus on implementation rather than standard setting. Kosovo could adopt “full ISA,” thereby avoiding the use of scarce resources to adapt the standards. Issues relating to making copies of Albanian and Serbian language translations of the ISA that comply with IFAC translations policy available to auditors and other interested parties can be addressed through collaboration and co-operation with the regulators and professional bodies of neighboring countries.

V. PERCEPTIONS OF THE QUALITY OF FINANCIAL REPORTING

60. **Corporate financial reporting in Kosovo is perceived to be of very low quality, with the exception of the audited financial statements of financial institutions, which are perceived to be of relatively higher quality.** The higher quality of the audited financial statements of these financial institutions has been attributed to BPK’s monitoring and enforcement, to the restriction on audit firms allowed to audit financial institutions, and to the banks’ ability to attract qualified professionals.

61. **The users of the audited financial statements presented by POEs are unable to rely on them.** Audits are typically conducted in POEs and their financial statements are generally available publicly. However, auditors generally express a qualified audit opinion or a disclaimer of opinion, which obviously reduces significantly the reliability of the financial statements. These issues result from environmental factors beyond the control of the audited entity and its auditor (e.g., issues as to who has legal title over the assets). The usefulness of corporate financial reporting is significantly hampered in an environment where such issues remain to be resolved.

62. **Although financial institutions are perceived as having financial statements of higher quality (in relative terms), they also face similar issues as Kosovo’s POEs. These result in qualified audit opinions or disclaimers of audit opinions.** Also, within the banking sector, the foreign-owned institutions are perceived to have higher quality financial reporting than the domestic banks.

63. **The (audited) financial statements prepared by SOEs and SMEs are not relied upon by external users.** This situation is exacerbated by the fact that (audited) financial statements are not generally perceived as useful by the significant users of financial information, thus giving little incentive to enterprises to improve the quality of their financial statements. Examples of such lack of interest are:

- Banks predominantly undertake collateral-based lending and therefore have a tendency to be more concerned with the existence and value of secured assets rather than the financial statements of the enterprises to which they lend.
- The tax authorities are interested only in financial information based on the provisions of the Tax Code leading to firms designing underlying data recording systems aligned to the recognition and measurement criteria embodied in the Tax Code.
- The lack of sanctions against enterprises failing to comply with accounting standards or auditors failing to comply with auditing standards creates an environment within which financial statements tend to be regarded as irrelevant.

VI. POLICY RECOMMENDATIONS

64. **The recommendations of this ROSC are interrelated and mutually supportive and are designed to improve the financial reporting environment in Kosovo.** These recommendations, which are explained below and sequenced in Figure 1, fall under the six major pillars of the accounting and auditing infrastructure. In many instances, the reforms in each pillar will need to be conducted in parallel, as the six pillars reinforce each other. For example, strengthening the standard-setting process without similarly bolstering the monitoring and enforcement mechanism will fail to address non-compliance with accounting standards. In terms of priority, the emphasis will need to be on building technical capacity across all the pillars. Figure 1 provides a simplified overview of key recommendations and suggested timing for implementation. 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 financial reporting requirements.

65. **Accordingly, with regard to the Statutory Framework it is recommended that a multi-disciplinary group of private and public stakeholders be established. While the group may wish to address some of the following issues in the context of the current revision of the Law on Financial Reporting, some issues should be addressed over the medium to longer term as legal uncertainties resulting from Kosovo’s particular status are being clarified and capacity increases:**

- Preparation of a detailed “transposition table” showing for each relevant provision of the *acquis communautaire* how corresponding Kosovo legal instruments implement the provision. This will allow Kosovo to establish an overview of existing differences between Kosovo’s legal framework and the *acquis communautaire* with a view to decide when and how Kosovo intends to achieve compliance.²⁵ The analysis should start with the Fourth, Seventh, and the new Eighth EU Company Law Directives, as well as the Banking and Insurance Accounts Directive.
- Drawing on this analysis, the group should contribute to the proposed amendments to the Law on Financial Reporting in order to align it more closely with the new Eighth EU Company Law Directive. The following requirements of the Directive should be phased in in such a manner as to ensure that the institutional framework is capable to support their implementation:
 - Approval of statutory auditors and audit firms (educational qualifications, professional examination, practical training, continuing education, and approval of auditors with a foreign qualification).
 - Establishment of a public register of statutory auditors and audit firms.
 - Quality assurance, investigations and penalties.
 - Establishment of a functioning public oversight system of the audit profession.

In that context, Kosovo has an opportunity to restructure the institutional framework and achieve a working balance between the roles of SCAAK and the KBSFR. A viable option would be to delegate some regulatory authority to SCAAK, subject to public oversight by the KBSFR. Under this structure, the KBSFR should retain the ultimate responsibility for the oversight of (i) the approval and registration of statutory auditors and audit firms, (ii) the adoption of standards on professional ethics, internal quality control of audit firms and auditing, and (iii) continuing education, quality assurance and investigative and disciplinary systems.

²⁵ Refer to *Corporate Sector Accounting and Auditing with the Acquis Communautaire*, Gielen, Hirata Barros, van der Plaats, World Bank, September 2006 (*to be released*).

- A requirement for *public interest entities*²⁶ to present their financial statements in conformity with IFRS.
- A requirement for enterprises that are not *public interest entities* other than micro enterprises to present their financial statements in conformity with KAS.
- A requirement for legal entity and/or consolidated financial statements to be audited only when there is a public interest for such an audit, irrespective of the entity’s legal form. However, should these requirements still result in a situation where the number of audits required by law is excessive as compared to the availability of qualified auditors in the market, policymakers should phase in these requirements with a view to ensure that statutory audit requirements do not overburden Kosovo’s audit capacity.
- A requirement for all statutory audits to be conducted in compliance with ISA. Policymakers may however wish to adopt the “ISA Plus” model, whereby—while ISAs would be adopted in full—additional standards and audit procedures may be imposed if they follow from specific requirements relating to the scope of the statutory audit (e.g., an additional requirement for bank audits to contribute to the BPK’s prudential supervisory process).
- A requirement for *public interest entities* (short term) and other corporations (longer term) to make their audited legal entity (and consolidated) financial statements, including the notes to the financial statements, readily available to the public²⁷ within a reasonable period after the balance sheet date.

66. **With regard to Accounting Standards it is recommended that:**

- Kosovo reach agreement with the International Accounting Standards Committee Foundation (IASCF) and the institutions responsible for the translation of the Albanian and Serbian language versions of the standards, to establish a process whereby the official translations of IFRS are readily available and affordable in Kosovo.
- The KBSFR maintain KAS as a simplified financial reporting system for application in entities that do not meet the definition of a *public interest entity*. Alternatively, Kosovo could review the ongoing project of the International Accounting Standards Board (IASB) on “Accounting Standards for SMEs.”
- The BPK revisit the relationship between prudential and general purpose financial reporting in the financial sector. IFRS or IFRS-based standards (such as KAS) are often a source of concern to supervisory authorities, notably because of fears that these standards could jeopardize the criteria that “regulatory own funds” have to fulfill, namely that they be (i) permanent, (ii) readily available for absorbing losses, and (iii) reliable as to their amounts. There are also some concerns that these standards could introduce volatility into financial institutions’ financial statements and, more particularly, into regulatory own funds, in ways which might not reflect the economic substance of institutions’ financial positions. The BPK should develop prudential filters for regulatory capital with a view to adjust regulatory own funds for

²⁶ Public interest entities should include, as a minimum, large financial institutions, POEs, and companies, which due to their size, in terms of number of employees, assets, and/or sales, have public accountability.

²⁷ The equivalent requirements exist in EU Member States as set forth in the Fourth and Seventh EU Company Law Directives, and the Transparency Directive.

changes appearing in the accounting equity of financial institutions applying IFRS (in the medium to longer term) or KAS.

In this context, the BPK should have regard to (i) the guidelines on a common reporting framework (COREP)²⁸ to be used by credit institutions and investment firms when they report their solvency ratio to supervisory authorities under the Capital Requirements Directive, and (ii) the guidelines establishing a standardized financial reporting framework (FINREP) for credit institutions operating in the EU. This framework enables credit institutions to use the same standardized data formats and data definitions for prudential reporting in all countries where the framework is applied, reducing the reporting burden for credit institutions that operate cross-border, and lower barriers to the development of an efficient internal market in financial services. This is particularly important in the context of Kosovo where a significant portion of the banking sector is foreign-owned.

67. **With regard to Auditing Standards it is recommended that:**

- Kosovo reach agreement with IFAC and the institutions responsible for the translation of the Albanian and Serbian language versions of the standards to establish a process whereby the official translations of ISA are readily available and affordable in Kosovo.

68. **With regard to the Monitoring and Enforcement of Accounting and Auditing Standards it is recommended that:**

- More direct action be taken with regard to the monitoring and enforcement of accounting and reporting standards by *public interest entities*. While a review of the financial information of these enterprises showed very significant obstacles to compliance with IFRS (refer to Paragraph 52 above), which are beyond their control, the review noted widespread non-compliance with IFRS requirements resulting from lack of capacity or willingness to comply on the part of preparers. Therefore, the KBSFR (and BPK) should prioritize accounting standard enforcement, drawing on internationally accepted principles of accounting standard enforcement. Standard No. 1, *Enforcement of Standards on Financial Information in Europe*, set forth by the Committee of European Securities Regulators (CESR) is a possible reference for the KBSFR (and BPK) even if these entities are not listed.
- The KBSFR and BPK should increase their human resources by employing more staff members who are familiar with IFRS. In order to fulfill their role as an accounting standard enforcement agency, the KBSFR and BPK should recruit additional staff with extensive knowledge and experience of IFRS. This may require revisiting the status of the KBSFR to allow it to offer compensation sufficient to attract and retain qualified staff.
- The BPK should seek to strengthen its relationship with statutory auditors to mutual advantage. While the objectives of supervisors and auditors are different, there are many areas where the work of the supervisors and of the external auditor can be useful to each other. The following are examples of types of other matters that may come to the attention of the auditor and may require urgent action by the supervisors:
 - information that indicates a failure to fulfill one of the requirements for a banking or insurance license;

²⁸ The guidelines are available at <http://www.c-eps.org/standards.htm>.

- a serious conflict within the decision-making bodies or the unexpected departure of a manager in a key function;
- information that may indicate a material breach of laws and regulations or the articles of association, charter, or by-laws;
- the intention of the auditor to resign or the removal of the auditor from office; and
- material adverse changes in the risks of the bank's or insurance undertaking's business and possible risks going forward.

Also, the BPK may contemplate requiring the statutory auditor to carry out specific assignments or to issue special reports to assist the supervisors in discharging their supervisory functions (e.g., reporting upon whether the systems for maintaining accounting and other records and the systems of internal control are adequate; the method used by the bank or insurance undertaking to prepare reports for the supervisors is adequate and the information included in these reports, which may include specified ratios of assets to liabilities and other prudential requirements, is accurate; etc.). In establishing such systems, supervisors should have regard to internationally accepted guidance such as the guidance issued jointly by the Basel Committee on Banking Supervision and the International Auditing Practices Committee of IFAC in January 2002, on the "relationship between banking supervisors and banks' external auditors." The effectiveness of this action hinges upon organizing the relationship in law to expressly waive the auditor's duty of confidentiality in his or her relationship with the supervisors. It also hinges upon ensuring that only duly qualified auditors are authorized to audit banks, insurance undertakings, and listed enterprises.

- All statutory auditors and audit firms should be subject to a system of quality assurance subject to public oversight. Quality assurance for the statutory audit is fundamental for ensuring good audit quality, which adds credibility to published financial information and adding value and protection to shareholders, investors, creditors and other stakeholders. The system may draw upon existing practices in EU Member States, especially countries, which joined the EU on May 1, 2004, which have had to implement quality such systems in circumstances similar, albeit not identical, to Kosovo's. Also, IFAC SMO 1, Quality Assurance is a useful guideline in this regard. The results of the external quality assurance system should feed into the Continuing Professional Development program and/or the disciplinary system, as appropriate.
- Kosovo should establish an effective system of investigations and sanctions to detect, correct and prevent inadequate execution of the statutory audit. The system may provide effective, proportionate and dissuasive civil, administrative or criminal penalties in respect of statutory auditors and audit firms, where statutory audits are not carried out in conformity with the Law, ISAs, and/or the Code of Ethics for Professional Accountants. Also, every measure taken or sanction imposed on statutory auditors and audit firms should be appropriately disclosed to the public. As for the quality assurance system, the system may draw upon existing practices in EU Member States and IFAC SMO 6, Investigation and Discipline is a useful guideline in this regard.

69. **With regard to the Development of the Accounting and Auditing Profession it is recommended that:**

- All statutory auditors and audit firms should be members of SCAAK. SCAAK (or the KBSFR) should establish a public electronic register of statutory auditors and audit firms so that interested parties can determine rapidly whether a statutory auditor or an audit firm has been approved, etc. This will be facilitated through registration in a public electronic register. Availability of the public register in foreign language(s) would greatly increase its usefulness especially in the context of foreign direct or portfolio investment.
- The capacity of SCAAK should be increased so as to enable it to make a more effective contribution to the audit profession in Kosovo. In particular it should be resourced so as it could
 - Operate a technical advice help desk for members;
 - Produce and distribute an audit manual for small audit firms; and
 - Develop a standard audit methodology and audit program pack for small audit firms.
- A detailed review of required activities of SCAAK and the KBSFR and twinning arrangements should be considered.
- Practical experience should be brought in line with IFAC requirements. Mentorship and supervision have to be promoted. It is necessary to review the present requirements for practical experience and to bring them in line with IES 5.

70. **With regard to Education and Training it is recommended that:**

- Starting from the present situation, emphasis should be given to developing an educational continuum from university through to the continuing professional development of accounting and auditing professionals encompassing the requirements of the IFAC IESs and, as regards statutory auditors, of the *acquis communautaire*.
- The university curriculum and educational material should be updated. Professors and lecturers have an opportunity to upgrade their skills and universities should seek to attract faculty members with up-to-date expertise in economics, business environment, corporate governance, business ethics, financial markets, quantitative methods, organizational behavior, management and strategic decision making, IFRS, ISA, etc. Universities will need to work closely with the KBSFR, SCAAK, and the business community to develop degree programs appropriate to the developing needs of the economy. The [Trans-European mobility scheme for university studies \(TEMPUS\)](#), which enables universities from EU Member States to cooperate with those in Western Balkans in higher education modernization projects, may provide examples, as well as a source of possible technical and financial assistance, of how the university sector can address weaknesses in the content and delivery of business, accounting and related subjects.
- SCAAK should also ensure that candidates for the audit qualification receive sufficient and relevant practical experience prior to the award of the qualification. Therefore, the COA should establish an associate membership for candidates for the audit examination so that practical can be both structured and monitored.
- Having established a robust basis for qualification it is essential that continued membership of SCAAK and retaining the right to conduct audits (i.e., the license issued by the KBSFR) is dependent upon completing a minimum level of CPD. Such CPD needs to be monitored by SCAAK (and the KBSFR) to ensure that all members

remain up to date with the developments in accounting and auditing standards and practices.