

REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC)

Albania

ACCOUNTING AND AUDITING

June 16, 2006

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Executive Summary

During the transition to a market economy, Albania successfully put in place several important elements of the institutional and statutory framework on financial reporting.

However, this assessment demonstrates that Albania needs to take further steps in order to achieve its goal of a sound financial reporting framework tailored to the needs of the Albanian economy and aligned with the EU *acquis communautaire* and international standards and practices. The existing framework is not always consistent and complete and limited technical and financial resources contribute to institutional weaknesses in several areas. International financial reporting and auditing have recently become more complex and rigorous. The EU body of law (*acquis communautaire*) on financial reporting and auditing has evolved significantly over the last years. In such a dynamic international regulatory environment, national financial reporting requirements can easily become out of line. The introduction of a new accounting law in 2004 with the objective of improving the quality of financial reporting in Albania also lays the foundation for improved alignment with the *acquis communautaire* and international standards and practices. The Albanian government is fully determined to undertake the necessary further steps and to give proper support to improve the financial reporting framework in Albania.

The introduction of a new accounting law is indicative of the current desire for change but more needs to be done to address existing shortcomings. Over the years, various stakeholders have done substantial work on an ad hoc basis to enhance the financial reporting and auditing environment. However, this needs to be accompanied by clear leadership from the government to set the tone for reform and coordinate the process. Otherwise, it will continue to proceed in an ad hoc manner with little gain. Due to recent reorganizations within the Ministry of Finance there is no longer a department responsible for private sector accounting and auditing activities. This should be addressed as some initiating and guiding capacities are necessary. In addition, building appropriate institutional capacity and further enhancements to the statutory framework governing financial reporting will be essential. The linkages to private and financial sector development and the Government's commitment to the recently concluded Stabilization and Association Agreement (SAA) with the European Union (EU), as a first step toward European integration, could serve as drivers for change.

There is a need to strengthen institutional and professional capacity and to remove excessive demands on existing capacity. Specifically, there is limited human capital in many key areas such as accounting and auditing standard setting, monitoring and enforcement, and in the preparation and

This report was prepared by a team from the World Bank on the basis of the findings from a diagnostic review carried out in December 2005. The staff team was led by Georgine Newman-Alawode (ESCPS) and comprised Frédéric Gielen (ECSPS) and Elona Gjika (ECSPS), as well as a team of experts, including Jean-Marc Jacquet, Anne Molyneux and Tomasz Wolanin.

auditing of financial statements. Albania has made several policy choices that put a strain on scarce institutional and professional resources. Some of these policies include: short mandatory audit firm rotation periods for some sectors; requirements for the appointment of two auditors for audits of certain types of joint stock companies; and the scope of IFRS application in the new accounting law. Several of these choices are not strictly needed for alignment with the *acquis* and for achieving high quality financial reporting. Therefore, they should be reconsidered in order to make them more proportional in relation to the existing institutional and professional capacity. The expansion of financial reporting and auditing requirements should be supported by parallel institutional and professional capacity building so that credible high quality financial reporting can be ensured and sustained.

The financial information provided by most small and medium size enterprises is not considered reliable. This is often attributed to the weakness on of enforcement and, to some extent, the limited capacity in the country to prepare and audit financial statements, as well as the high levels of informality in the economy and the strong desire to evade taxes.

The perceived level of financial transparency in Albania is not conducive to domestic or foreign investment. In general, low levels of transparency affect the ability of small and medium-sized enterprises (SMEs) to access credit from the formal financial sector. This is important in the context of Albania where it is estimated that 92 percent of all business enterprises are SMEs. Further, in the absence of reliable financial information shareholders and third parties cannot assess management performance thus hindering market based monitoring of companies and efficient allocation of scarce resources.

Main Findings

Regulatory Framework

- **The legal framework on financial reporting in Albania is characterized by some lack of cohesiveness.** In addition, laws and regulations need to be adequately communicated to entities which are expected to comply with them in order to facilitate compliance with the law.
- **There is very limited availability of published financial information in Albania.** The current requirements on filing and publication of financial statements are not in line with international best practice in this area, for example, the requirements of the First, Fourth, and Seventh EU Company Law Directives.
- **A new accounting law aims to address many of the shortcomings of the previous accounting and financial reporting requirements.** The accounting requirements in the previous accounting law, General Accounting Plan, and the Bank Accounting Manual were not satisfactory to ensure high quality financial information for *public interest entities* on which users could make informed economic decisions. They did not cover key areas such as: consolidation; leasing; construction contracts; and impairment of assets. The new accounting law attempts to address these issues by requiring the use of International Financial Reporting Standard (IFRS) for *public interest entities* and simplified reporting requirements for SMEs. However, the section of the law establishing the applicable accounting standards has been postponed until January 2008 so as to accommodate the translation of IFRS and finalization of National Accounting Standards (NAS) which have been published in the June 2006. Therefore, in the meantime a vacuum has been created since the old accounting law which outlined the previous “accounting standards” was repealed when the new law became effective.

Institutional and professional capacity

- **The accounting standard-setter, the National Accounting Council (NAC) needs substantially more technical and financial resources in order to fulfill its mandate.** As an independent body the NAC will be responsible for securing its own funding and staffing its

own activities.

- **There is an overwhelming need for training across all areas of the economy with respect to accounting, auditing and financial reporting.** The range and quality of education and training available in the pre- and post- certification process for accountants and auditors is insufficient to address the existing need for knowledge and experience. Regulators, management of companies, stakeholders, accountants, auditors and educators need basic to advanced training.
- **The monitoring and enforcement mechanisms are ineffective to induce compliance with accounting and auditing standards.** With the exception of the Bank of Albania there is limited enforcement of accounting standards. The reasons for the ineffective monitoring and enforcement activities include ambiguous legal authority, lack of operational capacity or authority, entities' inability to comply due to capacity constraints, and neglect by the authorities to fulfill this vital role. In addition, the enforcement authority is scattered across many regulatory bodies which leads to further inefficiencies. With respect to auditing standards, monitoring and enforcement are ineffective due to limited expertise in conducting reviews of audit firms, especially those that audit *public interest entities*.

The audit function

- **The regulatory framework for the audit function is developed in line with the former EU 8th directive, however the audit function needs to gain more credibility.** Users place little reliance on the audit opinion issued by local auditors. There are few auditors who have the knowledge and experience to conduct audits to international standards. The audit quality is exacerbated by a short audit season, many medium sized entities subject to statutory audits, and tax evasion.
- **In some cases auditors are not perceived to be independent of the audited entities.** This is a multi-faceted issue, which is linked to the lack of effective quality assurance systems—subject to public oversight—for monitoring audit quality and compliance with independence requirements.
- **Short mandatory audit firm rotation periods in the banking and insurance sectors have resulted in an uncompetitive situation and may have unintended consequences on audit quality.** Only four audit firms are authorized to audit banks and two insurance companies. The introduction of a mandatory audit firm rotation period of two years for insurance companies, and three years for banks restricts the choice of audit firms when combined with independence requirements. This exposes banks and insurance companies to a severe lack of choice in contracting audit services.

Policy Recommendations

While all the policy recommendations set forth in Section VI of this report are important, implementation of the following broad recommendations is vital in order to bolster the financial reporting framework with attendant positive effects on financial system stability, economic growth (including mobilization of investment capital) and the fight against corruption. In terms of priority, the emphasis will need to be on building technical capacity across all areas in order to improve the current situation, to facilitate holistic, strategic reform, and to ensure sustainability. These recommendations will be conducive to private and financial sector growth through:

- strengthening Albania's financial architecture and reducing the risk of financial market crises, and their associated negative impacts;
- attracting more foreign direct and portfolio investment and helping to mobilize domestic savings;
- facilitating the access of smaller-scale corporate borrowers to credit from the formal financial sector by lowering the barrier of higher information and borrowing costs; and

- assisting investors in larger-scale enterprises to evaluate corporate prospects and make informed investment and voting decisions, which will result in a lower cost of capital and a better allocation of resources. Financial reporting is also a building block of a market-based monitoring of companies which allows shareholders and the public at large to assess management performance thus influencing its behavior.

Action

Timing of implementation

- | | |
|---|-------------------------|
| <ul style="list-style-type: none"> • Enhance the statutory framework governing accounting, auditing and financial reporting. | <p>Within 18 months</p> |
| <ul style="list-style-type: none"> • Enhance and create <i>sustainable</i> standard setting structures for the production of high quality accounting and auditing standards and guidelines on their application. | <p>1 to 3 years</p> |
| <ul style="list-style-type: none"> • Establish systematic monitoring and enforcement mechanisms to ensure compliance with accounting and auditing standards. | <p>Within 18 months</p> |
| <ul style="list-style-type: none"> • Improve the quality of the work done by the accounting and auditing profession through extensive capacity development initiatives aimed at existing practitioners. | <p>1 to 7 years</p> |
| <ul style="list-style-type: none"> • Increase the number of accounting and auditing professionals able to prepare high quality financial statements and conduct high quality audits, respectively. This would involve providing incentives to attract bright graduates to the profession and raising the recognition of the qualification. | <p>1 to 7 years</p> |

I. INTRODUCTION

1. This assessment of accounting and auditing practices in Albania is part of a joint initiative of the World Bank and the International Monetary Fund (IMF) to prepare Reports on the Observance of Standards and Codes (ROSCs). 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 audit regulation. For countries aspiring to join the European Union (EU), such as Albania, the assessment also has regard to the relevant requirements of EU law, the *acquis communautaire*. The report sometimes takes a position that goes beyond the *acquis* (e.g., it recommends the use of IFRS for *public interest entities*³). These positions are clearly identified.

2. **Since its transition to a market economy Albania has consistently experienced strong annual GDP growth rates, averaging 5.7 percent over the period 2000-2005.** After 46 years of being a centralized and isolated economy, the period of transition was almost derailed in 1997 by a deteriorating macroeconomic situation. Although the country has recovered from the crisis, a high proportion of the population still lives in poverty and educational attainment indicators remain low. This is worrisome since levels of education are directly related to the quality and availability of skilled labor to fill the needs of a growing financial and private sector.

3. **Approximately 92 percent of the 35,000 enterprises in Albania are small enterprises, defined as employing one to four employees.** The financial reporting requirements for these small entities and for medium-sized entities as well, are important given the actual and potential impact on banking intermediation, tax collection and financial discipline. A balance needs to be achieved between the benefits of basic financial information which facilitates business and economic decisions and the costs of burdensome reporting requirements.

4. **The main source of financing for Albanian enterprises is informal, family generated funding, which has implications for levels of financial disclosure.** Albania has the lowest level of bank credit to the private sector as a share of GDP in the region although it has been experiencing significant increases year on year from a low basis. Financing sources and ownership concentration affect the information needs of owners versus investors, disclosure requirements, and corporate governance structures (“insider” versus “outsider” models). In Albania, the absence of an active capital market and current levels of bank credit to the private sector explain the scattered demand for financial transparency.

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

² Within this report, ISA refer to the International Standards on Auditing and related practice statements developed by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC).

³ Within this report, public interest entities are those in which the general public has an interest by virtue of the nature of their business, their size, their number of employees, or their range of stakeholders. Examples include banks, insurance companies, investment funds, pension funds, listed companies, and large enterprises, including large state-owned enterprises.

5. **The banking sector in Albania represents 90 percent of Albania's financial sector.**⁴ Previously limited financial intermediation is increasing and most of the outstanding loan stock is denominated in foreign currency. The significant foreign exchange position and the rapid credit expansion necessitate a more rigorous financial reporting framework in order to support accurate recording and measurement of banks' assets and liabilities, and attendant foreign currency risk exposure at both the borrower and lender levels.

6. **Currently, the non-bank financial sector is limited but growth in this sector would need to be accompanied by institutional reform.** With a focus on motor third party liability, the 11 existing insurance companies have combined premiums representing 0.5 percent of GDP. Presently, there is limited historical technical reference and expertise in insurance accounting and auditing. There is one leasing company but with the new leasing law and the apparent demand for other sources of financing, this sector could grow significantly. There are no companies currently traded on the stock exchange. However, with the introduction of the new Law on Leasing and with the effectiveness of the Law on the Insurance Supervising Authority (March 2006) and based on the demand for other financing resources, it is expected that this sector will increase significantly.

7. **State-owned entities (SOEs) play a significant role in the Albanian economy, particularly in the electricity and communications sectors, and the oil refinery industry.** SOEs, as some of the largest entities in Albania, are important as *public interest entities* and as possible future privatization candidates. Financial transparency and adequate financial disclosures should be required of these entities in order to facilitate good governance, fiscal discipline and optimum allocation of scarce resources.

8. **This report considers all the aforementioned areas and outlines the main reasons for Albania to continue with the accounting and auditing reforms undertaken, albeit in a more holistic and systematic fashion.** In this context, this report sketches policy recommendations to enhance the quality of corporate financial reporting. It is expected that the National Steering Committee (NSC) will develop a Country Strategy and a detailed Country Action Plan (CAP) based on the recommendations outlined in this report as an initial step in the reform process.⁵

II. INSTITUTIONAL FRAMEWORK

A. Statutory Framework⁶

9. **The legal framework on financial reporting lacks consistency.** The laws are not harmonized with each other and are often based on different legal models. For example, one of the main laws for the banking sector is based on common law sources but the Company Law is based on a continental European model. The use of these various models may be building

⁴ See World Bank's Albanian Financial Sector Assessment, September 2005.

⁵ At the beginning of the assessment the Ministry of Finance established a National Steering Committee, composed of representatives of the National Accounting Council (NAC), Albanian Institute of Approved Chartered Auditors (IEKA), Albanian League of Accountants (LPKM), Accountants and Financiers Association of Albania (SHKFSH), Albanian Securities Commission (ASC), Bank of Albania (BoA), Ministry of Finance, Insurance Supervisory Authority of Albania (ISAA), Supreme Audit Institution, and representatives from audit firms to review the assessment and act on the recommendations.

⁶ This report outlines the laws applicable to accounting, auditing and financial reporting. It does not attempt to provide more than an introduction to the issues and is not meant to be an exhaustive rendition of the law nor is it legal advice to those reading it.

incompatibilities into the system. This contributes to difficulties interpreting, implementing and thus complying with the laws and regulations.

10. **The legal identity of all entities in Albania is established in the Law on the Civil Code of the Republic of Albania (hereinafter the “Civil Code”) dated July 1994.** It identifies the nature of commercial entities as private legal persons. It further outlines the liabilities of legal persons, the creation and content of obligations, and the legal foundations of the agency (management versus owners) relationship.

11. **The formation and regulation of business entities in Albania is governed by the Law on Commercial Companies (hereinafter the “Company Law”), which was last amended in 1995.** It is complemented by various sector specific laws, regulations, and guidelines. The use of guidelines, while useful for implementation, can cause difficulties where there are frequent changes and companies are unable to remain up to date.

12. **In order to address shortcomings in the previous accounting law, a new accounting law was recently enacted.** The Accounting Law (1993), complemented by a General Accounting Plan which provided detailed guidance including a chart of accounts, outlined the applicable accounting and financial reporting requirements for all business entities in Albania. This law was repealed when the new Law on Accounting and Financial Statements (hereinafter “Accounting Law (2004)”) became effective on January 1, 2006. The new law requires the use of IFRS for the preparation of the legal and consolidated financial statements of *public interest entities* and National Accounting Standards (NAS) for the preparation of all other financial statements. However, the entry into force of Article 4 of the new law, which establishes the accounting standards applicable to business entities, has been postponed until January 1, 2008 due to problems with the translation of IFRS and the finalization of National Accounting Standards (NAS). As a result companies will continue to apply the standards in the General Accounting Plan, which now has no legal basis.

13. **There are four main types of business entities outlined in the Company Law.** The types of entities regulated by the Company Law are: 1) general partnerships, 2) limited partnerships, 3) limited liability companies (LLCs) and 4) joint stock companies (JSCs). The focus of this report is on entities where shareholders have limited liability, that is, LLCs and JSCs.

- *Limited Liability Companies* (ShPK) are established by one (in the case of sole traders) or several shareholders who are responsible for losses only up to the limit of the value of their contribution to the minimum capital required. These companies are prohibited from issuing or guaranteeing the issuance of securities. This limitation of liability to the minimum required capital is contrary to long standing business associations, which establishes that subsequent capital contributions are subject to the same principles as the initial contribution to capital. This is especially worrisome given that audit firms can only be established as LLCs and have civil liability to their clients and third parties for failure to conduct their duties appropriately. LLCs normally have a single tier management structure (board of directors) and directors have joint or several liabilities to the company or third parties for violation of the laws.
- *Joint Stock Companies* (ShA) are established by shareholders who are held responsible for losses only up to the limit of their contribution to the starting capital (see discussion above on this issue). Differences in the minimum starting capital and the ownership of the capital distinguish the three main categories of JSCs, i.e. unlisted JSCs, listed JSCs, and State Companies (fully owned by the state or a public agency). Banks and insurance

companies must be established as JSCs according to the banking and insurance laws. All JSCs except banks are required to have a dual board system. The supervisory board appoints and exercises continuing supervision over the board of directors.

14. **The previous accounting law and the new Accounting Law (2004) establish that for all entities, the legal representatives of the entity are responsible for the probity of financial statements.** There is no available data on how compliance is monitored and enforced but the low level of compliance with accounting and financial reporting requirements (refer to Section III) suggests that monitoring and enforcement need substantial improvement. The Accounting Law (2004) extends responsibility for the accuracy of the financial statements to the supervisory board but it does not establish whether liability is joint or several, or what sanctions will be applicable for non-compliance. In any event, enforcing compliance in order to protect users of financial statements would require a judicial system with capacity and willingness to sanction non-compliance with legal financial reporting requirements.

15. **The Company Law establishes civil liability to the company and third parties for auditors, members of the board of directors and the supervisory board with respect to financial reporting and auditing but this is untested.** Auditors are liable to the company and to third parties for damages caused by their mistakes and negligence in conducting the audit. However, in their contracts with companies some audit firms have “capped” their liability to the company, as a multiple of their audit fees.⁷ Members of the board of directors are responsible, individually or jointly, to the company or third parties for violations of applicable laws and for their errors in managing the company. However, the members of the supervisory board are only responsible for their personal errors. Further, auditors and the supervisory board are not responsible for the actions of management unless they knew about them and did not report them to the shareholders. The ROSC team could not identify any case whereby legal action was successfully taken against auditors, the board of directors or the supervisory board.

16. **In line with international best practice, the Company Law requires shareholders to approve the legal entity financial statements.** Members of the board of directors are required to submit the entity financial statements (audited where applicable) for approval to the general shareholders’ meeting within six months of the end of the financial year. In JSCs shareholders also approve the consolidated financial statements. The right of shareholders to approve the legal entity financial statements is important in that it allows the owners of the company to check on the performance of management and its stewardship of the entity’s resources.

17. **The current accounting requirements are outlined in the Accounting Law (2004), the General Accounting Plan, and other sector specific laws as outlined in Table 1 below:**

Type of entity	Legal entity financial statements	Consolidated financial statements	Audit	Publication
SMEs (including sole proprietorships and limited partnerships)	Unspecified with postponement of Article 4 of the Accounting Law (2004)	None	None	Yes
LLCs	General Accounting Plan and Accounting Law (2004)	Required by the Accounting Law (2004)	Required by Company Law if certain thresholds are exceeded	Yes
JSCs	Same as LLCs	Same as LLCs	Required by	Yes

⁷ There is no expressed right for this approach in the Civil Code or the Law on Commercial Companies and it is yet to be tested in Albania.

			Company Law	
Banks	Detailed accounting requirements in Bank Accounting Manual, and Accounting Law (2004)	Banking Law	Required by Company Law	Yes
Insurance Companies	General Accounting Plan, Insurance Law and Accounting Law (2004)	Same as LLCs	Required by Company Law	Yes
SOEs	Same as LLCs	Same as LLCs	Required by Company Law	Yes

Table 1: Current accounting, auditing and financial reporting requirements

The Accounting Law (2004) requires listed entities (none in Albania), large unlisted entities (yet to be defined in secondary legislation), and financial institutions to prepare their legal entity and consolidated financial statements according to IFRS. All other corporate sector entities must prepare their financial statements in accordance with NAS drafted by the National Accounting Council (NAC) and approved by the Minister of Finance. The scope of application of IFRS has become more proportionate with the new Accounting law (2004); however it goes somewhat beyond the required use of IFRS under the *acquis* and could place significant demands on scarce resources. With the postponement of the entry into force of Article 4 of the new accounting law there is a need for greater clarity and guidance as to the accounting requirements applicable during the next two years, specifically the accounting standards to be used by SMEs, other large corporate sector entities and the insurance sector.

18. **Unless the Bank Accounting Manual is updated and aligned with IFRS, banks will face conflicting financial reporting requirements when Article 4 of the Accounting Law (2004) goes into effect.** The Banking Law still requires banks to prepare their individual statutory and consolidated financial statements in accordance with the Bank Accounting Manual, which was based on IFRS extant in 1998. It has not been updated since publication and omits important financial disclosures related to financial instruments (refer to Section III).

19. **The Banking Law requires all controlling entities to prepare consolidated financial statements but there are no consolidation standards.** The Bank Accounting Manual does not outline the standards for preparation or presentation of consolidated financial statements. In addition, the definitions of “controlling entity” in the Banking Law fall short of the requirements set forth in IFRS or the Seventh EU Company Law Directive, resulting in consolidated financial statements that do not include all the entities within a group and which present incomplete financial information.

20. **The Company Law establishes annual audit requirements for all entities except small entities not exceeding certain thresholds as shown in Table 3:**

<i>Type of Entity</i>	<i>Mandatory audit requirements</i>
LLCs	Must appoint an auditor if two of the following three criteria exceeded: 1) Balance sheet assets of 6 million Lek (equivalent to approx. EUR 48,618) 2) Annual sales of 12 million Lek (equivalent to approx. EUR 97,236) 3) An average of 10 employees
Listed JSCs	Must appoint <u>two</u> auditors
Unlisted JSCs with less than 20 million Leks in capital, incl. SOEs	Must appoint one auditor
Unlisted JSCs with more	Must appoint <u>two</u> auditors

than 20 million Leks in capital, incl. SOEs	
Banks	Must appoint one or two auditors (see above)
Insurance companies	Must appoint one or two auditors (see above)

Table 2: Requirement for annual audit

21. **There is no specific legislation that establishes which audit standards should be applied for statutory audits.** However, the professional auditing body, as the only body responsible for developing auditing standards, has mandated the use of ISAs for its members, and these are the standards which auditors in Albania purport that they comply with.

22. **The exemption from an annual audit of certain non-listed companies is compliant with the spirit of the Fourth EU Company Law Directive.** However, the thresholds (see Table 2 above) are extremely low compared to the maximum audit threshold limits set forth in the Directive and therefore quite small entities are subject to the audit requirements. While Albania, like some small EU Member States, may wish to use lower thresholds, it should be recognized that these extremely low thresholds will impose an audit obligation on very small companies, which may contribute to poor audit quality. Thresholds are best set after a detailed study of the business structure to determine the demand and supply factors that would determine a suitable threshold since an unknown market cannot be effectively regulated. Only then can the benefits for keeping such low thresholds, such as fostering an “audit culture,” be assessed against the low audit quality which results from such a requirement.

23. **There is little evidence that the current requirement for joint audits contributes to audit quality in Albania and in practice it is not complied with.** Many of the companies reviewed in Section III exceeded the capital requirement (discussed in Paragraph 20 above) but did not appoint joint auditors. The purported justifications of joint audit are that it provides additional assurance about audit quality and enables lower tier audit firms to gain experience by working with top tier firms. In the context of Albania, this requirement raises a number of practical issues given the limited human resources. Considering the level of technical capacity in local audit firms, the possibility of a top tier firm agreeing to conduct a joint audit and relying on the work of local auditors is remote. In addition, this requirement adds to the issues arising from audit firm mandatory rotation as discussed in Paragraph 25 below and the lack of audit capacity as discussed in Paragraph 33 below.

24. **The Bank of Albania approves the statutory auditor to perform the statutory audit of banks’ financial statements.** Given the capacity of audit firms this pre-approval process is good *ex ante* monitoring of the quality of the audit of banks. Approval is based on mainly administrative criteria and a minimum of five years experience of the audit firm. This experience requirement eliminated all local audit firms from auditing banks, leaving banks in the position of having to select local member firms of international audit firm networks that are active on the Albanian audit market. The insurance regulator recently introduced similar requirements for insurance companies.

25. **The banking and insurance regulators severely restrict banks’ and insurance companies’ choice of auditors because of the short periods specified for mandatory rotation of audit firms.** The Bank of Albania requires three-yearly mandatory rotation of the audit firm conducting statutory audit of banks while the Insurance Supervisory Authority of Albania (ISAA) requires mandatory rotation after two years. This requirement is more stringent than the *acquis* and may not necessarily achieve the aim of auditor independence while subjecting entities to limited audit firm choice. Of the four audit firms currently approved to audit banks and insurance

companies, only two firms are active in the audit market. Therefore, having used one auditor for the maximum period, these entities would have to choose the other auditor in the market. This exposes banks and insurance company to virtually no choice with respect to audit services and limits competition in the audit market without even considering the requirement for joint auditors.

26. **The Accounting Law (2004) simplifies the filing requirements for all entities.** Under the previous accounting law there was significant non-compliance with the filing and publication requirements and as a result financial information was not readily available in Albania. The new accounting law requires all entities to file their legal entity and consolidated financial statements (audited where applicable) one month after approval by the shareholders' meeting to the relevant courts (local courts in each district). This is an improvement over the previous law, which had different filing deadlines for business entities and also for legal entity and consolidated financial statements. However, none of the local courts have the physical or staffing capacity to facilitate compliance. Therefore, unless this capacity issue is addressed there will be limited compliance with, or monitoring of, the filing requirement mirroring the difficulties experienced by the state statistical body under the previous law.

27. **There is no requirement to make publicly available the audited legal entity or consolidated financial statements.** LLCs, JSCs and listed companies had to publish their un-audited financial statements, along with the certification of the Certified Accountant, 30 days after approval by the shareholders. All entities were required to make available to their employees and shareholders the information presented in the financial statements but it was unclear whether the full financial statements or only partial extracts from them should be made available. The new accounting law is silent on the publication of audited or un-audited financial statements by business entities and this represents a step backwards in comparison to the previous law.

28. **Banks comply with the filing requirements mandated by the Bank of Albania.** After the approval of the audited financial statements by the shareholders' meeting the law requires banks to publish their financial statements together with the auditor's report in the banks' official bulletin (annual report). Legal entity financial statements of some banks are available on their websites. Other banks make available to the general public only non-statutory audited financial statements prepared in accordance with IFRS, published in English. Due to limited availability of audited statutory financial statements of banks it is difficult for public users to compare the quality of financial statements and assess the financial standing of a given bank.

29. **Insurance companies do not generally comply with the filing and publication requirements established in the Law.** The regulatory framework for insurance companies was recently upgraded with the passing of a new Insurance Law and complementary regulations issued by ISAA in 2004. Insurance companies must submit their legal entity financial statements, which comprise the balance sheet, profit and loss account, technical prudential reports, and the auditor's opinion to the ISAA by March 31. These financial statements and the auditor's report must be published in one of the company's periodic financial publication by June 30. Periodic financial publication is undefined and there are no records of insurance companies publishing their financial statements. In practice, the financial statements are not always submitted to the ISAA in a timely fashion.

30. **Overall, Albania's current requirements and practices for public interest entities fall short of international best practices, including those in the *acquis*, with respect to filing and publication of financial statements.** There is no requirement for access to the documents in the central registry of companies to be given to third parties upon application or appropriate penalties

for failure to disclose accounting and other documents as, for example, in Article 6 of the First EU Company Law Directive. These requirements are not meant to be exhaustive of all good practices that Albania should adopt but are mentioned due to the positive impact on the availability of financial information that could result and to the initial level of resources which will need to be deployed to create the necessary infrastructure. Albania should mandate appropriate sanctions for failure to comply with publication requirements as laws without appropriate sanctions do not encourage compliance, and undermine regulatory authority to enforce them in the absence of other positive or negative deterrents.

B. The Profession

31. **The profession is young and, in spite of their best efforts, the three existing professional bodies have had difficulties fulfilling their roles.** When assessed against International Federation of Accountants (IFAC) Statements of Membership Obligations (SMOs), the Albanian Institute of Authorized Chartered Auditors (IEKA), the Albanian League of Accountants (LPKM), and the Accountants and Financiers Association of Albania (SHKFSH) need substantial improvement. Currently the professional bodies are undertaking efforts to align themselves with IFAC's SMO's. The IEKA for example, has already begun to introduce most of the elements prescribed in SMOs of IFAC.

The Audit Profession

32. **The title of “Certified Auditor” is a protected designation and individuals who are conferred with the title must be registered members of IEKA.** Statutory protection of the right to conduct statutory audit safeguards the public interest by ensuring that only qualified individuals are allowed to do so. IEKA, an associate member of IFAC which was established in 1997 and the oldest of the three professional bodies, was designated as the professional organization for Certified Auditors.

33. **The number of auditors in Albania does not appear to be sufficient to meet the market's demand.** Currently, there are an estimated 150 certified auditors, the majority of whom are sole practitioners. The Ministry of Finance estimates that there are approximately 2,000 companies requiring annual audits. This demand for audit services is further compounded by a “short” audit season since most companies in Albania are required to file both their financial statements and tax returns with the tax authorities by March 31. In the current context, the demand factors exacerbate the problem of low audit quality already affected by limited public oversight (discussed in Paragraph 34 below), the content and quality of the education and examinations administered for professional qualification requirements (discussed in Paragraph 36 below and Section II. C below), and the fee setting arrangements (described in Paragraph 42 below).

34. **The auditing profession is partially self-regulated by IEKA and supervised by the Ministry of Finance in support of the public interest. However, the current government regulation of the profession is insufficient to fulfill the role of a public oversight system.** A system of public oversight of statutory auditors and audit firms is important in order to ensure that the quality assurance, investigation and disciplinary systems are adequate to promote high quality audits. The Ministry of Finance's supervisory oversight of IEKA is exercised through the appointment of a primary and two complementary representatives to the governing organ of IEKA, the Council. These representatives approve all decisions made by the Council except those related to professional standards and budget. This arrangement should be improved by making a clear distinction between the external oversight of IEKA and direct involvement in its

governance, and by establishing a system of public oversight through phasing in key provisions of the new Eighth EU Company Law Directive including, but not limited to, selecting individuals to participate in the oversight process under an independent and transparent nomination procedure; ensuring that the system is governed by a majority of non-practitioners who are knowledgeable in the areas relevant to auditing; and putting in place transparency mechanisms, including the publication of annual work-programs and activity reports. This system should have the ultimate responsibility for the public oversight of:

- the approval and registration of statutory auditors and audit firms;
- the adoption of standards on ethics, internal quality control of audit firms and auditing, and
- continuous education, quality assurance, and investigation and disciplinary systems.

35. **Government regulation of the profession through the Ministry of Finance will need to be enhanced in order to serve as a proxy for public oversight.** The audit profession's public consists of clients, creditors, government, employees, investors, the business and financial community, and others who rely on the objectivity and integrity of auditors. Any effective system of public oversight should take account of the needs of these stakeholder groups as no single stakeholder has a sufficiently broad scope to adequately reflect these diverse interests.

36. **Minimum competency requirements for membership of the audit profession are determined by the government and are as follows:**

- An Economics degree from a university;
- Age of at least 25 years;
- At least three years of professional experience working with an auditor and/or audit firm recognized by IEKA;
- Successful completion of examinations co-organized by the independent Examination Commission⁸ (discussed in detail in Section II.C below);
- Albanian citizenship of at least 5 years; and
- No criminal record.

IEKA requires its members to obtain continuing professional education in order to maintain the professional competence required for licensed auditors. The Examination Commission and IEKA believe that these competency requirements limit members of the profession to highly qualified individuals. However, this perception is not widely held by all auditors, regulators or companies in Albania and many interviewees expressed the view that the education and training, which are described fully in Section II.C, need to be better aligned with international standards and practices.

37. **The system of licensing foreign auditors and firms in Albania is fairly open with minimum requirements.** As with local audit firms and individuals, licensing is conducted through the Registration Commission comprised of five members. The Registration Commission is an independent organ and IEKA appoints only one of five members to this Commission. The Registration Commission approves local and foreign individuals and firms as auditors to carry out audit activities. Foreign qualified individuals (with a home country audit license) are required to pass an examination on Albanian laws relevant to the statutory audit and provide proof that they

⁸ The members of the Examination Commission are appointed by the Minister of Education and are as follows: one representative (chairman) from the Ministry of Education; one representative from the Ministry of Finance; the Chairman of the National Accounting Council; one representative from IEKA; and one professor from the Higher Education Institutions in the field of Civil or Penal Law.

have not been disbarred from working in the profession in their country of origin in order to be registered as certified auditors (sole practitioners) in Albania. Foreign audit firms are required to have authorization to conduct statutory audits pursuant to applicable legislation in their country of origin. According to Article 36 of Government Decree No.150/2000 foreign audit firms can operate in one of the following ways:

- by ensuring the presence of the qualified auditors in Albania during the performance of the audit;
- by establishing a branch, agency or office in Albania; or
- by establishing and registering a subsidiary company in Albania which is fully owned by one or several foreign audit firms.

Given the limited number of local audit firms in Albania, foreign audit firms have expanded the pool of available auditors with sufficient theoretical knowledge and technical skills to conduct audits of financial statements prepared according to IFRS. However, the current arrangement raises challenges for the regulation of these firms, where cross border services are provided, such as the legal right of access to working papers held in the home country and the ability to review the quality control arrangements of the firm in its home country. Therefore, an appropriate quality assurance system to monitor them would need to be instituted, perhaps in cooperation with their home country regulator.⁹

38. **The register of auditors updated and prepared by the Registration Commission needs to be enhanced to provide timely and relevant information.** The register includes the names and other pertinent details related to individual members, local and foreign audit firms. Although publicly available, it is not updated in a timely manner (currently once per year) and does not incorporate all the information required to inform the public and to effectively monitor the activities of auditors.

39. **IEKA has developed a Code of Ethics for its members based on IFAC's Code of Ethics for Professional Accountants.** The translated Code of Ethics will become effective on June 30, 2006 and will become a reference for IEKA's members upon publishing at the beginning of 2007.

40. **There is evidence that the independence of auditors from the audited entities is not always observed in practice.** The current practice in Albania is not in line with the independence requirements of the IFAC Code of Ethics for Professional Accountants. While there are factors outside the profession which directly affect auditors' ability to act independently (e.g., the limited capacity in many companies to prepare proper financial statements), the breaches of independence requirements adversely affect the perceived value of an audit.

41. **There is a need for transparency reporting requirements for statutory auditors of public interest entities in Albania.** Given the significance of *public interest entities* to the economy, stricter rules are necessary on auditing, including information on the auditors who conduct audits of the financial statements. Transparency reporting by these audit firms would facilitate additional monitoring and supervision and also enhance public confidence in the statutory audits of *public interest entities*. Information to be provided on an annual basis by the audit firm should include: description of the legal structure and ownership; membership of a network of audit firms; description of the internal quality control system; information regarding

⁹ Chapters VIII and XI of the Eighth EU Company Law Directive could provide guidance on how Albania may wish to enhance the regulation of foreign audit firms.

the fees earned for statutory audits, other assurance services, tax advisory services and other non-audit services; basis for partner remuneration; and others.

42. **Hourly statutory audit fee for local auditors is currently determined by the Government Decree No.150/2000. It is reset annually by the Ministry of Finance in consultation with IEKA.** This decree has put in place a system for determining the normal time (number of hours) required to conduct an audit based on a company's total assets and income. It also includes an exceptions for usage of this system to large entities, listed companies, and financial institutions. Foreign audit firms are exempt from applying the hourly statutory audit fee set by the Minister of finance and from applying the normal time (number of hours) determined by government decree NO. 150/2000. The rationale for this fee setting is to prevent auditors from offering extremely low fees in their attempt to attract audit clients without due attention to the audit quality. Whilst this approach may prevent "lowballing" on audit fees, a better approach would be to monitor quality via external quality assurance. The requirements in the Eighth EU Company Law Directive regarding independence, including audit fees, could serve as a benchmark.

The Accounting Profession

43. **Previously, the Ministry of Finance regulated the right to provide accountancy services in Albania but the new Accounting Law 2004 is silent on the issue.** The Ministry of Finance awards the designation of Certified Accountant to individuals who provide external professional accountancy services. Certification requires at least three years of experience in accounting and passing an examination administered by the Ministry of Finance. Companies were required, unless prohibited by other regulation, to have their financial statements prepared by a Certified Accountant or by one employee graduated in Finance. This apparent deregulation of accountancy services is a positive step given the recent debate in the EU.¹⁰

44. **Certified Accountants apply rules on the preparation of Financial Statements specified by accounting law and depending on the reporting model chosen, Financial Statements are more oriented to the needs of the tax authorities than to the needs of investors.** While the signature of the Certified Accountant is not required by law, a practice has emerged whereby Certified Accountants sign tax declarations along with management. This practice is the *de facto* norm because of the widely held perception that it minimizes the risk of tax inspections. The lack of understanding, demonstrated by tax regulators and entities, of the distinction between tax reporting and financial reporting contributes to the current situation which ultimately leads to distortions in statutory financial statements.

45. **The roughly 1,500 Certified Accountants are not regulated beyond the certification phase.** Approximately one half of all Certified Accountants in Albania are members of Institute of Certified Accountants - IKM (former LPKM), a small minority has membership in SHKFSH, and the others choose not to be members of a professional organization. This situation raises serious concerns about the professional and ethical standards that Certified Accountants adhere to and the resulting impact on the quality of the financial statements which they prepare.

46. **IKM attempts to regulate its members through its own internal rules, such as statute, internal regulations and the Code of Ethics as issued by IFAC in 2001, translating and adopting only PART A applicable to all professional accountants.** IKM is working on the

¹⁰ See "Economic Impact of regulation in the field of liberal professions in different EU Member States", Ian Paterson, Marcel Fink, Anthony Ogus, Institute for Advanced Studies, Vienna, January 2003 (available on the DG Competition website at <http://europa.eu.int/comm/competition>).

drafting of professional codes and on the qualification of its members with IFRS, NAS and ISAs. However, its development is limited by funding and capacity constraints. It has signaled its intention to negotiate a relationship with the Association of Certified Chartered Accountants (ACCA) which is based in the United Kingdom (UK). It has close relations with IEKA which it collaborates with for some training courses on IFRS. Such collaboration is practical and sensible given its resource limitations. Furthermore, IKM also collaborates with the Tirana University, Faculty of Economics regarding the coordination of the qualification projects.

47. **The SHKFSH, another accounting organization in Albania, is comprised of individuals who have an interest in accountancy in Albania.** It is a private entity with some requirements for membership. Its members include Certified Accountants accounting professors, teachers, students, and tax and customs inspectors.

C. Professional Education and Training

48. **The professional education and training of accountants and auditors need to be substantially revised in order to meet the demands of those requiring their services.** There are significant challenges related to the education, training and certification of professional accountants and auditors in Albania. For example, the certification process is not highly regarded by some employers and employees of auditing firms. Reasons cited included: skepticism of the content of training and tuition material; limited confidence in the examination process; lack of translated IFRS material. Some employers prefer to sponsor their employees in obtaining international certifications such as the UK ACCA, and to a lesser extent the American Certified Public Accountant (CPA).

49. **The best graduates are not attracted to the accounting and auditing profession.** In general, the best graduates are attracted to those careers where the starting salaries are higher and the prospects for career development are greater such as in the fields of banking and finance. Given the increasing complexities of the standards and regulations it is necessary that bright and talented individuals are attracted to join and remain in the profession.

50. **There are some weaknesses in the university accounting curriculum especially related to international accounting and auditing standards, and business ethics.** These findings were borne out in a recently conducted study, *Global Accountancy Education Benchmarking Pilot Project* commissioned by the United States Agency for International Development (USAID).¹¹ The accounting curriculum does not sufficiently cover auditing or ethics and the coverage of IFRS is minimal as well. In addition to revising the curriculum, there is a need to provide resources to effectively teach it. During the finalization of this report, the ROSC team was informed that the curriculum was very recently improved concerning audit and IFRS subjects. However, the timing of this information did not allow further assessment.

51. **The content of the professional accounting (Certified Accountants) and auditing (Certified Auditors) education falls short of International Education Standard (IES) 2,**

¹¹ See *Report on the Results of the Global Accounting Education Benchmarking Pilot Project: Promoting Regional Integration, Transparency and Accountability by Supporting the Development of the Accountancy Profession*, R. William Phelps (USAID) and Dr. Gert Karreman (CARANA Corporation). The full report is available at: <http://www.carana.com/assets/gaebFinalReport.pdf>

Content of Professional Education Programs.¹² The Certified Accountants’ professional examination does not cover extensively IFRS, ISA, business ethics, information technology and other critical areas. The Certified Auditors’ professional examination also needs to be enhanced in order to fully cover key areas such as IFRS, ISA, ethics, etc. In addition, potential candidates must fulfill all other competency requirements (outlined in Paragraph 36 above) prior to sitting professional examinations. Professional examinations are organized and supervised by the independent Examinations Jury, whose members are appointed by the Minister of Education.¹³ The five examination subjects are:

- Accounting, analysis of accounts and “review services;”
- Civil Law, Company Law, Criminal, and Labor Law to the extent they affect the statutory audit of financial statements
- Accounting, legal and professional regulations (related to the audit profession – including: auditing standards, professional regulations, ethics, etc.);
- Organization, management and internal controls of enterprises, including information system; and
- Taxation;

These five examination subjects do not sufficiently cover all the range of areas outlined in IES 6, *Assessment of Professional Capabilities and Competence*. Specifically, areas minimally covered include IFRS, cost and management accounting, corporate governance, etc.

52. **The current length of time required to fulfill the practical experience obligation for certification as a Certified Auditor is in line with international standards. However, the quality of the practical training needs substantial improvement.** The requirement for three years experience must be obtained with and documented by a certified auditor. IEKA reviews the documentation but does not assess training providers to ensure that they have appropriate working environment or the necessary skills. This approach will need to be reviewed taking into account the number of auditors who are able to provide quality practical training.

53. **The current examination of professional competence for Certified Accountants is insufficient to ensure that successful candidates are adequately qualified.** The examination, which is organized and overseen by the Ministry of Finance, consists of one written paper covering areas such as accounting, company law, fiscal law, auditing and financial issues. It does not fulfill the requirement of IES 6 with respect to covering “a sufficient amount of the whole range of professional knowledge, professional skills, and professional values, ethics and attitudes for the assessment to be credible...” Consequently, there are doubts about the competence and abilities of individuals certified through this process to prepare financial statements based on increasingly complex standards.

54. **IEKA’s requirement of Continuing Professional Development (CPD) for its members is a positive step and is in line with international trends.** Members of IEKA are required to complete a minimum of 40 hours of annual CPD training in order to maintain their ability to conduct audits. CPD programs need some enhancement to ensure that members of the profession develop and maintain sufficient theoretical knowledge and professional skills. This

¹² All IFAC member bodies are expected to comply with International Education Standards (IES) for Professional Accountants, which can be described as generally accepted “good practice” in the education and development of professional accountants.

¹³ The members of the Examination Jury comprise a representative of the Ministry of Education (chairman), a representative from the Ministry of Finance, the Chairman of the National Accounting Council, a representative from IEKA, and a law Professor.

training is currently offered only through IEKA by members who receive annual training under “training the trainers” programs. Broadly, the CPD programs need more profound coverage of IFRS, ISA, and ethics and other audit related topics.

55. **There are also some CPD requirements for Certified Accountants imposed by the Ministry of Finance or the accounting bodies. As per a MoF decision issued in 1998, the Certified Accountants are required to complete a minimum of 2-3 days training every two years.** In this regard, LPKM collaborates with IEKA to provide post-certification training to their members, including some topics on IFRS. LPKM has conducted full course training in Introduction to IFRS and is preparing the training course on National Accounting Standards and another course on IFRS

D. Setting Accounting and Auditing Standards

56. **The role of the NAC is two-fold, that is, translating IFRS into Albanian and preparing NAS in conformity with the Accounting Law (2004).** Under the new law, the NAC is no longer an organ of the Government but “a public professional organization with the status of a legal person.” As an independent body the NAC will be responsible for its own funding and staffing activities and there are concerns about its viability because of resource limitations. In addition, there are strict criteria for composition, selection and dismissal of the members.¹⁴ Translation of IFRS is still pending almost two years after the passing of the new law and while funding of the translation process is an issue, the availability of translators able to produce high quality translation is of greater concern. While this situation is not uncommon in countries in the non-English speaking world, it is a hurdle that must be overcome in order to begin the process of implementation of IFRS. Fundamentally, the translation of IFRS will also facilitate the education and training of the preparers, users and auditors of financial statements prepared by *public interest entities*.

57. **The sustainability of the process of setting NAS is questionable under the present circumstances.** The NAC effectively outsourced the setting of the NAS due to limited technical capacity, with funding provided under a donor financed project. An international consulting firm was hired to develop the first fourteen NAS “based on IFRS, but modified for the Albanian environment and the country’s stage of development.” A sustainable standard setting process is required to amend these standards and prepare new ones as circumstances warrant. Further, the NAC’s limited resources could affect its status as an independent accounting standard setter. In addition, given the scope of the work required of the NAC, the current staffing arrangements needs significant bolstering to support it in the technical aspects of its work.

58. **There was a consultative process in the preparation of the NAS.** The NAC embarked on a consultative due process, inviting comments and disseminating information on the new accounting standards, notwithstanding limited resources. However, accountants, users of financial statements, the business community, regulatory authorities, and other interested individuals and organizations overwhelmingly demonstrated little or no knowledge of these accounting standards. Those with knowledge of the new standards had made little, if any, preparation for implementing them and stated that they expected the new requirements to be postponed. This suggests that the NAC may not be taken seriously, which could have significant

¹⁴ The NAC should comprise two members nominated by professional organizations, two members nominated from the economics faculty of universities, two members nominated by the Union of Commerce and Trade Chambers, and three members nominated by the Ministry of Finance.

implications for compliance. This concern also extends to the decision to postpone implementation of the accounting standards to January 1, 2008.

59. **Banks have to prepare their financial statements in accordance with the Bank Accounting Manual, which needs updating.** It was prepared by the Bank of Albania and approved by the Council of Ministers in 1998 and consists of four major parts:

- Chart of accounts and general accounting principles and general principles of bookkeeping and accounting documentation;
- Accounting schemes – description of the principles related to the main banking operations and a number of examples of the most common banking operations with the corresponding accounting entries;
- Format of the financial statements; and
- Reporting forms to be submitted to the Bank of Albania for supervisory purposes.

The Bank Accounting Manual indicates that banks' financial statements consist of the balance sheet, income statement, off-balance sheet statement, cash-flow statement, and disclosure notes.

60. **There is ambiguity as to the authoritative source of standard setting for banks.** The Accounting Law (2004) requires banks to prepare their financial statements according to IFRS whereas the Banking Law requires banks to prepare their statutory financial statements in accordance with the Bank Accounting Manual prepared by the Bank of Albania. The law should clarify which accounting standards are applicable, and definitively establish the standard setter for banks, since there is likely to be contradiction between IFRS and the Bank Accounting Manual. Otherwise, banks may feel obliged to prepare two sets of financial statements.

Auditing Standards

61. **There is no clear legal authority for establishing national standards on auditing.** IEKA is the body responsible for developing professional standards (as mentioned by government decree Nr. 150/2000) because its members have adopted the use of ISA's in 1999 for periods ending on or after December 31, 2006. IEKA's action makes it the *de facto* auditing standard setter in Albania. In order to address this gap in the legal framework, a new draft Audit Law has been prepared, which mandates the use of ISA translated into Albanian.

62. **The role of the Council of IEKA as the *de facto* standard setter is to translate ISA.** Members of IEKA, appointed by the Council of IEKA to the Standard Setting Committee, led the translation of the 1999 version of the IFAC Handbook of International Auditing, Assurance and Ethics Pronouncements, which covered ISAs and IPSAs. These were subsequently approved by majority vote of the Council of IEKA after revision and editing. Changes or modifications to ISA since 1999 are published to the IEKA Journal. Currently, IEKA has signed an agreement with IFAC that conforms to IFAC translation policy, for translation/reproduction/distribution of the 2006 Handbook of International Auditing, Assurance and Ethics Pronouncements. After a period of review and editing, it will be published in 2007 and become mandatory for members in 2007"

E. Enforcing Accounting and Auditing Standards

63. **The existing monitoring and enforcement mechanisms pertaining to financial reporting by unregulated entities are ineffective.** The previous accounting law established that the Ministry of Finance could fine each member of the board of directors, or third parties who prepared the financial statements between 3,000 and 5,000 Leks (equivalent to approximately EUR 24 to 40) for non-compliance with accounting standards but there were no reported cases of enforcement. It is doubtful that these low levels of fines could serve as a deterrent for non-compliance. The new accounting law does not establish sanctions for non-compliance with the requirements of the law. This issue should be addressed as the current situation is compounded by lack of an effective audit pillar to report on non-compliance with accounting and financial reporting requirements.

64. **The Bank of Albania's priority in enforcement is with respect to prudential reporting as opposed to general purpose financial reporting.** The statutory financial statements of banks prepared under the previous Accounting Law are generally of good quality due to the detailed accounting regulations governing the banking sector and the enforcement functions performed by the Supervision Department of the Bank of Albania. However, the shift to new accounting standards (described in Paragraphs 17 and 60 above) could lead to a decline in the quality of the financial statements as supervisors and preparers become familiar with the new standards. The Banking Law establishes the Bank of Albania's authority to enforce accounting regulations and conduct supervision activities. Supervisors conduct full scope on-site examination on each bank once per year. While this establishes a regular review of compliance with applicable accounting regulations, the Bank of Albania focuses more on prudential reporting than on general purpose financial reporting. Consequently, misstatements and errors in general purpose financial statements may remain undetected unless prudential considerations warrant it.

65. **The number of Bank of Albania staff involved in enforcement activities appears to be adequate but they will require considerable training to effectively enforce Article 4 of the Accounting Law (2004).** There are currently 22 members of staff in the Supervision Department, 18 involved in on-site supervision and four working in off-site supervision. This number appears to be sufficient given the number of banks and that banking supervisors have expertise in the accounting requirements outlined in the Bank Accounting Manual and can challenge banks and their auditors where differences arise. After IFRS implementation, banking supervisors will need to have sufficient technical accounting knowledge, for example in IFRS 7, *Financial Instruments: Disclosures*, IAS 32, *Financial Instruments: Disclosure and Presentation*, and IAS 39, *Financial Instruments: Recognition and Measurement*, to effectively monitor and enforce compliance with IFRS.

66. **It is unclear what sanctions could be imposed in the event a bank did not comply with accounting and financial reporting requirements.** The Banking Law establishes sanctions for non-compliance with the provisions of the Law. Such penalties include administrative and remedial sanctions, fines on the Board of Directors, and revocation of licenses. However, there is no mention of specific sanctions related to non-compliance with accounting and financial reporting requirements and whether management, the entity, or both would be held responsible. The Accounting Law (2004) refers only to general administrative, civil or criminal liability based on the provisions of the Civil Code, Penal Law or other laws based on damage caused or at the request of interested parties. There is no indication of the parties to be charged where there are violations. Clarity as to the requirements and sanctions available for non-compliance is an important underpinning of an enforcement framework as it makes clear to participants the obligations and penalties for non-compliance.

67. **ISAA is not yet an effective enforcer of accounting and financial reporting requirements of insurance companies in Albania.** The Supervision Department of ISAA has seven members of staff of which three are responsible for off-site supervision. The main focus is on prudential reporting as opposed to general purpose financial reporting. The staff, mainly with backgrounds in finance, is more concerned with technical and performance data and has limited expertise to challenge inappropriate accounting treatments in the financial statements prepared and submitted to ISAA. The significant deficiencies in the financial statements reviewed and discussed in Section III, and the lack of sanctions applied to any of the companies involved, is indicative of lax enforcement of accounting standards in the insurance sector. ISAA's effectiveness will be dependent on an increase in the number and expertise of its supervision staff and respect for its authority by those entities that fall within its purview.

Auditing Standards

68. **IEKA's quality assurance review system needs significant improvement in order to consistently detect non-compliance with auditing standards.** IEKA's authority to monitor compliance with auditing standards is established in IEKA Council Decision 15/2002, under which IEKA is required to conduct mandatory reviews of its members, including sole practitioners, once every four years or more frequently if non-compliance is suspected. Due to a shortage of adequate staff with sufficient expertise, reviews are conducted once every seven years. Monitoring and enforcement are conducted by a sub-committee of IEKA Council, the Quality Control Committee. On an annual basis the Quality Control Committee selects and approves members of IEKA to conduct quality assurance reviews. It compiles the work program and guidance for these reviews and provides training to the reviewers. This system conducted 28 reviews, representing approximately 20 percent of members, in 2005. None of the local members of international audit firm networks have been reviewed and language has been cited as a problem since these firms keep most of their audit files in English (refer to Paragraph 37 above). The quality assurance review process appears to be ineffective because of the levels of knowledge and experience of reviewers.

69. **IEKA's full compliance with SMO 1 *Quality Assurance* and the Eighth EU Company Law Directive would strengthen the monitoring of compliance with auditing standards.** In order to improve the current system and eventually adopt international best practice, for example that outlined in the Eighth EU Company Law Directive, IEKA will need to reconsider areas such as the professional education and criteria of those who conduct reviews; the process of selecting reviewers; the funding of the review process and how it affects the independence of the process and the reviewers; the scope of the reviews; and annual publication of the overall results of the reviews. In addition, the requirements of SMO 1 *Quality Assurance*, such as applying a risk based approach to the quality assurance review and taking corrective and disciplinary actions, needs to be complied with.

70. **Investigation and discipline of non-compliance with auditing standards and rules of ethics and independence is conducted by the Disciplinary Commission with input from IEKA¹⁵.** The Commission, which is independent of IEKA, has responsibility for investigating complaints made against registered auditors by IEKA or third parties. Appeals of the decisions

¹⁵ The Disciplinary Commission comprises a lawyer (Chairman) appointed by the Minister of Economic Cooperation and Trade, a member appointed by the Minister of Justice, a member appointed by the Minister of Finance, a qualified professional in the field of enterprise management appointed by the Chamber of Commerce, and a member of IEKA.

are handled by a separate Appeal Chamber for Disciplinary issues whose members are different from those on the Disciplinary Commission. Of the four to five cases referred by IEKA to the Disciplinary Commission (discussed in Paragraph 70 below) annually, it is unclear how many were as a result of repeated failures to comply with auditing standards. The sanctions available to IEKA before the issue is addressed by the Disciplinary Commission include issuing warning letters. The sanctions do not include the authority to fine, suspend or remove members from IEKA as these sanctions are only imposable by the Disciplinary Commission. Four or five cases are brought before the Disciplinary Commission annually. However, since the Disciplinary Commission does not publish a report on its activity the nature of the cases and their outcomes are not readily available. There does not appear to be a clear distinction between the investigation and disciplinary process in order to safeguard the rights of members and others involved in the process. This could be addressed by adherence to SMO 6 *Investigation and Discipline*.

III. ACCOUNTING STANDARDS AS DESIGNED AND AS PRACTICED

71. **This section outlines the accounting *standard and compliance gaps* analysis.** The *standard gap* analysis compares Albanian accounting requirements (hereinafter, local GAAP) with IFRS in order to identify significant differences, which may adversely impact the reliability of local GAAP-based financial statements (refer to Paragraphs 0 below to 74 below). The *compliance gap* analysis focuses on the compliance of the statutory and voluntary/contractual (e.g., required by a lender) financial statements with local GAAP and IFRS, respectively, in order to identify any shortcomings (refer to 75 below to 80 below).

72. **The review of the General Accounting Plan and information provided by stakeholders revealed several areas of differences between local GAAP and IFRS.** This analysis was conducted based on the requirements in effect at the time of the review, as stated in the Accounting Law (1993) and the General Accounting Plan.¹⁶ Selected key differences between local GAAP and IFRS that may have a significant impact on the financial statements of *public interest entities* are :

- ***Several topics relevant to unregulated companies are not covered by any standard.*** They include IFRS 3, *Business Combinations*; IFRS 5, *Non-Current Assets Held for Sale and Discontinued Operations*; IAS 11, *Construction Contracts*; IAS 14, *Segment Reporting*; IAS 17, *Leases*; IAS 19, *Employee Benefits*; IAS 23, *Borrowing Costs*; IAS, 28, *Investments in Associates*; IAS 30, *Disclosures in the Financial Statements of Banks and Similar Financial Institutions*; IAS 31, *Interest in Joint Ventures*; IAS 34, *Interim Financial Reporting*; IAS 36, *Impairment of assets*; and IAS 40, *Investment Properties*.
- ***Limited accounting policies, explanatory notes and other disclosures.*** The current requirements differ from IAS 1, *Presentation of Financial Statements* because the Cash Flow Statement and the Statement of Changes in Equity are not required. Further disclosure requirements such as those specified in IAS 10, *Events after the Balance Sheet Date*, IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*, IAS 24 *Related Party Disclosures*, and IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, are not required.

¹⁶ The due diligence mission was conducted in December 2005 before the Accounting Law (1983) was repealed. In December 2005 enterprises were required to prepare financial statements in compliance with the Accounting Law (1993) and the General Accounting Plan.

- ***Different accounting treatment of key items*** may have a significant impact on entities' financial statements include:
 - IAS 16, *Property, Plant and Equipment (PPE)* allow a variety of depreciation methods in order to allocate the depreciable amount of an asset on a systematic basis over its useful life. The local GAAP only permits use of the straight-line method which may not adequately reflect the pattern of use of PPE and may result in under- or overstatement of assets and income.
 - IAS 21, *The Effects of Changes in Foreign Exchange Rates*, requires that foreign currency gains and losses are recognized in the income statement when they arise whereas under local GAAP, foreign currency translation gains and losses are deferred in the balance sheet till the related monetary asset is derecognized. This may result in under- or overstatement of the total assets or liabilities in the balance sheet.

73. **Currently there are specific differences between IFRS and local GAAP pertaining to banks.** As discussed in Paragraph 18 above, banks are required to prepare financial statements in compliance with the Bank Accounting Manual. Selected key differences that may have a significant impact on the financial statements of banks include the following:

- ***The Banking Manual does not reflect changes to International Accounting Standards (now, IFRS) since 1998.*** Relevant omissions include IAS 30, *Disclosures in the Financial Statements of Banks and Similar Financial Institutions*, IAS 32, *Financial Instruments: Disclosure and Presentation*, and IAS 39, *Financial Instruments: Recognition and Measurement*. Consequently, local GAAP differs significantly from “full IFRS,” in particular regarding the recognition, measurement, and disclosure of financial instruments and the nature and extent of risks arising from these instruments. This could preclude users of banks' financial statements from obtaining a true and fair view of the financial condition of banks.
- ***Allowance for loan losses are based on a formulaic methodology, which may result in under- or overstatement of the loan portfolio as compared to IFRS.*** Local GAAP requires banks to calculate impairment in the unsecured portion of loans and receivables on the basis of a provisioning matrix that specifies a range of fixed minimum provisioning rates for each category (Standard – 1%, Watch list – 5%, Substandard – 20%; Doubtful – 50%; and Loss – 100%). While this approach may be adequate for prudential purposes, it does not comply with IAS 39, which requires the allowance for loan losses to be calculated as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate. The use of minimum provisioning rates has the following consequences:
 - It removes a significant amount of judgment from the assessment of loan losses, which greatly simplifies the enforcement of accounting requirements and introduces a certain degree of “prudence” in bank accounts.
 - It may average out the reported results of the banking sector across banks and over time, which may adversely impact the capacity of the Bank of Albania to detect changes in banking sector risks and the risks a given bank is taking. It may also hamper market discipline.
 - It may impact interest rate pricing, since banks are required to set aside a minimum amount of provision irrespective of the actual credit risk of a borrower.

Whilst these requirements should only relate to prudential reporting rather than IFRS financial statements, the review noted that certain banks also use the Bank of Albania regulations in preparing their (voluntary) IFRS financial statements. The review also noted

that the supervisory authorities and audit firms do not always challenge the fact that prudential accounting requirements are intermingled in IFRS financial statements

- ***Suspension of interest accrual on impaired assets is inconsistent with IAS 39 discounted cash flow methodology.*** Regulations require that banks suspend interest accrual on all loans classified as “substandard” or worse. While suspending interest accrual is rational in the context of a formulaic loan loss measurement methodology, it departs from IAS 39, since it is contradictory to the use of a discounted cash flow measurement policy (refer to IAS 39, Application Guidance (AG), Section 93).
- ***Share capital fluctuates with changes in exchange rates.*** Local GAAP requires that banks revalue their share capital using the closing rate at each balance sheet date, which results in a foreign exchange difference recorded as a “revaluation difference.” This revaluation difference is also included in the determination of the capital adequacy ratio. Such accounting treatment differs from that under IFRS, which requires that equity be considered as “non-monetary item” and therefore measured at historical cost in a foreign currency and translated using the exchange rate at the date of the transaction, so that no revaluation difference is recorded.
- ***Banking fees and commissions are recognized upfront instead of being taken to profit using the effective yield.*** Local GAAP requires that loan or borrowing origination fees be recognized in the income statement when received or incurred, respectively. This methodology is not in line with the measurement of financial instruments at amortized cost in IAS 39, which requires that fees and commissions be deferred and amortized to the income statement based on the effective interest rate of the instrument.
- ***Forward foreign exchange contracts are not recorded in the financial statements.*** Local GAAP requires forward foreign exchange contracts to be treated as off-balance sheet transactions, which do not give rise to an entry in either the balance sheet or income statement until they are settled by the payment or receipt of the currencies to be exchanged. Forward foreign exchange contract gains or losses are accounted for on the settlement date. This methodology does not comply with IAS39, which requires that all derivative instruments, including forward foreign exchange contracts, be measured at fair value, where changes in fair value are recorded in income statement or equity in case of cash flow hedging instruments. Complying with IAS 39 would contribute to greater transparency and better management of the risks associated with such financial instruments.

74. **There are specific differences between IFRS and Albania accounting requirements pertaining to insurance companies.** Insurance companies are required to prepare financial statements in compliance with the Accounting Law and Standing Rule No. 1 “On the Annual Reports of Insurance and Reinsurance Companies” issued by ISAA. Consequently, the differences between local GAAP and IFRS result from a combination of two factors, i.e. (i) insurance companies are subject to the same financial reporting requirements as other enterprises, which differ from full IFRS; and (ii) insurance companies also have to comply with regulations issued by the ISAA regarding the measurement of technical reserves, which are formulaic and differ significantly from the measurement principles that would apply under “full IFRS.” For example, insurance companies calculate the reserves for claims Incurred But Not Reported (IBNR) in conformity with an approach they agree with the ISAA. While this may suffice for the market at its current stage of development, the industry will need to develop expertise to enable specific and accurate measurement of reserves, which is consistent over time and across the industry.

75. **The ROSC assessed the compliance gap sampling:**

Eight sets of audited financial statements, two enterprise sector companies, one insurance company, and five banks, **which purport to be prepared in accordance with IFRS.**¹⁷ The small sample size in the enterprise and insurance sectors is primarily due to the difficulty faced in collecting IFRS financial statements.¹⁸

- **19 sets of audited financial statements**, 11 enterprise sector companies, four banks, and four insurance companies, **which purport to be prepared in accordance with local GAAP.**¹⁹

76. **The IFRS consolidated financial statements often include a considerable amount of standard wording, which may not deal adequately with the events and circumstances of that company and reduces the relevance of the financial statements to external users.** The standard wording is usually drawn from model financial statements provided by the local member firms of international audit firm networks and reflects the lack of knowledge and understanding of IFRS. In several cases, the standard wording includes accounting policies for events and transactions which are not relevant to the companies concerned. The audit firms assert that they do not prepare the financial statements and that they only assist as far as is ethically possible.²⁰

77. **The IFRS consolidated financial statements of the two enterprise sector entities appear to comply with IFRS.** Other than the areas of non-compliance duly highlighted by the auditors in their audit report, no major areas of possible non-compliance were identified. As indicated above, the sample of enterprise sector IFRS financial statements is small and therefore the results of the assessment above are unlikely to be representative of the capacity of the Albanian enterprise sector to comply with IFRS. However, a number of conclusions can be drawn from the review of these financial statements, meetings with a number of enterprise sector companies and their auditors:

- ***Lack of accountants with experience in IFRS.*** The two sample companies are newly incorporated companies with foreign direct investment and outlined difficulties in recruiting and retaining qualified accountants able to prepare IFRS financial statements. This resulted in reliance on local member firms of international audit firm networks to provide significant assistance in the preparation of IFRS financial statements (refer to Paragraph 76 above). The lack of experienced accountants will be compounded in Albanian enterprises, and reliance on auditors is likely to increase as the requirements of the Accounting Law (2004) take effect.
- ***Albanian enterprises will face considerable difficulty in measuring assets and liabilities in conformity with IFRS.*** The two sample companies with foreign direct investment do not have legacy issues (e.g., valuation of property, plant, and

¹⁷ All financial statements in the sample are audited by local member firms of international audit firm networks. Four audit reports were unqualified (one included an emphasis of a matter paragraph), three were qualified, and one included a disclaimer of opinion.

¹⁸ IFRS financial statements are not required by statute and therefore not readily available. Due to the sample's small size, it cannot be considered to be representative of all companies. Hence, the findings, although useful for illustrating potential problems in financial reporting, pertain to shortcomings found in the financial statements of specific companies.

¹⁹ Seven sets of financial statements in the sample are audited by local member firms of international audit firm networks and 12 sets by local audit firms or sole practitioners. 13 audit reports were unqualified, five were qualified, and one report was unclear.

²⁰ In several instances the electronic file of the sample audited financial statements left little doubt as to who had prepared the financial statements, since the properties ascribed the file to the local member firms of international audit firm networks.

equipment where the acquisition cost is uncertain) but Albanian enterprises face considerable difficulty in valuing property, plant and equipment. The lack of appraisers with internationally recognized qualifications is likely to lead to significant difficulties in the use of IFRS with the transition from local GAAP to IFRS for those companies that are unable to calculate the IFRS carrying amount of property plant and equipment.

- ***Accurate recognition of assets and liabilities is a challenge for Albanian enterprises under IFRS.*** Many companies still struggle to deal with bookkeeping for cash and similar transactions or reportedly maintain two sets of books to evade taxes. A majority of companies also struggle to deal with accrual accounting and disclosures. They also have difficulty identifying intra-group transactions as their identification was unnecessary in the past because of either the focus on legal entity financial statements or the lack of group structures.

78. **The IFRS consolidated financial statements of the five commercial banks purport to comply with IFRS but there is evidence of non-compliance with IAS 21, *Effects of Changes in Foreign Exchange Rates* in three banks.** One bank uses the US\$ as the measurement (functional) currency, a practice which conflicts with SIC 19, *Reporting Currency—Measurement and Presentation of Financial Statements under IAS 21 and IAS 29*. Two banks treat equity as a foreign currency monetary item which conflicts with IAS 21. In addition to these issues, the review and discussions with management and auditors highlighted the following possible areas of non-compliance with IFRS:

- ***Under- or over valued financial assets and liabilities:*** A number of bank financial statements set forth that “the lack of liquidity in the Albania market means that it is not possible to determine the fair value of all financial assets and financial liabilities.” Hence, these banks concluded, without supporting evidence, that the “fair values of trading and investment securities are not materially different from their carrying values.” In the absence of a rigorous attempt to assess the fair value, it is impossible to determine whether the values are reasonable.
- ***Use of prudential measurements to determine recognition of assets and liabilities in IFRS financial statements:*** The application of IAS 39, *Financial Instruments: Recognition and Measurement*, may be distorted by the prudential requirements for loan loss provisioning. While the notes to the financial statements rightly set out that “... for the purpose of measuring the allowance for loan losses, the recoverable amount of loans is measured at the present value of the expected future cash flows,” bank management was unaware of this measurement policy. Also, certain financial statements set out that “loans are placed on non-accrual status when interest or principal is overdue for more than 90 days,” which may be contradictory to the use of a discounted cash flow measurement policy.

79. **The IFRS consolidated financial statements of the insurance company purport to comply with IFRS but were duly qualified by the auditors due to material non-compliance with IFRS and scope limitation, including:**

- ***The company does not measure property, plant and equipment in accordance with IAS 16, *Property, Plant and Equipment (PPE)*.*** The company revalued PPE as of December 31, 1997 by means of coefficients rather than the use of fair values as required by IAS 16. Consequently, the carrying value of PPE (and the related depreciation expenses) may be over- or understated.

- *The company failed to revalue insurance liabilities for losses and loss adjustment expenses and unearned premium insurance liabilities, denominated in foreign currency at the exchange rate at the balance sheet date.*
- *The auditors have been unable to determine whether the amounts of premiums received are correctly stated and to gather sufficient data to assess some insurance liabilities.*

As discussed in Paragraph 76 above, many of the accounting policies are standard wording and do not relate to events or transactions covered by the financial statements.

80. **With the exception of the banking sector, the quality of local GAAP-based financial statements was generally weak with a number of significant non-compliance issues.** As mentioned below, these issues are so significant that, in most instances, users of these financial statements would be unable to make an informed decision on their basis or, worse, could be misled in their decision-making process. The issues noted included:²¹

- *While the sample bank financial statements generally appear to comply with local GAAP, all banks overstated their cash and cash equivalents. Also, one of the banks uses the US\$ as the measurement (functional) currency.* All banks included deposits with the Bank of Albania (statutory reserves) in cash and cash equivalents. Some also included time deposits in cash and cash equivalents. These amounts are not highly liquid. Including them as part of cash and cash equivalents may present a more favorable picture of a bank's liquidity than the actual case.
- *All insurance companies in the sample fail to present a statement of cash flows and a statement of changes in equity.* Also, one of the insurance companies fails to present consolidated financial statements. Three out of four insurance companies fail to disclose any relevant information on the accounting policy and composition of their insurance premiums, liabilities, and technical reserves. These shortcomings are such that a reader of the financial statements cannot draw any conclusions on the basis of preparation or the financial condition of the company.
- *Enterprise sector financial statements are generally unclear.* Among the 11 sample financial statements, four included tax returns rather than financial statements prepared in conformity with local GAAP and two used a cash basis of accounting.

IV. AUDITING STANDARDS AS DESIGNED AND AS PRACTICED

81. **The auditing standards adopted in Albania are ISAs and the resources applied to translating ISA appears to be well in advance of the level of current understanding and usage of ISA.** The problems identified with regard to the practice of ISA are at a much more basic level. For example, problems with the independence of auditors, objective of an audit, audit risk assessment, basic audit procedures, and other such common problems were noted. The major challenge facing Albania is in education regarding ISAs and encouraging and enforcing implementation of the basic principles contained in the standards.

²¹ The ROSC team decided to report only on issues which were deemed material and beyond doubt. Hence, several potential non-compliance issues are not reported in this report, when the ROSC team was unable to conclude without question as to the nature and materiality of the non-compliance.

82. **Differences in the technical proficiency, level of experience and level of resources across the audit firms result in differences in audit quality.** The review of audited financial statements identifies specific issues that adversely impact the average quality of auditing practices in Albania:

- ***Inadequate and inconsistent internal quality control across audit firms.*** While some local member firms of international audit firm networks with a direct presence have the benefit of firm-wide internal quality control procedures, others have limited support. Issues which raise concerns about the audit of financial statements (including IFRS financial statements) carried out by local member firms of international audit firm networks include:
 - Non-compliance with the IFAC Code of Ethics for Professional Accountants, in particular Section 8, *Independence*. This matter is discussed in Paragraph 39 above.
 - Non-compliance with ISA 240, *The Auditor’s Responsibility to Consider Fraud in an Audit of Financial Statements*. The review noted that several local member firms of international audit firm networks do not systematically undertake the procedures required under ISA 240 although the standard is likely to be very relevant in an environment where tax fraud is often cited as rampant. This conclusion was made on the basis of direct statements from the local member firms of international audit firm networks and also from audit firm reviews conducted by the World Bank for fiduciary purposes.
- ***A significant number of audit reports prepared by local audit firms were so poor as to preclude a user of these audited financial statements to reach any conclusion about the work undertaken by the audit firm.*** These included the following issues:
 - Based on the review of the financial statements, 10 of the 19 financial statements audited by local audit firms were, beyond any doubt, prepared by the auditor. Confusion as to the role of the auditor is illustrated by the inclusion in the notes to the financial statements of “audit adjustments” which were not recorded.
 - Again, 4 of the 19 audit reports included an audit opinion on tax returns in lieu of the financial statements illustrating the lack of understanding among auditors (and management) about the objective of an audit.

The insurance industry and specialists are at an early stage of development. In testing the completeness and accuracy of claims reserving, the audit firms do not appear any further advanced than the insurance companies subject to their review.

V. PERCEPTION OF THE QUALITY OF FINANCIAL REPORTING

83. **There is a general perception that, with the exception of banks, the financial statements in Albania are of a low quality.** The higher quality of the banks’ financial statements has been attributed to closer monitoring and enforcement by the Bank of Albania, restriction on audit firms allowed to audit banks, and banks’ ability to attract highly qualified professionals. On the other hand, the poor perceived quality of the financial statements of other entities, in general, stems from limited demand for financial information from third parties, dominance of tax reporting in the absence of other demand, limited or no enforcement by the appropriate authorities, and limited capacity of auditors and accountants.

84. **Banks do not rely on the financial statements presented by potential borrowers in determining whether to extend credit.** Although entities are required to submit their financial

statements as part of the loan application process, banks generally base their lending decisions on other factors including the amount of collateral, business forecasts and site visits.

VI. POLICY RECOMMENDATIONS

85. **The recommendations of this ROSC are interrelated and mutually supportive and are designed to collectively improve the financial reporting environment in Albania.** 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.

86. **Accordingly, it is recommended that the statutory framework governing accounting, auditing and financial reporting be enhanced using a holistic approach, taking into account other laws and regulations, including company law, tax law, etc.** It is recommended that a multi-disciplinary group be established to undertake the following:

- a comprehensive review of all the legislation related to accounting, auditing and financial reporting in order to identify vague or conflicting requirements, including those related to consolidation, and applicable accounting standards for non-bank financial intermediaries and microfinance institutions.
- preparing an audit law compliant with the Eighth EU Company Law Directive to include, but not limited to, the establishment of a public interest oversight system for the audit profession, enhanced quality assurance for statutory audits, and regulations on the registration of local and foreign auditors, including audit firms.
- establishing appropriate thresholds for simplified financial reporting requirements and exemption from annual statutory audit, including the proxies used to determine economically significant entities. This will avoid burdening SMEs with excessive financial reporting and auditing requirements. Conversely, it will ensure that *public interest entities* are subject to more demanding transparency and disclosure requirements. This should be done through an analysis of the business structure in Albania.
- requiring *public interest entities* to make their legal entity (and consolidated) financial statements readily available to the public within a reasonable period after the balance sheet date.
- harmonizing the tax framework with accounting, auditing and financial reporting legislation. IFRS and NAS will introduce new categories of revenues and expenses, therefore guidance will need to be given on how to reconcile the accounting profit/loss with the taxable profit/loss. In the absence, of guidance entities will intermingle tax and accounting standards in the preparation of financial statements.

87. **It is recommended that the accounting standard setting structure be enhanced to make it sustainable.** This would entail:

- expanding the current standard setting body to include a broader range of stakeholders in order to systematically address the needs of private and public sector stakeholders in the standard setting-process, including the appropriateness of the scope of IFRS and NAS application, that is simplified reporting requirements for SMEs and more rigorous reporting requirements for *public interest entities*.
- mobilizing funding and technical expertise in order to ensure that the accounting standards are up-to-date.
- documenting, disseminating and implementing a clear strategy for the drafting and adoption of standards, which includes an effective consultative process. This will help address the low level of awareness and implementation of accounting standards currently exhibited.
- exploring synergies with respect to translating accounting and auditing standards according to International Accounting Standards Committee Foundations (IASCF) and IFAC translation policies. The NAC should explore opportunities to collaborate with the auditing standard-setter, including pooling resources and using common software.
- banking and insurance regulators to engage in international forums exploring the relationship between prudential and general purpose financial statements in order to design prudential filters. This would address regulators' concerns that application of IFRS could jeopardize regulatory criteria of own funds and introduce volatility in the financial statements. In this context, the Bank of Albania should have regard to (i) the guidelines on a common reporting framework (COREP)²² 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 Albania where a significant portion of the banking sector is foreign owned.

88. **It is recommended that a sustainable auditing standard setting structure be created.** This would necessitate:

- establishing a sustainable auditing standard-setting process, ensuring the translation of ISAs and developing relevant audit practices, especially for SMEs
- mobilizing funding and technical expertise to ensure that ISA are translated in a timely manner. This could include exploring synergies with respect to translating IFRS.

89. **It is recommended that systematic institutionalized monitoring and enforcement mechanisms be established to ensure compliance with accounting and auditing standards.** This would require:

- updating legislation to clearly outline the authority of regulatory bodies to enforce accounting and auditing standards and to modernize the sanctions currently existing in order to make them better deterrents. While they were developed in the context of

²² The guidelines are available at <http://www.c-eps.org/standards.htm>.

listed companies, Albania may wish to have regard to the principles of accounting standard enforcement set out by the Committee of European Securities Regulators. Qualified audit reports should trigger investigations of the entities and unqualified audit reports, which should have triggered a qualification, should also lead to investigation of the audit firm.

- establishing 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 Members States, especially countries, which joined the EU on May 1, 2004, which have had to implement quality assurance systems in circumstances similar, albeit not identical, to Albania'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.
- requiring statutory auditors and audit firms that conduct statutory audits of *public interest entities* to prepare and publish annual transparency reports. These reports should include a description of the network and its legal and structural arrangements, where the audit firm belongs to a network; information on the governance structure of the audit firm; a description of the internal quality control system; a list of the *public interest entities* which were audited by the audit firm during the years; and other relevant information that would assist users of the financial statements to gain confidence in the quality of the audit work conducted.
- establishing 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 Audit Law, ISA, 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. The system may draw upon existing practices in EU Members States and IFAC SMO 6, *Investigation and Discipline*, is a useful guideline in this regard.
- adequately staffing, in terms of numbers and expertise, the bodies responsible for monitoring and enforcement. Reviewers must have expertise to review financial statements to determine whether the accounting standards have been complied with. Likewise, reviewers of audit firms should have the capacity to assess whether the internal control mechanisms within firms are adequate and effective to ensure the performance of high quality audits.
- enhancing the 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 would greatly increase its usefulness especially in the context of foreign direct or portfolio investment.

90. **It is recommended that the professionalism and the quality of the work done by the accounting and auditing profession be improved.** This would be facilitated by:

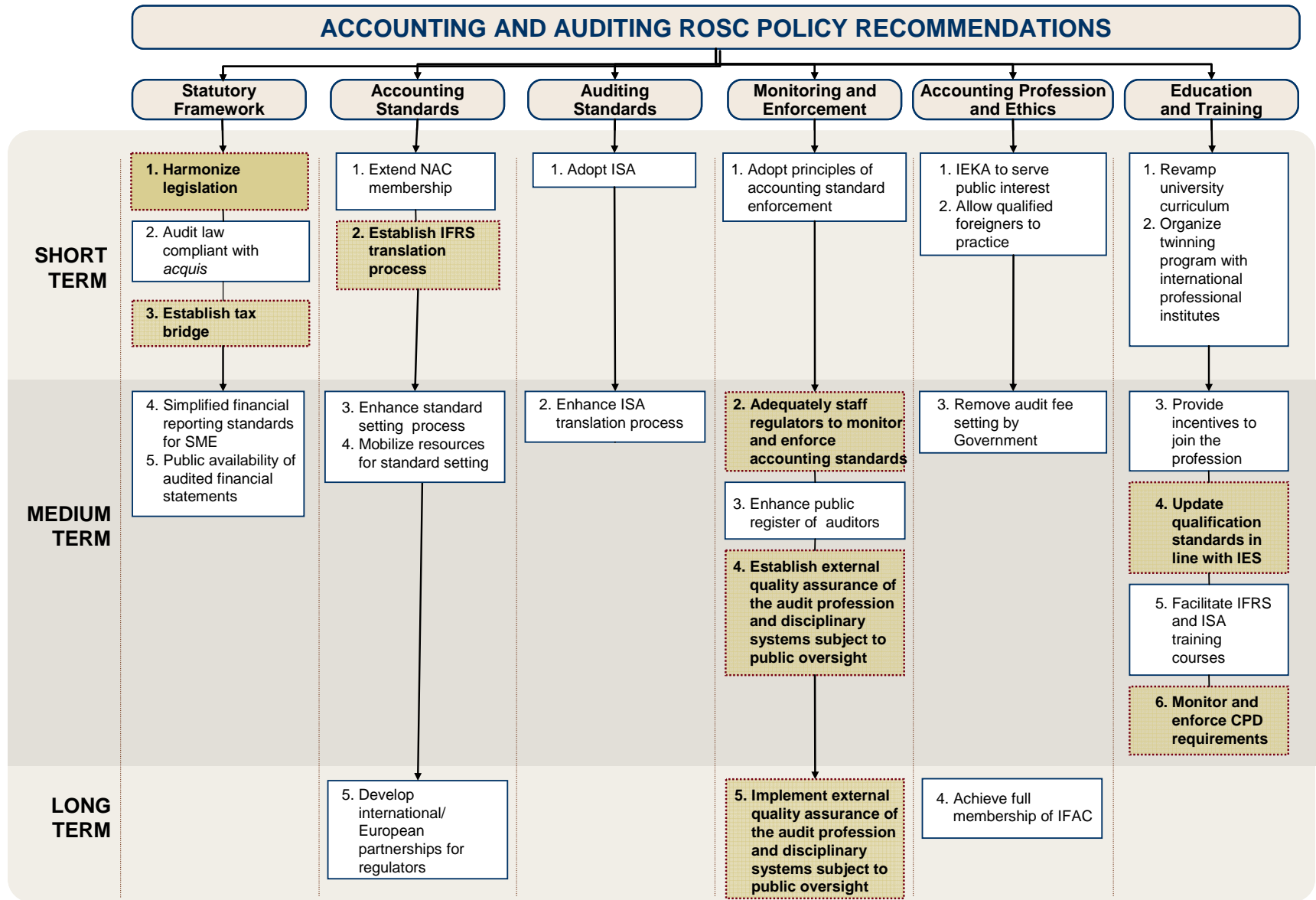
- clarifying IEKA's mandate to include serving the public's interest.
- removing audit fee rate setting by the Government, which currently restricts the scope and quality of auditors work. Instead more reliance should be placed on the

quality assurance review and investigation and disciplinary process to monitor auditor independence and audit quality.

- seeking (full) membership of international bodies, such as IFAC and, over time the European Federation of Accountants. Membership in these international bodies often provides the discipline and structure to help local professional bodies adhere to minimum standards, which helps them improve.
- Clarifying the role and responsibilities of Certified Accountants and considering the merits of a regulatory underpinning.

91. **With regard to education and training, it is recommended that the number of accounting and auditing professionals able to prepare high quality financial statements and conduct high quality audits, respectively, be increased. Initiatives to attract bright graduate to the profession and to raise the recognition of the accounting and auditing qualifications in Albania should also be launched.** This would require:

- revamping the university accounting curriculum to include more material on IFRS, ISA, business ethics and corporate governance.
- providing incentives for individuals to join the profession. Incentives could be by way of government and business entities offering scholarships for university students to study accountings.
- updating the qualification standards in line with IFAC IES. This would include updating the content of the professional examination syllabus, the content of the professional examination and the assessment of the examination in order to include critical areas that are currently omitted. This would lead to better qualified professionals and better recognition of the qualification. Given the shortage of resources in Albania, synergies should be explored between the education and qualification of accountants and auditors.
- co-ordinating and facilitating training courses, particularly in the areas of IFRS and ISA, taught by regional and international experts. Accounting and auditing courses should progress from basic to advanced level. In addition, courses should be provided in specialist areas such as financial reporting and auditing of banks and insurance companies.
- systematically monitoring members for CPD compliance and considering suspending licenses of members for non-compliance.
- establishing a professional accountancy education centre to provide up-to-date training in accountancy, auditing and financial reporting and other related subject areas.
- establishing or re-establishing linkages with international accountancy professional bodies.



 critical success factors

Figure 2: Policy Recommendations