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Croatia's EU Accession: Case Studies on Reform and the Transposition of the Community Acquis



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Preface

The genesis for this publication was conceived within the context of the *EU Road to Europe – Program of Accounting Reform and Institutional Strengthening* (EU REPARIS) regional program, which aims to provide assistance to the countries of Central and South East Europe on corporate financial reporting reform, particularly candidate countries to European Union (EU) accession. It is a product of close collaboration between the EU's most recent Member State, Croatia, and the Centre for Financial Reporting Reform (CFRR), which has extensive knowledge and experience working with countries in Europe and Central Asia to implement high-quality financial standards.

Prior to attaining membership in the EU, candidate countries are required to agree to the *acquis communautaire*, the entire body of European law. During the 2004 and 2007 EU enlargement rounds, a total of 12 countries gained EU membership and their experiences provided a plethora of information on the scope of the reforms that typically characterizes adoption and implementation of the *acquis communautaire*. However, available literature tends to focus on the gaps that countries have to address but offer limited experiential documentation of how countries scale the monumental undertaking of alignment with the *acquis communautaire*.

This collection of case studies is an attempt to share the how of one country's odyssey. Through Croatia's decade long journey from application in 2003 to EU membership in 2013, it offers a glimpse into how countries go about large-scale reform using the corporate financial reporting reform process as the lens through which the story is told. In so doing, the main objective is to offer practical insights to other EU candidate countries specifically, and in general to others seeking to adopt or modify their financial reporting framework and build administrative and institutional capacity to implement.

This publication is the end result of a series of interviews of current and former Croatian officials who were directly involved in critical reform activities. The CFRR elicited a broad variety of perspectives in order to demonstrate the complexities of implementing change when it involves powerful stakeholders who may agree on the overall direction in which they wish to go but not on the paths that should be taken. It is the hope of the CFRR that readers will find the publication informative and useful in providing practical knowledge on the process of reforms, and that it will enrich the discussion on adoption and implementation of international norms.

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The views presented in this publication are the personal views of the authors and other contributors, and do not necessarily reflect those of the institutions with which they may be affiliated.



Acronyms and Abbreviations

APOC	Audit Public Oversight Committee
CFRR	Centre for Financial Reporting Reform
CNB	Croatian National Bank
COA	Chamber of Auditors
EC	European Commission
EU	European Union
FINA	Financial Agency
FRSB	Financial Reporting Standards Board
HANFA	Croatian Financial Services Supervisory Agency
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
MoF	Ministry of Finance
PAO	Professional Accountancy Organization
REPARIS	Road to Europe – Program of Accounting Reform and Institutional Strengthening
RiF	Računovodstvo i financije – Croatian Association of Accountants and Financial Experts
SAA	Stabilization and Association Agreement
SME	Small and Medium-sized Entities
SMO	Statement of Membership Obligations

Section

1

Introduction

Croatia, a founding member of the former Republic of Yugoslavia and a current member of the European Union (EU), is a high-income country in Europe and Central Asia. Growth of the economy is dependent on the export of goods and services, and since 2012 the government has prioritized improving the business climate and raising competitiveness in order to compete in the EU common market, and to reverse the lower growth rates that it has experienced since the 2008 global economic recession. Given that high quality financial reporting promotes good corporate governance, reduces uncertainty and risk, can help to lower the cost of capital, and boosts investor confidence, it will play a critical role in the country's strategy to champion private-sector led growth for economic development. Croatia's preparation to join the European Union (EU) required reform of its corporate financial reporting framework and practices, among other things, and laid the foundation for enhanced financial reporting and increased transparency.

Although the country's accession to the European Union (EU) on July 1, 2013 was a single historical point in time, it encapsulated years of transformation of the statutory and institutional framework in every aspect of the economic, social and political spheres of the country. Accession negotiations, which lasted approximately six years, centered upon Croatia's full alignment of the 35 Chapters of the *acquis communautaire*, the dynamic cumulative body of EU laws that covers all treaties; EU legislation (including standards adopted and referred to in the legislations); Court verdicts; and all types of decisions arising from the Foreign and Security Policy and Justice and Home Affairs provisions of the treaties.

The purpose of this publication, which focuses on Croatia's adoption and implementation of the corporate financial reporting aspects of the *acquis'* Chapter 6 Company Law, is to enhance understanding of how successful transitions work in practice, that is, what makes some reforms succeed where others fail. It attempts to answer questions such as: what happens when countries adopt international standards; what issues arise when one tries to merge differing legal traditions; how to achieve reform when there are capacity constraints and key implementing institutions are missing; what are the different strategies that can be used during various phases of a reform process; and, more generally, what factors encourage failure or lead to success?

“You could be an Eurosceptic but it was impossible to believe that we would not be part of the European Union.”
- Sinisa Petrovic

In order to bring the practicalities of reform to the forefront, the authors relied on first-hand accounts from individuals who had leadership roles or were members of Chapter Working Groups during the approximately 10 years of change that culminated in Croatia’s membership in the EU. As a result, the publication reflects a variety of perspectives on the complex subject of reform but is not intended to be a comprehensive or complete evaluation of the issues. In addition, the 10 interviews conducted between 2014 and 2015 were supplemented with available written documentation such as EU screening and progress reports.

The findings from the interviews and source documents are presented in **Section 2**, which provides an overview of the country context and the state of the corporate financial reporting framework using the *acquis* as a reference point, followed by **Section 3** that covers some specific approaches taken to align the corporate financial reporting framework with the requirements in Chapter 6 of the *acquis communautaire*. **Section 4** highlights the lessons learned and summarizes steps that could be taken after accession to further enhance corporate financial reporting in Croatia. This publication is of direct relevance to countries that aspire to EU membership and those responsible for helping accession countries on that path, as well as countries seeking to adopt a robust corporate and financial reporting framework. It may be read in sequence or as individual sections depending on the interest of the reader.

Context and the State of Affairs: The Starting Point

The first formal step of Croatia's complex transformation on the path to EU membership began with the signing of the Stabilization and Association Agreement (SAA) in October 2001. Although that and other key milestones, some of which are shown in Box 1, provide a snapshot of progress made at specific points in time, they do not provide details about the factors that led to particular actions.

BOX

1

Key Milestones in Croatia's EU Accession

October 2001	Stabilization and Association Agreement (SAA) signed
March 2003	Application for EU membership
June 2004	Confirmation of Croatia's candidacy
October 2005	Accession negotiations began
June 2006	Formal commencement of Chapter Negotiations
June 2011	Closure of last of the 35 Negotiating Chapters
December 2011	Adoption of decision by European Council (EC) on Croatia's admission to the EU
December 2011	Accession Treaty signed by Croatia and the EU
July 2013	Croatia's accession to the EU

These details are important to understanding how reform is accomplished, given that change invariably takes place within a particular context and never in isolation. Therefore, it is important to begin the discussion with the state of affairs and an idea of what needed to be done since reformers always have to contend with a flux of socio-political and economic circumstances while attempting to keep reform agendas on track.



General Context

The European Commission (the Commission) noted in its 2004 *Opinion on Croatia's Application for Membership of the European Union* that Croatia, an upper middle-income country, had stable functioning democratic institutions, the opposition political parties playing a normal role in their operation. It featured a functioning market economy and relatively high GDP growth rates in the recovery period after a recession in 1999. By 2004, Croatia boasted a fair degree of macroeconomic stability, a well-educated labor force, and a highly developed banking sector. The Commission concluded that Croatia was at a favorable starting point to begin the accession transition process, notwithstanding issues with the judicial sector, high trade balance and current account deficits, and mixed results in areas such as unemployment, privatization, and the state's dominance in certain areas of the economy. Further, harmonization of the country's legal framework with the *acquis communautaire* (also referred to as the *acquis*) was already progressing pending effectiveness of the SAA.

BOX

2

A more rigorous accession negotiation process: Benchmarks

In addition to an increase in the number of chapters that Croatia and subsequent candidate countries needed to negotiate, the Commission introduced *benchmarks* - opening and closing - after the beginning of accession negotiations with Croatia.

Opening benchmarks are conditions that must first be met prior to opening negotiations. These are applied in areas where the screening phase indicates that considerable efforts would be required to achieve alignment with the *acquis*, for example the absence of basic legislation.

Closing benchmarks are conditions that are required to be fulfilled before a chapter can be closed. Negotiations are considered concluded only once all 35 chapters are closed and confirmed by the European Council.

The benchmarks, which are legislation, action plans, internal procedures or specific implementation actions, are designed to provide clear guidance and a framework for reforms, as well as allow the EU to enhance monitoring of candidate countries' progress.

Of the 35 chapters of the *acquis*, Croatia had 23 opening benchmarks in 11 chapters and 104 closing benchmarks in 31 chapters. Most benchmarks had sub-categories and Croatians estimated that they had to fulfill a total of 400 conditions.

However, the Commission noted in its assessment of Croatia's ability to assume the obligations of membership that "the *acquis* has become more onerous, and present a greater challenge for future accessions than was the case in the past." For example, after the 2007 EU enlargement rounds, Croatia and subsequent candidate countries were required to negotiate the 35 chapters (listed in the Annex), instead of the previous 31, into which the *acquis* was divided according to policy areas. Also, the more than 80,000 Official Journal pages that comprised the evolving *acquis*¹ pointed to the vast administrative and technical task facing countries preparing for accession. In addition, the Commission made it clear that Croatia's accession to the EU was contingent on its ability to implement the *acquis* as alignment with the *acquis* was a necessary but not sufficient condition to meet the obligations of EU membership².

The remainder of the section outlines the existing condition of the corporate financial reporting framework prior to the start of negotiations. It highlights the gaps that needed to be addressed and thus provides a sense of the scale of reforms that were necessary.



Chapter 6 Company Law: Corporate Financial Reporting

Corporate financial reporting rules are established in Chapter 6 Company Law of the *acquis*, which governs the operation of companies in the internal market and covers traditional company law issues such as the rules of formation, registration, merger and division of companies. It also includes disclosure requirements, rules for the protection of shareholders and creditors with respect to mergers and takeovers, presentation of annual and consolidated accounts including simplified rules for small and medium-sized enterprises (SMEs), and other aspects of corporate financial reporting. Several directives, regulations and recommendations in Chapter 6 Company Law (henceforth Chapter 6) establish the rules for corporate financial reporting as follows:

- **First Council Directive** – requires the disclosure of the financial reports of limited liability companies including balance sheets and profit and loss statements, and stipulates penalties for non-compliance.
- **Fourth Council Directive** – regulates the presentation and content of annual reports and annual accounts - comprising a balance sheet, a profit and loss account and notes to the accounts. The Directive stipulates the options for layout of the balance sheet and balance sheet items, and requires annual accounts to be audited by a statutory auditor.
- **Seventh Council Directive** – regulates consolidated (group) accounts and mandates that any company that legally controls another company must prepare consolidated accounts. It requires consolidated accounts to be audited by statutory auditors.

1 The Commission of the European Communities in its communication to the European Parliament and Council in 2001 on *Codification of the acquis communautaire* estimated that the *acquis* was comprised of over 80,000 Official Journal pages and was expected to grow at approximately 5,000 pages per annum. Updating and simplifying the *acquis* was considered necessary in order to facilitate better transposition and translation among other things.

2 European Commission. (2004). *Opinion on Croatia's Application for Membership of the European Union*. Brussels: European Commission.

- **Regulation (EC) No. 1606/2002** – obliges companies listed on a regulated market to prepare their consolidated accounts in accordance with EU endorsed International Financial Reporting Standards (IFRS). It includes an option to extend the requirement to the consolidated accounts of non-listed companies and to annual accounts.
- **Eighth Council Directive** (also known as the Audit Directive) - governs the audit of financial statements, establishes the duties of auditors, and defines professional principles to ensure auditor professionalism, impartiality and independence. It requires external quality assurance of audit activities and independent public oversight of the auditing profession.

The Directives require member states to achieve particular results but do not dictate the exact means of achieving the results, thus proving flexibility to countries' implementation process. Candidate countries are obliged to change their legislation in order to implement the Directives if national rules do not comply, in a process referred to as *transposition*. Many candidate countries struggle with aligning national rules and practices with the *acquis* in the absence of specific guidance from the EU on how to proceed in practice.

Croatia started transposition of the *acquis* prior to the beginning of negotiations. The country had amended its Accounting and Auditing Acts in 2005 with an effectiveness date of January 1, 2006 by the time the Commission issued its 2006 *Screening Report: Croatia* - an in-depth analysis of the degree of alignment of Croatia's legislation and institutions with the *acquis*. The amendments to the Acts increased alignment with the Directives governing accounting and auditing and established two key institutions, the Financial Reporting Standards Board (FRSB) and the Croatian Chamber of Auditors (COA) in March 2006. While taking into consideration the positive changes introduced by the new legislation and institutions, the Chapter 6 section of the *Screening Report* also highlighted areas of non-compliance. **Table 1** provides a summary of the significant accounting and auditing areas, which would later be the subject of Chapter 6 closing benchmarks during the accession negotiations.

At the opening of Chapter 6 negotiations in June 2007, Croatia had no opening benchmarks for the Chapter but was subject to closing benchmarks that obliged it to align the Companies Act, the Audit Act and its accounting legislation with the *acquis* and complete alignment with the directive on take-over bids.³ In addition to harmonization of legislation, Croatia had to demonstrate implementation of (i) a system of external quality assurance review of audit activities, (ii) an effective independent public oversight function over the audit profession, (iii) national financial reporting requirements compliant with the relevant directives, and (iv) mechanisms to ensure the publication of financial statements.

A little over two years after the opening of the Chapter 6 negotiations, the Chapter was successfully closed in October 2009, with Croatia having fulfilled the closing benchmarks. The next section provides a detailed account of the country's approach to alignment of Chapter 6 of the *acquis*, while taking into consideration local needs, overcoming significant time constraints, dealing with vested interests, managing reform fatigue, contending with limited financial and technical resources in key areas, and coping with EU legislations that were in a state of flux.

3 Fourth meeting of the Accession Conference the ministerial level with Croatia, Brussels, 26 June 2007

TABLE

1

Summary of Croatian corporate financial reporting framework vis-à-vis requirements in the *acquis*

<i>Acquis communautaire</i>	Croatian Law	Areas of non-alignment with the <i>acquis communautaire</i>
1 st Council Directive	Companies Act 2003	<ul style="list-style-type: none"> • Disclosure and publication of financial statements • Electronic access to company registers
4 th Council Directive	Accounting Act 2005	<ul style="list-style-type: none"> • Accounting requirements for small and medium-sized enterprises (SMEs) • Requirements for measurement and recognition • Requirements for the layout of the balance sheet and profit and loss account • Deadlines for publication of financial statements and annual reports of private limited liability companies • Issuance of national interpretations of IFRS (then IAS) • Scope of audit requirements for annual accounts
7 th Council Directive	Accounting Act 2005	<ul style="list-style-type: none"> • Specification of consolidation criteria. • Obligations for the preparation of consolidated accounts • Requirements for measurement and recognition • Requirements for the publication of consolidated accounts • Issuance of national interpretations of IFRS • Scope of audit requirements for consolidated accounts
8 th Council Directive	Audit Act 2005	<ul style="list-style-type: none"> • Requirements for the authorization of statutory auditors • External quality assurance of audit activities • Independent public oversight of the audit profession



Alignment with the acquis: Getting from here to there

Croatia utilized a defined organizational structure in its accession negotiations that included a Negotiation Team of 13 members (Chapter Negotiators⁴ led by a Chief Negotiator). The Negotiation Team, with responsibility for negotiation at an expert and technical level with EU institutions and Member States, ensured that EU requirements were understood locally and implemented as required, and also reported on the progress towards full alignment. The Team coordinated the work of the Working Groups, which were composed of a variety of stakeholders, for the 35 individual chapters.

Croatia's drive to attain membership in the European Union (EU) – the strong sense of urgency and political will – provided a powerful impetus for individuals and institutions to work collaboratively, rapidly and decisively to transform the legal, administrative, and institutional landscape. Nevertheless, observers and experts of reform would agree that while urgency and political will are indispensable to wide scale country level reform, other ingredients such as change management are critical to achieving targeted results. Hence, the successful alignment of the corporate financial reporting framework in Croatia with the *acquis communautaire* (the *acquis*) is as much a product of the specific approaches employed to guide the overall reform process of Croatia's accession to the EU, as well as distinct actions taken to harmonize national and international accounting and auditing standards. This section reveals the mechanics of a successful transition using the corporate financial reporting framework as a reference point.

“Europe is a state of mind. It’s not just the process of creating laws and institutions, but creating trust: trust created through recognized procedures and systems.”
- Sinisa Petrovic

⁴ Chapter Negotiators were responsible for single or multiple chapters.



Change Management

As mentioned earlier, Croatia EU accession benefited from a strong political commitment present from the beginning through to the very end, notwithstanding the ebb and flow of a decade long process. Therefore, the main challenge facing the country was how to foster the cooperation of stakeholders and institutions commitment.

This could have been a nightmare if there were not a coalition in place. The coalition process ensured that work that needed to be done could not be obstructed by any political party.




Consensus Building and De-politicization of the Reform Process

In January 2005, ahead of the effective date of the Stabilization and Association Agreement (SAA) and the start of accession negotiations, the Croatian Parliament, a key actor in legislative harmonization, issued the *Declaration on the Fundamental Principles of Negotiation of Full Membership of Republic of Croatia in the EU* (hereinafter the Declaration). The Declaration included the Parliament's commitment to (i) cooperate with the government to ensure the success and speed of legislative harmonization without obstruction, (ii) established a National Committee as working body of the Parliament to work with the Government, and (iii) support the conclusion of the negotiations within the shortest period of time. Also, both the Government and the Parliament pledged to back each other in a separate *Statement of the Croatian Parliament and the Government of the Republic of Croatia on Joint Actions in the Process of Negotiations on Membership of the EU* (the Statement) (2005).

The composition and the organizational structure of the National Committee for Monitoring Accession Negotiation, formed in accordance with the Declaration, was also a fundamental factor that buttressed consensus building and depoliticized the reform process. The Committee was led by the opposition leader, co-chaired by a ruling party representative and comprised equal numbers of parliamentary majority and the opposition members, as well as members of trade unions, employers' association and academia. Through this arrangement opposition parties were integrated into the accession process and their views were fully considered.

Importance of the approach



Building consensus and de-politicizing the process at the outset enabled the negotiating team to focus on the technical issues of transposition instead of political maneuvering. It also fostered support from different political parties for accession and for the actions that needed to be taken. In addition, by concretizing the process in the Declaration and Statement, the Government and Parliament safeguarded the stability of the process and facilitated continuity in membership of the change team uninfluenced by the political tide. As a result, Chapter Negotiators and the Working Groups formed for each Chapter remained the same except for some members who were nominated to other key positions in the Government or Judiciary, for example as Minister of Finance or as a judge on the Constitutional Court. The continuity was considered a critical success factor for the reforms.

Working Group Composition and the Balance of Managerial and Technical Competence



Working Group Structure

In a similar manner to the formation of the National Committee for Monitoring Accession Negotiation, the Negotiating Team and Chapter Working Groups were designed to eschew political considerations and instead focused on technical competence and garnering a variety of perspectives. Chapter 6 Working Group members were chosen based on technical competence, instead of exclusively from ministerial staff, and were drawn from a range of public and private sector stakeholders institutions. As a result, the Working Group, kept relatively small at approximately 25 members, included representatives from the Ministries of Finance and Justice, Central Bank, accounting and auditing Professional Accountancy Organizations (PAOs), Chamber of Commerce, associations of entrepreneurs, and large companies who could offer technical insights into a specific area of Chapter 6 Company Law (Chapter 6). Strong stakeholder involvement provided the expertise needed to resolve technical issues, and the variety of perspectives that ensured that issues were considered fairly and thoroughly from different standpoints.

Importance of the approach

The composition of Chapter Working Groups ensured that there was (i) the requisite technical expertise, (ii) diverse perspectives in problem solving and to facilitate stakeholder buy-in and broad support, and (iii) help with communication of reform objectives and progress to important constituencies, which served to enhance the degree of acceptance of changes.



Balancing managerial skills with technical competence

As indicated in Section I, the corporate financial reporting reforms required under Chapter 6 involved the development of national accounting standards, as well as new institutions to regulate the services provided by the audit profession. The Chapter 6 Negotiator, a professor of company law, had some knowledge of accounting and auditing issues covered under company law, which did not extend to the technical intricacies of the subject matter. The Chapter Working Group members provided the necessary technical expertise, while the Chapter 6 Negotiator focused on managing the Group so that members could best respond to technical subject matter challenges.

Importance of the approach

It allowed those with relevant expertise to operate with autonomy provided their actions did not jeopardize the outcome of the process as a whole, and made sure the process had mechanisms for management and accountability in place.



Leading for Results: Managing Necessary Allies and Strong Challengers

Small and Flexible Core Team

Within the Chapter 6 Working Group, the Ministry of Finance was responsible for driving the corporate financial reporting reforms to achieve alignment with the EU First, Fourth, Seventh, and Eighth Council Directives, as well as applicable regulations and recommendations. A small team within the Ministry comprised of four professionals and a team leader was tasked with operationalization of Croatia's (i) design and implementation of national accounting standards that were fully compliant with the EU Directives, (ii) publication and electronic access to companies' financial statements, (iii) a system of external quality assurance review for audit activities, and (iv) establishment of independent public oversight of the audit profession. The team, which was allowed to work independently, was given access to political leaders and sufficient authority to accomplish its objectives. It worked very closely with representatives and experts from the audit and accounting profession, without whom the successful adoption and application of the Directives would have been impossible.

Importance of the approach

Keeping the core team small and flexible helped with the efficiency and speed with which tasks could be completed. Empowering the team enabled it to broker cooperation and respond to conflicting stakeholder demands.

Carrots and Stick: Granting autonomy and exercising authority

The Ministry of Finance's collaboration with key stakeholders, especially the Chamber of Auditors (COA), was indispensable. Nevertheless, the cacophony of conflicting goals that inevitably arises when multiple players are involved necessitated strong leadership from the Ministry in order to avoid gridlock. Some of the changes that were required had a profound impact on the market for audit services and the audit profession and generated intense reaction from stakeholders. For example, the Ministry had to oversee the liberalization of audit fees, raising the size threshold for companies that would be subject to statutory audits, and imposing quality assurance reviews on a profession that had never been subjected to a system of external quality assurance. The Ministry needed the profession to not only support these changes but to put them into practice. Thus, the COA was simultaneously a necessary ally and strong challenger to change the status quo. The Ministry of Finance's approach was to grant authority to stakeholders to work with the team in the Ministry to determine the arrangements that would be implemented as long as they satisfied the requirements of the EU Directives. It simultaneously reserved the right, backed by the law, to exercise political authority to intervene in conflicts that could not be resolved by stakeholders and which threatened to delay or derail the reform process (See example in Box 3).

Importance of the approach

Stakeholders who are critical to the implementation of specific reforms must have influence in the design and choice of courses of action – otherwise reformers risk de facto non-compliance. On the other hand, reformers must reserve some veto power to resolve deadlocks and keep stakeholders engaged. Carrots without sticks can lead to stakeholder strategies that maintain the status quo, while sticks without carrots can lead to rules that are not carried out in practice.

“You need a team in the Ministry to coordinate the reform. Its structure should be minimal but it should be efficient and have power and autonomy. There's no need to create unnecessary structures – it is better to use light and flexible groups.”
- Damir Kaufman



BOX

3

Breaking a deadlock

There were considerable differences within the audit profession regarding the reforms. There was a perception that the new rules favored large audit firms and were designed to promote consolidation within the audit industry. Some members of the profession felt that small firms seemed destined to lose out due to increased licensing requirements that required resources they did not have coupled with a shrinking market caused by increased thresholds for mandatory statutory audit. Also, historical differences between the two groups into which the profession had originally been divided became manifested in an ongoing resistance to the establishment of a system of external quality assurance review of audit activities operated by the Chamber of Auditors. In general, accountants and auditors could not reach agreement on liberalizing the market for audit services or establishing a system of external quality assurance reviews, and the leaders of the profession could not break the stalemate. Essentially, EU accession requirements went against too many of their interests and the profession's governance processes had failed to yield a way forward within a reasonable period of time.

The Ministry of Finance stepped in using transitional clauses in the law, which provided the State with the necessary powers to advance reform. It called a general assembly of the Chamber of Auditors and reiterated that the requirements of the *acquis* upon which Croatia's candidacy rested were not negotiable. Furthermore, the profession could choose to comply or be subjected to regulation by the government – an option that the government was not interested in pursuing. The Ministry was able to persuade the profession that effective self-regulation was preferable to direct regulation by the Ministry.

In Croatia, the Ministry of Finance pursued a strategy of light intervention but projected its power and its ability to use it when necessary. If the law had not permitted Ministerial intervention – sometimes as minimal as making alternatives clear – change would not have occurred.

“Not only do [the EU] want the substance, they want the form. I could critique the EU accession process. There was an insistence on formal issues that was sometimes difficult. But, even if it is complicated and maybe even unnecessary, the good things prevail.”
- Sinisa Petrovic

Communication and Raising Awareness – Linking Key Stakeholders with Brussels

When Croatian auditors were informed of EU requirements early in the accession process there was intense resistance to the changes that would be necessary. Clear communication and raising awareness of the objectives of the Directives became critical to calm dissent and enable progress by the profession. The Chapter 6 Negotiator recognized that direct contact between Croatian stakeholders and the European Commission (the Commission) was necessary and arranged for local representatives of the profession to travel to Brussels. The meeting allowed stakeholders to ask questions, express frustrations, familiarize themselves with the EU and build relationships.

Importance of the approach

It provided a valuable opportunity for Croatian corporate financial reporting stakeholders to meet with the rule makers. Most importantly, the information-gathering visit helped to remove roadblocks, and reduced the resistance to reforms at the local level.





Operationalizing Specific Reforms

The corporate financial reporting reforms required in Chapter 6 centered upon accounting standard setting, regulation of the profession, and transparency in company financial reporting. The successful implementation of necessary changes was equally dependent on the players involved, who are described in Box 4, and the strategies employed. At the forefront of the approaches that were undertaken stood the relationships and dynamics between stakeholders, and these were heavily colored by their perspectives and goals. This remainder of this section of the publication presents the reform journey beginning with the alignment of rules (transposition of the *acquis*) through to key implementation activities.

BOX

4

Stakeholders involved in the implementation of corporate financial reporting reforms

Existing Stakeholders

Chapter Negotiator played the usual role of organizing the Chapter Working Groups and provided a communication link with the EU.

Ministry of Finance led the technical reform process and negotiated with local stakeholders in the adoption and implementation of corporate financial reporting rules and regulations.

Chamber of Auditors developed self-regulatory capacity of the profession and a system of external quality assurance review of audit services.

FINA ensured compliance with disclosure and publication requirements.

New Stakeholders

During the reform process two independent boards were established to facilitate compliance with technical accounting and auditing areas of the *acquis*. Initially, the boards, which are listed below were informal and flexible structures that brought together a variety of stakeholders with technical skills and helped to avoid bureaucracy and unnecessary costs.

Financial Reporting Standards Board (FRSB) was responsible for drafting EU compliant national accounting standards.

Audit Public Oversight Committee (APOC) was tasked with oversight of the audit profession.

Other Active Participants

The Croatian National Bank, the central bank of Croatia, and the **Croatian Financial Services Supervisory Agency** (the unified regulator of the capital markets and insurance companies) also contributed to the efforts to reform accounting and auditing practices given the linkages between general-purpose financial reporting and prudential reporting of regulated entities.

Transposition of the Directives and Legal Reforms

In Croatia, alignment with the *acquis* required rapid changes to local laws, as well as the adoption of new laws. This placed significant strain on the Croatian legislative apparatus. The volume of work overwhelmed Parliamentarians as they struggled to cope with limited time to consider new legislations, the complexity of the new legal requirements in the *acquis*, a lack of sources of detailed explanations and guidance on new legislation, and the absence of alternative options from which to choose. In order to work effectively, the Parliament separated the technical and political aspects of enacting new legislation. Parliamentary committees discussed draft legislation from a technical perspective, whereas plenary discussions were reserved for political maneuvering, for example with respect to the *acquis* requirement that the provision of audit services must be open to all EU citizens.

Accepting imperfect but expedient measures

Ultimately, the Croatian government chose to import the EU Directives almost verbatim into Croatian legislation, which resulted in rapid transposition of the Directives into Croatian Law. While this approach served to keep the reform process on track, it led to less than perfect transposition in some areas that require some post-accession remedial work. First, the comparably less prescriptive EU Directives as transposed did not fit the Croatian civil law tradition, characterized by explicit details and clear decrees. Second, the speed with which transposition occurred also affected consistency and coherency between and within various local laws. Remedial issues that will need to be addressed in order to ensure that the transposed Directives have the desired effect include, but are not limited to:

- *Clarification*: some areas of the EU Directives are general and subject to differing interpretations. Therefore, more detail needs to be added to national legislation to facilitate implementation. For example, the duties and role of an independent public oversight body for the audit profession needs to be defined in detail.
- *Consistency*: different terminology and definitions for the same terms exist in the Companies Act that is written by lawyers, and the Accounting Act that was primarily drafted by accountants. This has led to contradictory requirements.
- *Gaps*: understandably EU Directives do not explicitly state remedies for non compliance, which falls within the domain of national legislations. Direct transposition of EU legislation has created gaps in Croatian legislation with respect to sanctions for non-compliance– a requirement in Croatian jurisprudence to remedy non-compliance.

Importance of the approach

In the face of an overwhelming volume of work and in service to a higher overall objective – EU membership – Croatia chose a good option instead of the best option. The best option would have necessitated careful consideration and drafting “best-fit” national legislation. A less than perfect option facilitated timely transposition of EU legislation into national legislation.



Regulation of the profession – Chamber of Auditors and the Audit Public Oversight Committee

At the start of the Chapter 6 negotiations in June 2007, the audit profession was in the midst of a reorganization that would continue as Croatia strove to implement requirements of the Eighth Directive.⁵ Changes up to that point focused on governance and unification due to the history of the profession in Croatia, which is summarized in Box 5, and less on the typical functions of a professional accountancy organization (PAO). Those functions include (i) design and operation of a system of quality assurance review of audit activities in the jurisdiction; (ii) organizing and implementing the education of members of the profession - with respect to initial professional development and continuing professional education; professional examination and certification; (iii) maintaining registers of members and statutory auditors; (iv) overseeing investigation and discipline; (v) contributing to the adoption and implementation of rigorous professional and ethical standards, as well as accounting standards; and (vi) representing the interests of the profession domestically and internationally. The Chamber of Auditors (COA), established in 2006 and only partially fulfilling the role of a PAO, became a key player in the fulfillment of Croatia's EU aspiration, which was contingent on full alignment – adoption and implementation – of the *acquis*.

TABLE

2

Croatia Status of Compliance as at June 2007

8 th Council Directive Requirement	Selected Elements of the Requirement	Croatia's Status of Compliance
External Quality Assurance	<ul style="list-style-type: none"> Review system established All statutory auditors and audit firms subject to system of quality assurance Independence of reviewed auditors and audit firms Subject to public oversight PIEs subject to inspection at least once every three years 	No system of quality assurance established.
Public Oversight of Statutory Audit	<ul style="list-style-type: none"> Public oversight body established Governed by practitioners Knowledgeable in areas relevant to statutory audit Funding arrangements preserves independence of oversight body 	No public oversight of statutory audit.
Statutory auditor – qualification and characteristics	<ul style="list-style-type: none"> All statutory auditors subject to educational qualifications, professional examinations, practical training continuing education, system of investigation and penalties 	Some aspects established but weak overall

⁵ The Eighth Council Directive 2006/43/EC was issued in 2006 with an effectiveness date in 2008. Since, Croatia's accession was expected to take place after the Directive became effective, alignment with the Directive was included in the Chapter 6 negotiations. The 2008 EC Recommendation on external quality assurance for statutory auditors and audit firms auditing public interest entities (PIEs) also featured prominently in Croatia's alignment with the *acquis communautaire*. The Directive was amended in 2014 by Directive 2014/56/EU along with the issuance of Regulation 537/2014 *On specific requirements regarding statutory audits*.

Due to its historical background, lack of unity, and limited capacity, the profession was ill equipped to assume important self-regulatory functions and successfully respond to the changes in the audit sector. So although the legal framework to align the audit requirements was in place by 2009, implementation of the requirements, which was delegated to the COA by the Ministry of Finance, took an additional two years for changes to be operationalized.

Turning point

Unable to reform itself from within, in 2009 the Chamber of Auditors sought membership in the International Federation of Accountants (IFAC), the global organization for the accounting and auditing profession. Membership in IFAC generally provides the discipline and structure to help professional accountancy organizations (PAO) adhere to basic benchmarks outlined in its seven Statements of Membership Obligations (SMOs).⁶ The SMOs are meant to guide PAOs in serving the public interest by (i) supporting the adoption and implementation of international standards, (ii) maintaining quality assurance review systems, and (iii) operating investigation and disciplinary mechanisms. IFAC rejected the Chamber's membership application on the grounds that it at the time it was too institutionally weak and lacking the mechanisms needed to assess and enhance the quality of the profession. The rejection served as a galvanizing moment spurring the leadership of the Chamber to become more organized and proactive in reforming the profession. The approach taken to building an effective quality assurance review system is outlined in subsequent paragraphs.

BOX

5

History of the Croatian audit profession

Prior to 2002, the audit profession was represented in two bodies – the Croatian Association of Auditors and the “Benedikt Kotruljevic” – each with different certification and professional examination. Neither body was a member of international body representing the accounting and auditing profession, unlike the local accounting body - the Croatian Association of Accountants and Financial Experts.

The merger of the two bodies in 2006 in accordance with the Audit Act of 2005 outwardly unified auditors in a single PAO (the Chamber of Auditors (COA)). However, tension within the newly formed CAO arose due to conflict related to members' qualifications and competence, which remained the same for each group due to a grandfathering system. Differences manifested themselves in an ongoing schism and coupled with a custom of loose organization within the profession hindered the Chamber's ability to fulfill its mandate as a self-regulatory institution subject to oversight by the Ministry of Finance.

Responsibilities such as operation of a system of quality assurance review were neglected, and could be attributed to limited human resource and technical capacity, as well as an inexperience born of tradition within the country that did not tend toward self-governance or self-regulation.

⁶ The seven SMOs are: SMO 1 *Quality Assurance*; SMO 2 *International Education Standards for Accountants and Other Pronouncements issued by the International Accounting Education Standards Board (IAESB)*; SMO 3 *International Standards and Other Pronouncements issued by the International Auditing and Assurance Standards Board (IAASB)*; SMO 4 *International Ethics Standards Board for Accountants (IESBA) Code of Ethics for Professional Accountants*; SMO 5 *International Public Sector Accounting Standards Board (IPSAS) and Other Pronouncements issued by IPSAS Board (IPSASB)*; SMO 6 *Investigation and Discipline*; and SMO 7 *International Financial Reporting Standards (IFRS) and Other Pronouncements issued by the International Accounting Standards Board (IASB)*.

“Of course nobody wanted to be checked. Auditors had never been subject to quality assurance and were afraid.”
- Tihana Mavric

External quality assurance

The Chamber’s successful implementation of an effective quality assurance review system was contingent on its ability to overcome two key obstacles, that is (i) a profession that was resistant to being checked and was fearful about the gaps that inspections would reveal, and (ii) lack of qualified staff to develop a methodology and conduct quality assurance inspections. Chapter 6 *closing benchmarks* specified a minimum of six quality assurance inspectors to which Croatia agreed but as at 2009 the COA was able to employ only three experienced auditing and accounting professionals, sufficient to meet existing needs, who were independent and competent to conduct inspections and. Its plan to progressively employ qualified individuals as the need arose was not acceptable to the Commission, which meant that a strategy had to be devised to comply with the *closing benchmarks*.

The main approach involved acquiring assistance from outside of Croatia to design the methodology for the quality assurance program, hiring non-Chamber members who had previously practiced auditing to conduct inspections, and to launching an outreach campaign to encourage auditors and audit firms to participate in the quality assurance review process. Specifically, through a World Bank grant, the COA hired the Institute of Chartered Accountants in England and Wales (ICAEW) to prepare the methodology that would quality assurance inspections. It also increased the salary for inspectors so that it could attract high-quality professionals to perform inspections. Armed with new personnel and a modern methodology, quality assurance review began in 2011 and the first phase focused on the largest 30 audit firms in the country. Where gaps and areas of non-compliance were found, the remedial actions that were recommended focused on assisting firms to strengthen policies, practices and procedures as opposed to being punitive. Nevertheless, the first year remained challenging as some auditors resisted being inspected, while others did not present themselves for inspections or withheld pertinent information. Thus, the Chamber developed an active communications strategy aimed at demonstrating the value and importance of quality assurance for both auditors and the public interest. The outreach program encouraged collaboration and helped to quell dissent in the profession.

Importance of the approach

The benefit of outsourcing the creation of the methodology and recruiting inspectors from outside the COA was twofold. First, it allowed the profession to acquire the capacity and capability to regulate the profession and attempt to improve audit quality. Second, it enabled Croatia to comply with the closing benchmarks in a shorter time frame than it would have been able to if it remained dependent on internal competency within the Chamber. In addition, its decision to use educative measures as opposed to punitive sanctions to coerce compliance and to focus on the value auditors improving audit quality in the outreach program was instrumental in building trust with auditing professionals who were resistant to being inspected.

Public oversight

The EU 8th Council Directive and the 2008 Recommendation on External Quality Assurance for Statutory Auditors and Audit Firms stipulates basic requirements for public oversight of statutory audits that EU candidate countries must fulfill prior to accession. These requirements include:

- Legal establishment of the public oversight system;
- Appointment of the persons in charge;

- Independence of the public oversight body from the profession;
- Adequate financial resources to perform activities;
- Adequate human resources to carry out its duties, including oversight of the system of quality assurance reviews.

As indicated earlier, although the new Directive and Recommendations were issued after Croatia's accession negotiations began, the country was required to full these requirements since they would be effective before the negotiations were completed. Amendments to the Audit Act 2005 in 2008 established the legal basis for the country's Audit Public Oversight Committee (APOC), however actual implementation lagged the operationalization of the Committee. Croatia's progress in complying with the Directive were stymied by (i) the limited guidance on how to implement the EU requirements, (ii) the choice of various models of public oversight of the audit profession, (iii) lack of experience and a limited number of retired auditors to ensure independence of the Committee, and (iv) the cash outlay required to fund the Committee to maintain its independence and ensured that it could conduct its activities effectively. Furthermore, legislation that established the public oversight body did not provide sufficient details on nomination procedures or criteria for Board membership.

Despite the challenges, the Negotiating Team developed a framework for a public oversight body that complied with EU stipulations and was suited to the local context and constraints. The APOC, currently a member of the International Forum of Independent Audit Regulator, became operational in 2011, as a body under the Ministry of Finance (MoF). It is tasked with oversight of the COA and statutory audit activities in the jurisdiction. The seven Committee Board members, who were nominated by the MoF subject to approval by the government, were drawn from the MoF, a university law professor, and active members of the audit profession. The Committee had a very limited budget and so Board membership was primarily an honorary function with members receiving only symbolic pay for their work.

Although the public oversight body was operational, its effectiveness and sustainability was constrained by the availability of funding, Board members' limited experience supervising the COA, and a lack of knowledge and experience in accounting and auditing. The active auditors on the Committee provided some of the necessary technical knowledge but their continued membership on the Committee was unfeasible given the independence requirements for public oversight bodies in the 8th Council Directive. While other countries recruit retired professionals to comply with the independence requirements, which restrict the involvement of active audit professional in the public oversight body, Croatia did not have that option as it had few retired accountancy professionals with the requisite skills. In addition to the aforementioned issues that challenged the country's nascent public oversight body from within, it also had to contend with a steadily deteriorating relationship with the COA that had been initially collaborative. The ensuing tension arose due to poor communication and undefined boundaries related to their respective responsibilities and authority. In spite of the initial weaknesses in the public oversight function, the main objective – its operationalization - had been met.

Importance of the approach

Given the constraints that Croatia faced, some of which could not be addressed in the short term, the country decided during the pre-accession stage to focus on the basic requirements of the 8th Council Directive with respect to establishment of a public oversight system and to work with the COA to implement a quality assurance review program. By putting a basic framework in place, Croatia laid a foundation that it could later refine and strengthen in order to improve the public oversight function and improve audit quality.

“Each member state has to identify a model, create an institution and comply in its own way in the areas of public oversight.”
- Željko Faber



Harmonizing local and international standards - The Financial Reporting Standards Board

The 2005 Accountants Act led to increased alignment with the 4th and 7th Council Directives in the area of differentiated reporting based on company size. However, gaps remained in the legislative framework related to: recognition and measurement criteria for the preparation of financial statements; the format (layout) of companies' financial statement; broader application of IFRSs than stipulated in Regulation (EC) No. 1606/2002; missing reference to consolidated accounts and a clear definition of the scope of entities subject to consolidation; and the issuance of national interpretations for IFRSs. In sum, the EU considered IFRS to be a special accounting treatment that should be applied to in the preparation of the consolidated financial statements of companies whose securities trade in a regulated market. The Regulation allows the optional application of IFRS outside the mandatory application and all limited liability companies were obliged to comply with the measurement and recognition criteria and layout stipulations in the 4th Council Directive. Croatia strongly resisted this requirement and was reluctant to abandon the country's practices at that time. Croatia had adopted international accounting standards in the early 1990's to facilitate financial reporting that was compatible with operating in a market economy and for the cost-efficiency that would be attained by avoiding the enormous effort and resources needed to develop and update national accounting standards. However, translation of IFRS significantly lagged promulgation of the standards by the International Accounting Standards Board (IASB) and was incomplete, which meant that companies were not complying with the standards.

Setback

At the suggestion of the Chapter 6 Negotiator, members of the accounting and auditing profession traveled to Brussels to meet with the Commission to discuss a compromise that would enable them to comply with EU Directives without dispensing with their accounting standards framework. The Commission's response was unequivocal and made clear that full compliance with the Directives was non-negotiable - harmonization with the common market meant that all member states had to comply with the 4th and 7th Council Directives. Croatia would not be allowed to maintain the status quo or apply the emerging standards for Small and Medium-Enterprises (SMEs) that were being developed by the International Accounting Standards Board (IASB) or United Nations Conference on Trade and Development (UNCTAD) guidelines. After the meeting, Croatia had two choices – transpose one of the options offered by the Directive directly into national legislation or develop its own national accounting standards.

Accounting Standard Setter - Independent Board or the Profession?

Croatia established an accounting standard setter in order to develop national accounting standards and implement the other requirements of the 4th and 7th Council Directives. The establishment of the FRSB in 2006 in accordance with the 2005 Accountants Act as independent standard setter represented a departure from the country's norm of centralized government control. The nine-member Board was selected by the MoF and worked on a voluntary basis independent of the State. An independent board was the preferred alternative to delegating the accounting standard setting process to the profession based on the time constraints for complying with the Directives and the need for close collaboration with the MoF.



Importance of the approach

Working with an independent standard setter instead of the profession facilitated a low-cost, flexible structure that allowed Croatia to align the corporate financial reporting framework without undue delays.

“Everything was started by a question addressed to the EU on whether all companies could use international standards. The response was that this was not a good idea. They found it hard to imagine that a small coffee shop might produce their reports according to big international standards.”
- Ivan Cevizovic

National Accounting Standards - Import or locally develop?

Confronted with the choice of developing national accounting standards by translating and copying relevant parts of the 4th and 7th Council Directives, Croatia chose to design national accounting standards adapted to local needs that complied with the Directives. The FRSB, with a very limited budget, brought together approximately 12 financial accounting experts and economists from universities and industry led by a retired Professor of Economics to prepare the standards. The Board assigned one or two individuals to draft a specific standard, which was discussed within the group of preparers and subsequently submitted to the Board for approval. Upon approval of the 14 draft standards, a group member was tasked with reviewing the final standards in order to harmonize technical terminology and writing style. The highly committed team, motivated by the intellectual challenge of creating the nation's first set of national accounting standards, completed the project with considerable pride and in a short period of time.

Throughout the process, a logical structure was adhered to in drafting the standards that took into consideration the mandatory components of the Directives, and the familiarity of financial statement preparers with IFRSs. As a result four overriding principles, applied in a set order, guided the standard setting process, as follows:

- 1. Application of requirement in the Directives** – stipulations in the Directives were prioritized since the Directives were mandatory;
- 2. Use IFRS where options or gaps existed in the Directives** - since preparers were used to IFRS it minimized the need for them to contend with changes unless absolutely necessary;
- 3. Choose simplest option if IFRS provided several options, required sophisticated judgments or a number of disclosure requirements** – contributed to a simpler reporting framework; and
- 4. Documented best practice in specific areas where no IFRS exists.**

Simplified accounting standards that were geared towards ease of compliance with the law and the proper filing of tax statements were very important, in a country with an economy characterized by 99.5% of companies classified as micro, small or medium-sized.⁷ Also, preparers highlighted that they found the previous standards (IAS) to be very complex and that disclosures could sometime span more than 60 pages.

Creation of a universal reporting framework, which is highlighted in Box 6, was also considered in an attempt to simplify further but the obstacles to creation of such a framework were insurmountable.

In addition to the logical approach described earlier, standard setters ordered the standards sequentially according to the structure of the balance sheet for ease of understanding by preparers. Also, the use of exposure drafts and discussions were employed to gather feedback on the proposed standards, and the final standards included explanatory text to support companies in their application of the new standards. The public's reception of Croatian Financial Reporting Standards (CFRS) was overwhelming positive as described in Box 7. Most small companies were satisfied with the new fixed reporting formats required by the Directive, and preparers were pleased with the clarity of the CFRS. Larger firms perceived the EU formats to be overly prescriptive, and the FRSB addressed their concerns by allowing them to prepare reports in accordance with EU endorsed IFRS with reconciliation to the EU Directives.

⁷ According to the EU, a medium-sized enterprise is defined as an enterprise with fewer than 250 persons and annual turnover not exceeding EUR 50 million or annual balance sheet total of less than EUR 43 million. A small enterprise is defined as employing fewer than 50 persons with annual turnover and/or annual balance sheet total not exceeding EUR 10 million. A microenterprise is defined as an enterprise employing fewer than 10 persons with annual turnover and/or annual balance sheet total not in excess of EUR 2 million.

BOX

6

The allure of a universal reporting framework

During the preparation of the Croatian Financial Reporting Standards (CFRS) the Financial Reporting Standards Board (FRSB) investigated the possibility of creating a universal reporting framework. Such a framework held the promise of using a single report for multiple uses – financial reporting, tax reporting, statistical reporting, and prudential and other regulatory reporting. The idea was attractive as a mechanism to help companies lower the considerable costs associated with creating different reports for different users.

Eventually, the idea was abandoned as it proved to be impossible to harmonize the requirements of the Directives with a model that also incorporated specific local reporting obligations. In the end, it was decided that CFRS would have a standard balance sheet with some additional items that are not included in the 4th Directive.

BOX

7

Consultation and compliance

Despite the initial unwillingness, the EU Directives Brussels' requirements eventually were understood, accepted, and even embraced. In reality, a large number of Croatian accountants had never been fully convinced that IFRSs were suited to the majority of Croatian businesses - SMEs. They were difficult to implement and contributed to non-compliance.

In order to prepare Croatian Financial Reporting Standards (CFRS) that incorporated the needs and capacity of the local context, the standard setting process introduced consultative feedback from users and preparers of financial statements. This inclusive approach was not only welcome but became the standard for the preparation of legislation in the Croatia.

In the year following publication of CFRS, few requests for clarification were received and of those received most could be resolved by issuing minor explanations. Today stakeholder involvement has become the norm for the preparation of all financial reporting legislation, and the positive impact is that citizens and the markets feel that they can contribute to making the rules and are better able to prepare for changes as they arise.

The completed CFRS complied fully with the Directives and the Commission required Croatia to prepare a table of concordance to demonstrate full compliance with the Directives. Upon Croatia's amendment of the Accounting Act in 2008, which led to parliamentary approval of CFRS and the requirement for mandatory preparation of annual financial statements in accordance with the standards, the *closing benchmarks* related to accounting were closed.

Importance of the approach

By choosing to prepare national accounting standards, Croatia avoided common problems of literal translation such as the difference in meaning of some concepts in international standards when used domestically. For example, annual reports in the 4th Directive was confused with annual accounts in Croatia Accounting Act and later had to be clarified. This approach also afforded standard setters with the opportunity to factor in the needs of financial statement preparers, tailoring standards to the local economy, which was dominated by micro, small and medium-sized enterprises. Also, it enabled participation of local stakeholders in the standard setting process leading to robust standards that were more likely to be complied with. Embracing simplicity in the design of the standards was an important element of the approach that served to facilitate enhanced preparation of financial statements and boosted compliance.



Implementing reform through established and proven institutions: The Financial Agency (FINA) and the disclosure requirements

According to the 2007 World Bank Report on the Observance of Standards and Codes (ROSC) – Accounting and Auditing (A&A) for Croatia, significant changes needed to be implemented to align the filing and publication practices with the requirements in the Court Register and Accountant Acts and the *acquis communautaire*. The report specifically noted that while an amendment to the Court Register Act in March 2007 incorporated the requirement for electronic publication of company information, including financial statements and reports, there were no defined sanctions for non-compliance. Also, although the amended Court Register Act stipulated that financial statements should be filed with the Court Register via the Financial Agency (FINA), the Agency lacked the information technology (IT) capacity to do so and the summarized financial information that it retained would not meet the disclosure requirements of the First, Seventh, and Fourth Council Directives.

FINA, a state-owned entity that receives no budget from the state, was established in accordance with the 2002 Financial Agency Act, and evolved from the monopolistic Institute for Payment (ZAP), which was previously formed from the reorganization of the centralized Social Accounting Services (SDK)⁸ in 1993. FINA was directly controlled by the MoF and one of its roles was to serve as a repository for companies' financial information, unlike its predecessor ZAP whose sole role was to execute domestic payments transactions. In 2007, there were no institutions in Croatia that had the capability to facilitate electronic filing and publishing of financial statement as required by the EU First Council Directive. The government had to decide whether it should create a new institution or work with an existing one to carry out the task. The MoF decided to work with FINA for a number of reasons, namely:

- Relationship with the MoF – the Ministry's control of FINA and its history of cooperation would make negotiations on technical specifications, staffing and funding easier than with a private counterpart;
- Existing infrastructure – due to FINA's current duties and previous responsibilities under the SDK and ZAP, it already had some of the infrastructure that was necessary for the collection and publication of financial statements;
- Capacity to change – the Agency had successfully undergone a series of transformations since its original inception as the SDK and so had a demonstrated capacity to handle change;
- Historical background – FINA's legacy of centralized financial transactions and experience with information technology also boded well for its success as a company registry.

The aforementioned factors were critical to the Agency's successful implementation of Croatia's electronically accessible Register of Annual Accounts within two years. In its 2009 Croatia Progress Report, the European Commission noted that, "the Register of Annual Accountants is accessible via the Internet and maintained by the Financial Agency FINA" and that the Agency received 70,065 annual accounts, 36,981 of which were published. According to data available from FINA, the compliance rate for submission of financial statements gradually increased from approximately 63% in 2008 to roughly 77% in 2012.


“Under socialism, the idea was centralization. That left us with a strong centralized reporting infrastructure. From a practical point of view, that was a really good thing.”
- Damir Kaufman

8 SDK was also responsible for collecting tax and financial information for statistical purposes.

In its new role, FINA ensured: the public availability of financial reports; the registration and filing of complete and accurate financial information; the provision of information to the MoF and Tax Administration about company's non-compliance with disclosure obligations; the collection of data for the Commercial Court Registry and the Central Bureau of Statistics; and the provision of data to for credit and risk evaluation and to other stakeholders such as academia, the media and the business sector. The Agency operates as an effective tool for publishing annual financial reports in accordance with the relevant EU Directives and as a "one-stop-shop" for financial information that meets the requirements of the EU Directives and the information needs of the MoF, the Ministry of Economy, the State Bureau of Statistics, and the markets. It has reduced the administrative burdens of business enterprises and lowered the cost of public administration by facilitating the submission of information for multiple regulatory purposes in one location.

By 2009, Croatia was able to satisfy the *closing benchmarks* related to disclosures through the amendments to the Court Register Act, the Companies Act and the Accounting Act. The amendments led to the introduction of electronic publication and a single register for all financial statements, direct access to the public register by all Commercial Court, and to the establishment of sanctions for non-compliance such as de-registration by the Commercial Court.

Importance of the approach



One benefit of using an existing, well-established institution as a central register for electronic publication of financial statements is the lower cost to initiate the project. In FINA's case it was especially beneficial because it already had some of the necessary infrastructure. Another key factor was the minimization of the risk of failure or delay since the Agency had experience with successfully changing business models coupled with a collaborative relationship with the MoF. Finally, by using FINA the government was able to capitalize on the fact that all companies in Croatia were already familiar with the institution and did not have to get used to a new one, and this facilitated a smoother transition.

In concluding this section of the publication, it is important to note that Croatia implemented significant legislative, administrative, and institutional changes in the areas of corporate financial reporting in spite of considerable time-constraints, high volume of work, and limited technical, human and financial resources. As a result, it satisfied all Chapter 6 Company Law benchmarks within four years of the launch of the Chapter 6 negotiations in 2007, and closed the last of the 35 Negotiating Chapters in June 2011 almost six years after accession negotiations began. The lessons learned along the way and a summary of some of the work that remained post-accession is outlined in Section IV.



4 Section

Lessons Learned and Next Steps

Encouraged by the promise of full membership, Croatians made monumental changes that affected every facet of the country's welfare. In the three years since Croatia's accession to the EU in July 2013, many of the reform leaders and key stakeholders have had an opportunity to reflect on the advantages and unfavorable consequences of courses of action taken during the process of alignment with the *acquis communautaire*. Although the accession process or any significant reform is never a one-size-fits-all undertaking, there are lessons learned that may be applicable to others embarking on such a journey. While some relate specifically to the corporate financial reporting reforms that took place as part of the Chapter 6 Company Law negotiations, others apply more broadly to any country or sector level reform process.



Lessons Learned

The top seven lessons learned are presented in no specific order of priority and reflect the essential role that each can played in the strategic execution of the reform agenda.

Powerful outside influences can instigate change that would otherwise not occur or happen slowly.

As stated elsewhere in this publication, membership in the EU is contingent on candidate countries fulfilling specific conditions, chief of which is alignment with the *acquis communautaire*, with the expectation of benefits such as access to the European common market. In the case of Croatia the unique opportunity of EU membership provided a clear and compelling objective to make demanding changes. Also, the structure of the accession negotiations around the chapters and the use of *opening* and *closing benchmarks* ensured that the targets were well known to everyone and imbued a sense of urgency and discipline. External targets imposed by outside influences, especially those offering future prosperity, can allow policy makers to effect change in spite of resistance, and in essence allow them to proffer a scapegoat to influential internal (domestic) stakeholders who wish to maintain the *status quo*. In the case of Croatia, trips to Brussels were arranged in situations where local stakeholders took issue with specific changes, for example the need for new accounting standards.

Political will and commitment are necessary but insufficient to keep the reform process on track in the absence mechanisms, such as binding agreements.

A change agenda, built upon political will or commitment that is dependent or contingent on the political process, is susceptible to failure if there is no guarantee that successors will maintain it. Croatia made the process apolitical through (i) a Declaration⁹ signed by the Parliament committing the legislature to cooperate, refrain from obstructing the negotiation process and to act as quickly as possible, and (ii) the issuance of a binding Statement¹⁰ by the Government and the Parliament pledging to support each other. In addition, a group¹¹ with legal backing that was formed to monitor accession negotiation was led by the opposition leader, co-chaired by a member of the opposition party, composed equally of parliamentary majority and opposition members, as well as trade unions, employers association and academia. It engendered commitment by including a variety of stakeholders in the various working groups, balancing technical and managerial competence, thus giving everyone a voice and ownership stake. The stability and sustainability conferred by combining political will and commitment with tools that build consensus and depoliticize the process was invaluable.

9 Declaration on the Fundamental Principles of Negotiation of Full Membership of Republic of Croatia in the EU

10 Statement of the Croatian Parliament and the Government of the Republic of Croatia on Joint Actions in the Process of Negotiations on Membership of the EU

11 National Committee for Monitoring Accession Negotiations

Public and private sector partnership is essential.

The public sector, as policy maker and regulator, relies on the private sector to implement its policies and regulations. By involving the private sector in the process, the public sector facilitates buy-in, which results in better regulations as evidenced by the overwhelmingly positive reaction to Croatian Financial Reporting Standards (CFRS). The partnership also optimizes knowledge sharing and exchange, which is important in environments with scarce human and technical resources.

Change leaders must grant autonomy but retain some authority in order to effectively intervene and break deadlocks.

In instances where it is important for stakeholders to manage specific areas of the change agenda, it is important for leaders to grant autonomy. For example, in the context of the corporate financial reporting reforms it was necessary for the auditing profession to regulate itself in order to implement key requirements of the *acquis communautaire*. However, disunity and disagreement among members of the profession led to inability to agree on the design and implementation of an external quality assurance mechanism, which threatened to delay alignment with the EU 8th Council Directive. Fortunately, the Ministry of Finance (MoF) was able to use transitional powers in the context of the accession negotiations to intervene temporarily in the governance of the auditing professional accountancy organization (PAO), the Chamber of Auditors (COA), to broker agreement and get the process back on track. Obstructions, whether intentional or inadvertent, can derail reforms and so leaders must reserve some power to unblock them and re-start the process.

Successful importation of international standards rests on the extent to which the local context is factored into the implementation.

The benefits of harmonization of accounting standards, whether within the EU for its member states or for those countries that have adopted International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB) have been widely discussed and will not be elaborated upon here. However, to the extent that IFRS and the 4th and 7th Council Directives are created external to countries but are implemented domestically, there is no escaping that their importation for local use cannot be a one-size-fits all approach. Assuming that implementation lies at the core of achieving the advantages of using international standards, then ignoring features of the local context such as the capacity of financial statement preparers and auditors, financial market structures, size of the corporate structures, and the legal system will lead to non-compliance and financial statements that cannot be relied upon. As a result, careful consideration of the options available in IFRS or the 4th and 7th Council Directives is more likely to lead to satisfying results. The Croatian Financial Reporting Standards Board's preparation of national accounting standards focused on balancing mandatory compliance with the Directives and simplified requirements that took the local context into account. The positive response to Croatian Financial Reporting Standards show that it is worthwhile to invest in resources in order to understand and make use of options that enhance local financial reporting.

Local historical or cultural traditions can help or hinder reform.

The fact that reforms are implemented by people, and never take place in vacuum, present opportunities to take advantage of historical, political or cultural norms to accelerate change or highlight areas that have to be carefully considered to avoid unnecessary setbacks. In the case of Croatia, the use of the Financial Agency (FINA) to operationalize the electronic filing and publication requirements of the 1st Council Directive took advantage of the Agency's historical relationship with the government and its experience as a centralized repository for financial and statistical information dating to the country's days as a member of the former Yugoslavia. On the other hand, the Chamber of Auditor's role as a self-regulator evolved slowly for a number of reasons discussed earlier including a political tradition of centralized rule in the former Yugoslavia that precluded associations from taking on regulatory roles. Early consideration of the inexperience with self-regulation that partly derived from a political and historical tradition of centralized government may have allowed for additional assistance to the Chamber to fulfill its role.

Institution building takes time so working rapidly and decisively may require sacrificing perfection for the sake of practicality.

Creating effective institutions goes beyond creating the physical or administrative structure necessary for them to function well. Similarly, basic human and technical resources are essential at the outset in order for operations to take off. In environments with limited resources and capabilities where doing nothing is not an option, it is critical to start somewhere - anywhere for that matter - and refine later on. Croatia's corporate financial reporting reform demonstrates this, for example in the transposition of the 1st, 4th and 7th Council Directives and in the establishment of a public oversight body that initially only partially met the 8th Directive's independence requirement. An important caveat to working with less than "perfect" institutions or a legal framework is a commitment to creating and implementing a medium to long-term strategy that covers making necessary revisions and building or strengthening capability.




Future Directions and Ongoing Changes

Reform is an ongoing process and the aftermath may be just as demanding, or even more so, in the absence of the galvanizing force that drove attainment of the initial objective. The great opportunity offered prior to accession is the sense of urgency and the political will that makes it possible for people to set aside differences and move in one direction. After accession, a different set of changes has to occur but the work takes place in circumstances that have reverted to the customary pace. In the post-accession period new people – more managerial and less entrepreneurial – are in charge, and policy initiatives can be considered in greater detail unencumbered by time-pressured deadlines.

The *acquis communautaire* is dynamic with the introduction of new legislation or changes to existing ones and transposition is a resource intensive exercise. Therefore, it is important to put in place robust mechanisms to ensure that EU legislations are translated into national legislation correctly and completely in a timely manner to facilitate proper application of the law. . After Croatia accession in July 2013, changes stemming from the changes in the EU legislation needed to be transposed or directly implemented in Croatia legal framework. The 2013 Accounting Directive and the 2014 Audit Directive and Audit Regulation introduce changes in the corporate financial reporting EU *acquis* in response to the challenges of the financial crisis and the economic crisis that has followed. Key changes aim at building differential reporting framework for entities subject to financial reporting obligations according to their size (accounting directive), and a stronger system for auditing for companies, especially PIEs (2014 Audit Directive).

Change is constant and reform is a necessity for growth and development. Undoubtedly, the next steps outlined here are simply the beginning of the next set of steps that will be necessary for the corporate financial reporting to play its role as a building block of a well-functioning economy.



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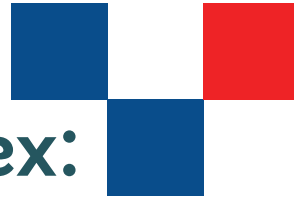
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Annex:

35 Chapters of the acquis communautaire

5. Free movement of goods
6. Freedom of movement for workers
7. Right of establishment and freedom to provide services
8. Free movement of capital
9. Public procurement
10. Company law
11. Intellectual property law
12. Competition policy
13. Financial services
14. Information society and media
15. Agriculture and rural development
16. Food safety, veterinary and phytosanitary policy
17. Fisheries
18. Transport policy
19. Energy
20. Taxation
21. Economic and monetary policy
22. Statistics
23. Social policy and employment
24. Enterprise and industrial policy
25. Trans-European network
26. Regional policy and coordinating structural instruments
27. Judiciary and fundamental rights
28. Justice, freedom and security
29. Science and research
30. Education and culture
31. Environment
32. Consumer and health protection
33. Customs union
34. External relations
35. Foreign, security and defense policy
36. Financial control
37. Financial and budgetary provision
38. Institutions
39. Other issues

This publication is fundamentally about the inner workings of country level reform and more directly how successful corporate financial reporting reform can be facilitated. It uses the alignment of Croatia's statutory and institutional framework with the European Union's *acquis communautaire* (the *acquis*) as the crucible in which critical aspects of the adoption, implementation, and application of international accounting and auditing norms are scrutinized. And what do we find?

The series of case studies in this publication tell stories of how to bind powerful stakeholders together for the duration of a decade long reform process, and surprisingly that working closely with the opposition is the best approach when working on the statutory framework.

Readers can expect to gain greater understanding of the importance of:

- Managing necessary allies and strong challengers to enhance regulation of the auditing profession;
- Balancing managerial and technical competence to promote robust standard-setting processes; and
- Understanding a jurisdiction's culture and history to uncover unexpected supporters or stumbling blocks in the effort to raise audit quality and enhance transparency.

Careful reading of the discussions on why specific approaches were beneficial to advancing Croatia's corporate financial reforms will yield valuable information for European Union candidate countries, and others who are interested in factors that lead to success or encourage failure.

