

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

**The Republic of Montenegro****ACCOUNTING AND AUDITING**

May 2007

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**EXECUTIVE SUMMARY**

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

***Regulatory and institutional framework***

During the transition to a market economy, the Republic of Montenegro successfully put in place many important elements of the institutional and statutory framework for financial reporting. However, this assessment demonstrates that Montenegro should take further steps in order to achieve its goal of a sound financial reporting framework tailored to the needs of the Montenegrin economy and aligned with the EU body of law (*acquis communautaire*), international standards and best practices. The government of the Republic of Montenegro is fully determined to undertake the necessary steps to further improve and align the financial reporting framework with the *acquis communautaire*.

The new law on accounting and auditing adopted in 2005 reflects this desire for continuous

This report was prepared on the basis of the findings from a diagnostic review carried out in Montenegro by a team from the World Bank in November 2006. The team was led by Erik van der Plaats (World Bank, Brussels) and comprised David Nagy (World Bank, Washington DC) and Aleksandar Crnomarkovic (World Bank, Belgrade), and a team of consultants including Gerhard Grabner, Gerald Kogler, Eddie Hodgson, Patrick Corrigan and Mr. Edward McEntee. The review was conducted through a participatory process involving various stakeholders and led by the country authorities.

improvement; however, the regulatory framework is not yet complete and not fully aligned with the *acquis*. The framework is not always consistent and limited human resources contribute to institutional weaknesses in some areas. In particular, the delay in the government decision on the body to which the government will delegate regulatory authority, including the adoption of IFRS (International Financial Reporting Standards) and ISA (International Standards on Auditing), created a regulatory vacuum and lack of clarity and legal certainty for companies, accountants and auditors.

International financial reporting and auditing requirements have recently become more complex and rigorous and also the *acquis* has evolved significantly recent years. In such a dynamic international regulatory environment, national financial reporting requirements can easily become out of line with the *acquis*. In particular the following issues need to be addressed: preparation of management reports, half year reporting for listed companies, electronic publication of financial statements, the approval and registration of audit firms, and the preparation of consolidated accounts.

The current requirement for the use of IAS/IFRS by all legal entities regardless of their size is not well suited for Small and Medium-sized Enterprises (SMEs) and puts an unnecessary strain on scarce institutional and professional accounting resources. The IFRS financial reporting framework has been developed for general purpose financial statements of listed companies and contains some complex accounting treatments and detailed disclosure requirements. The costs of application of the full body of IFRS, does not outweigh the benefits for SMEs. Moreover, in an environment with limited professional resources, proper application of IFRS by SMEs becomes a regulatory fiction instead of a well established sound financial reporting practice. It is recommended that the scope of IFRS application be re-examined with a view to defining a proportionate financial reporting framework properly linked to taxation accounting and taking into consideration the emerging draft IFRS on SME financial reporting.

The financial reporting framework applicable in Montenegro does, in principle, allow some limitation of the preparation and disclosure burden for SMEs by requiring cash-based accounting for companies with revenue of less than Euro 500,000 and the use of IFRS-based standard reporting forms issued as guidance by the Institute of Accountants and Auditors of Montenegro (IAAM) on the basis of the previous 2002 law on accounting and auditing. However, cash-based accounting is inconsistent with the IFRS framework and standards, which require accruals-based financial reporting. Moreover, the EU Accounting Directives would allow for much broader disclosure and publication exemptions. The regulatory framework for SME financial reporting should be reconsidered taking into account the optimal use of the exemption possibilities for preparation and disclosure of financial statements possible under the *acquis*. Future expansion of the scope of required IFRS application should be reinforced by parallel institutional and professional capacity building so that credible high quality financial reporting can be ensured and sustained.

There is a need to further strengthen institutional and professional capacity and to remove unnecessary demands on existing capacity. The capacity of supervisors, licensed auditors and certified accountants knowledgeable about IFRS is insufficient to properly implement the legal financial reporting obligations, with the possible exception of the banking sector. The new law on

<sup>2</sup> 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.

accounting and auditing (2005) introduced a Certified Accountant qualification in addition to the lower level Authorized Professional Accountant qualification. However, few accountants have obtained this higher qualification in the short time since 2005. Moreover, the law balanced the supply and regulatory demand for audits by significantly increasing the exemption criteria for statutory audits, combined with allowing foreign qualified auditors to become licensed. But despite these sound policy decisions, the current capacity of 34 licensed auditors remains too limited for the approximately 800 companies to be audited.

Overall, the Montenegrin education system with respect to accountants and auditors is of good quality, as was evidenced by an international study in 2005, but it would benefit from further strengthening. Areas for improvement to ensure the supply of highly qualified accountants include: completing an up-to-date accounting curriculum for the University of Montenegro; updating the outdated accounting text books (currently a 2001 translation of an international accounting text book is used); and developing properly supervised practical training for accountants and auditors and a system of continuing education for statutory auditors.

There is uncertainty about the organization of the accounting and audit profession in Montenegro. There is an urgent need for the professional organizations to come to a mutual agreement so that they can be equipped with the regulatory powers to complete the regulatory framework and to play their part in the training and (continuing) education of accountants and auditors.

#### ***Financial reporting issues in practice***

The review of financial statements identified some systematic accounting issues that need to be properly addressed in practice. In addition to a lack of detailed disclosures required under IFRS, the review identified a number of common recognition and measurement issues, such as asset valuation (e.g. the lack of impairment tests) insufficient disclosure of related party transactions (including those involving the State), improper reflection of taxes in the annual financial statements, and pension accounting.

The financial statements of banks that were reviewed were generally of good quality. This can be largely attributed to the intensive on- and off-site supervision by the Central Bank of Montenegro and possibly the influence of the foreign banks that own local banks. The quality of the financial statements of several Montenegrin banks is comparable to that of peers in the European Union.

The financial information provided by most SMEs was found to be poor and not in compliance with full IFRS. A significant number of the financial statements of SME companies reviewed showed arithmetic and reconciliation errors, as well as a lack of disclosures required under IFRS, such as cash flow statements and notes to the financial statements. These poor results partly reflect the inappropriateness of IFRS for SMEs in general, the limited capacity to prepare IFRS financial statements, and the absence of an audit requirement for SMEs.

Enforcement of IFRS financial reporting by listed companies by the Securities and Exchange Commission (SEC) is not systematic and the SEC lacks some necessary powers. The SEC operates with a relatively small staff and its enforcement role is hampered as the Securities and Exchange Act does not provide a basis for enforcing accounting standards. The SEC cannot levy fines or penalties for improper financial reporting. Although the SEC has recently undertaken several concrete corrective measures, issues raised in qualified audit reports even in the A and B segment of the securities market were not always followed up. The Ministry of Finance recently established a working group that will for a sample of legal entities assess their compliance with the Law on Accounting and Auditing including a review of published financial statements of

listed companies. Sound financial reporting is crucial for the Montenegrin securities markets in ensuring that the recent sharp increases of share prices remain based on underlying real economic factors. Insurance supervision does not yet exist and, as a result, the financial statements prepared by insurance companies do not generally match the quality those prepared by banks.

Public availability of financial statements is not common in practice. Despite a legal requirement for the publication of financial statements in the Central Registry of the Commercial Court, only 60% of the roughly 14.000 companies had filed their 2005 financial statements as of October 2006. This low percentage reflects the current lack of enforcement, limited sanctions, and the absence of “market discipline” incentives. The next challenge for Montenegro will be to ensure that audited individual and consolidated financial statements will be made available via electronic means in line with the *acquis* (First Company Law Directive).

### ***Audit function***

The audit function is not fully effective in Montenegro. Instead of adding credibility to published financial statements by convincing management to adjust the financial statements in accordance with audit findings, the generally accepted practice in Montenegro is that auditors qualify, disclaim or otherwise modify their audit reports. Approximately 80% of the audit opinions included in the sample of financial statements were modified in some way (as opposed to an estimated 4% in mature market economies). Moreover, it appeared that some of the qualified audit opinions should properly have been adverse audit opinions on the basis of ISA.

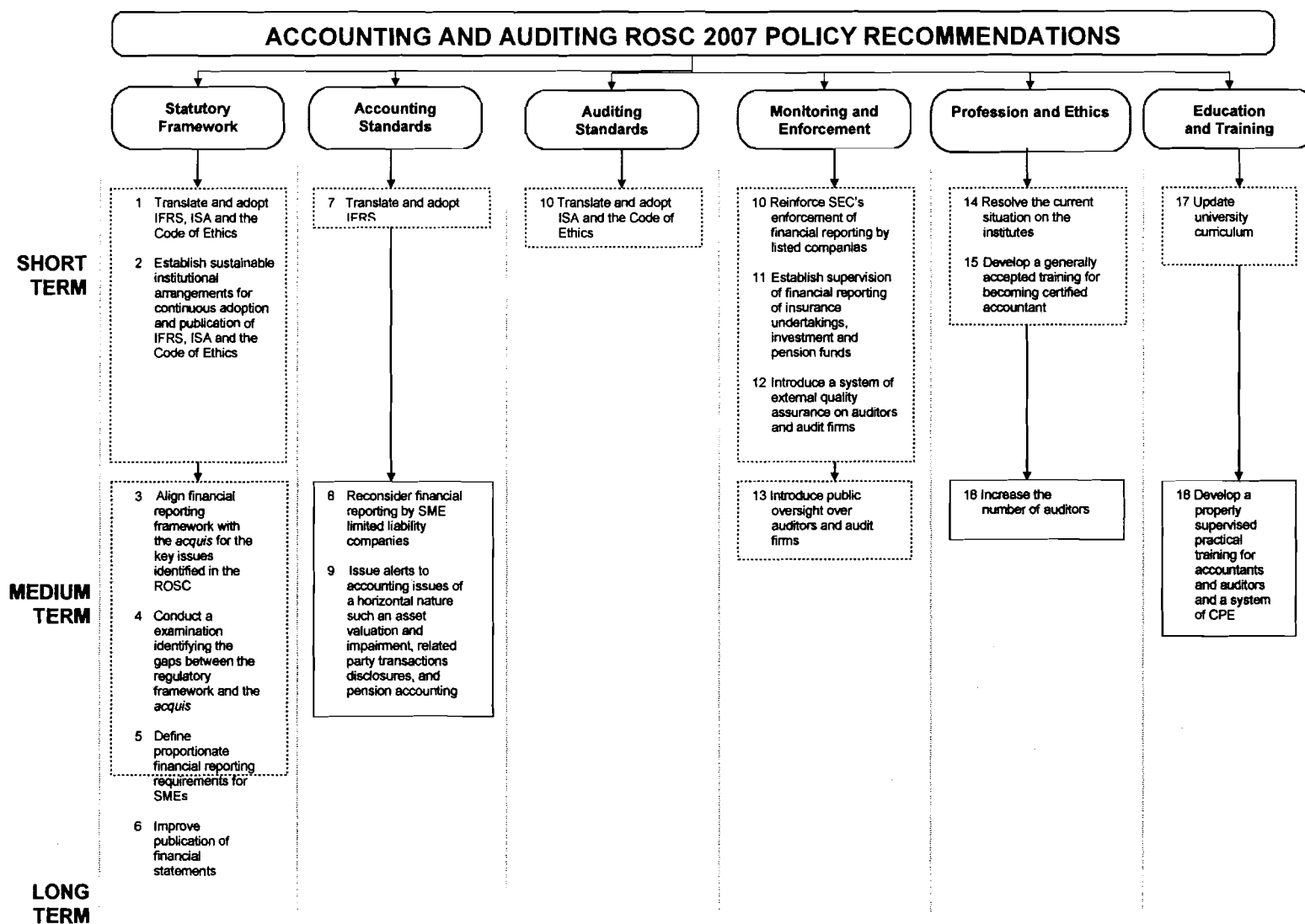
Auditors may be subject to undue management pressure because of the general lack of an audit committee function in public interest companies, the lack of requirements to report the reasons for dismissal of the auditor to supervising authorities and a generally passive role of shareholders, all which undermine effective corporate governance.

There is no quality assurance system to detect and correct poor audit quality in practice and to allow for an improvement of audit quality in general. The absence of a system of quality assurance is particularly serious for the audit of public interest entities<sup>2</sup> as statutory audit currently constitutes the most important mechanism for enforcing the proper preparation of IFRS financial statements.

Audit reports of the local member firms of the major international audit firm networks were in some instances less useful because they refer to the national GAAP as opposed to IFRS. This calls into question whether the financial statements of public interest entities were actually fully compliant with IFRS. There is no regulation on the approval of audit firms. The *acquis* includes requirements on the ownership and management of audit firms to enhance quality, independence and objectivity in the performance of audits. The current absence of such regulations in Montenegro creates potential independence problems because of common (state) ownership of audit firms and audited companies, and possibilities for undue influence within the audit firm by managers that are not licensed auditors.

The Government of the Republic of Montenegro should establish a multidisciplinary National Steering Committee (NSC) for accounting and auditing to advise policymakers, regulators, and other stakeholders on the implementation of the A&A ROSC recommendations. Based on the successful experience of other countries in the region, it is advisable that the NSC develops a detailed Country Strategy and Action Plan (CAP) to further enhance the quality of financial reporting in Montenegro.

Table 1: A&A ROSC Policy Recommendations



## MAIN ABBREVIATIONS AND ACRONYMS

A&A	Accounting and Auditing
CESR	Committee of European Securities Regulators
CPE, CPD	Continuous Professional Education, Development
EDCOM	Education Committee of IFAC (now IAESB)
EEA	European Economic Area
EU	European Union
FDI	Foreign Direct Investment
FSAP	Financial Sector Assessment Program
GDP	Gross Domestic Product
IAAM	Institute of Accountants and Auditors of Montenegro
IAASB	International Auditing and Assurance Standards Board
IAESB	International Accounting Education Standards Board (formerly EDCOM)
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IASCF	International Accounting Standards Committee Foundation
IES	International Education Standard
IFAC	International Federation of Accountants
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IPSAS	International Public Sector Accounting Standards
ISA	International Standards on Auditing
NSA	National Standards on Auditing
PIE	Public Interest Entity
POE	Publicly-Owned Enterprise
ROSC	Reports on the Observance and Standards of Codes
SEC	Securities and Exchange Commission
SEEPAD	South East Europe Partnership for Accountancy Development
SFRY	Socialist Federal Republic of Yugoslavia
SME	Small and Medium-sized Enterprise
SMO	Statement of Membership Obligation
SOE	Socially-Owned Enterprise
SSA	Stabilization and Association Agreement
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNSCR	United Nations Security Council Resolution

## I. INTRODUCTION

1. This assessment of accounting and auditing practices in Montenegro is part of a joint initiative of the World Bank and International Monetary Fund (IMF) to prepare Reports on the Observance of Standards and Codes (ROSC). The assessment focuses on the strengths and weaknesses of the accounting and auditing environment that influence the quality of corporate financial reporting and includes both a review of both mandatory requirements and actual practice. The report uses International Financial Reporting Standards (IFRS)<sup>3</sup> and International Standards on Auditing (ISA)<sup>4</sup> as benchmarks and draws on international experience and good practice in the field of accounting and auditing regulation.

2. In the light of Montenegro's desire to harmonize with the European Union (EU) this report also specifically assesses Montenegro's implementation and enforcement of the relevant portions of the *acquis communautaire*. The relevance of the *acquis communautaire* for Montenegro is twofold. First, it represents a high-quality model for the regulation of financial reporting and auditing applicable to countries of different characteristics and with different legal traditions. Second, the adoption of the *acquis*, on financial reporting and auditing would be instrumental to enhancing Montenegrin political association and economic integration with the EU. However, full alignment with the *acquis* should be phased and the pace of change should take account of the current needs and capacities of the Republic of Montenegro.

3. The ROSC recommendations are expected to assist the Montenegrin Government and institutions to introduce, implement, and effectively enforce the relevant portions of the *acquis* within their respective regulatory domains. These recommendations will also be beneficial to private and financial sector growth; this is particularly important for Montenegro where, in 2003, only 25% of employment took place in the private sector. Enhancing financial reporting can be conducive to economic growth as it can help to overcome an important constraint to growth in Montenegro: the relatively high cost of capital. Montenegro has moderate financing costs and modest – though rapidly developing – financial intermediation as manifested by real interest rates of 7.5% in 2006. Recent very high growth in volume of lending to the private sector has brought the total bank assets to approximately 80% of GDP which is comparable to several new Member States. Enhanced financial reporting could help to:

- mobilize domestic savings and attract more foreign direct and portfolio investment;
- facilitate access to credit by smaller enterprises;
- allow investors in larger-scale enterprises to better evaluate corporate prospects and make informed investment and voting decisions.

Furthermore sound financial reporting would:

- enhance confidence in the functioning of financial markets;
- strengthen corporate governance by allowing shareholders and the public at large to monitor management's performance;
- underpin a transparent and fair privatization process of former state owned companies.

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<sup>3</sup> International Financial Reporting Standards are issued by the International Accounting Standards Board, an independent accounting standard-setter based in London, United Kingdom. In April 2001, the IASB announced that it would adopt all of the International Accounting Standards issued by the International Accounting Standards Committee. For simplicity's sake the term IFRS will mean both IFRS and IAS in this report.

<sup>4</sup> International Standards on Auditing are the standards issued by the International Auditing and Assurance Standards Board of the International Federation of Accountants.

4. The Republic of Montenegro (Montenegro) obtained independence in June 2006 and has a strong focus on European integration. The EU has designated Montenegro as a potential candidate country for membership. Montenegro is one of the smallest countries in Europe with 640,000 residents and has a reported GDP of Euro 1,932 billion in 2006 (approximately Euro 3,055 per capita), 6.5% real growth compared to 2005. Before independence, Montenegro formed a State Union with Serbia (Serbia and Montenegro). Montenegro has been admitted as a member to the United Nations, the IMF and the World Bank. Official unemployment is high and most of those employed (60%) are employed in the public sector (primarily public administration, health, and education). Therefore, one of the major economic policy objectives is to develop a competitive private sector for generating economic growth and jobs. Negotiations with the EU on a Stabilisation and Association Agreement (SAA) for Montenegro<sup>5</sup> were concluded in October, 2007.

5. With respect to economic, financial sector and capital market regulation, Montenegro already had its own legislative, judicial and regulatory powers and therefore independence is not expected to have had a significant impact on the regulatory framework and institutional capacity applicable to financial reporting. Since 1997, Montenegro's economic reform program has rested on two broad pillars: macro-economic stabilization; and market-oriented structural reforms, including extensive price and trade liberalization, privatization, public administration reform, financial sector reform, and reforms aimed at improving the business climate and the labor market. In 2003, the Government of the Republic of Montenegro formally adopted its Economic Reform Agenda (ERA) covering the period 2003-2007, and a Poverty Reduction Strategy (PRSP). The ERA established a broad strategic vision of a liberalized, market-based economy, on which subsequent economic reforms have been based.

6. Several reforms aimed at improving the business climate and labor market flexibility were initiated in recent years. The Government enacted new enterprise, bankruptcy, and secured transaction laws to create a more favorable business environment. Several large companies and banks have recently been privatized in Montenegro. The institutional framework for banking supervision has also been strengthened over the past years with the introduction of new regulations on licensing, minimum capital requirement, asset classification and provisioning and large exposures. Privatization of banks has substantially progressed, but the state continues to hold minority shares in six banks, for a total of 10 percent of the banking system at end-June 2006. Montenegro has made significant progress in terms of both macroeconomic and structural reforms. With the implementation of currency and fiscal policy reforms, Montenegro has successfully reined in inflation and brought about macroeconomic stability.<sup>6</sup>

## **II. INSTITUTIONAL FRAMEWORK<sup>7</sup>**

### **A. Statutory Framework**

#### ***A.1 General legal basis for financial reporting and auditing***

7. **The Business Organization Law 2003 defines the types of entities that may conduct economic commercial activities in Montenegro as:** (1) individual entrepreneur, (2) general partnership,

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<sup>5</sup> See European Commission's page on Montenegro:  
[http://ec.europa.eu/enlargement/montenegro/eu\\_serbia\\_and\\_montenegro\\_relations\\_en.htm](http://ec.europa.eu/enlargement/montenegro/eu_serbia_and_montenegro_relations_en.htm)

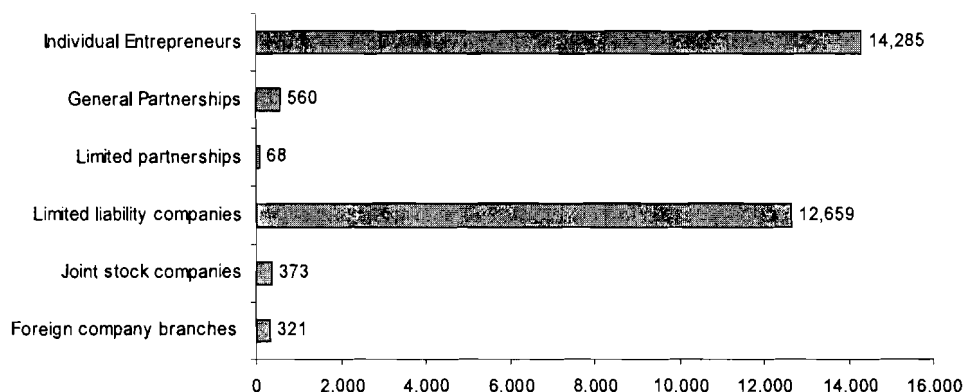
<sup>6</sup> Source: Montenegro Economic Memorandum, October 2005

<sup>7</sup> This report outlines the legal principles applicable to accounting, auditing and financial reporting and does not attempt to give anything more than an introduction to the issues. This report is not meant to be an exhaustive rendition of the law nor is it legal advice to those reading it.



(3) limited partnership, (4) limited liability company, (5) joint stock company, and (6) foreign company branches. The law defines rules and requirements on the formation, functioning and dissolution of the various types of entities. For limited liability companies and joint stock companies, the law defines the rights and obligations of shareholders and the responsibilities and liabilities of the company and its different organs. Joint stock companies and limited liability companies have a single board structure.

The following graph provides an overview of the number of companies established in Montenegro as at October 2006.



8. **The Business Organization Law (2003) and the Law on Accounting and Auditing (2005) define the basic requirements on financial reporting and auditing for legal persons** (joint stock companies, limited liability companies, and foreign company branches - approximately 13,300 entities in total). Additional requirements on financial reporting and auditing for financial sector entities are laid down in banking and insurance legislation. The following table provides an overview of the general legal basis for important elements of financial reporting and auditing by legal persons:

Main elements	Legal basis
Preparation of financial statements and applicable financial reporting framework (recognition and measurement)	Article 3 Law on Accounting and Auditing (2005): <i>all</i> legal persons (including foreign company branches) shall prepare financial statements in accordance with IFRS
Presentation of the financial statements (disclosure, lay-outs)	Article 3 Law on Accounting and Auditing (2005): prepare financial statements in accordance with IFRS (standard forms issued as guidance by the IAAM)
Components of financial statements (balance sheet, income statement, cash flow statement, changes in equity and management report)	No explicit requirements defined, but included within the body of IAS/IFRS (mainly IAS 1). Management report as required by the <i>acquis</i> is not covered.
Responsibility for the preparation of financial statements	Article 8 Law on Accounting and Auditing (2005): financial statements shall be signed by the responsible person determined by the general act of a legal person and by the manager of the financial or accounting department.
Statutory audit of financial statements	Article 12 Law on Accounting and Auditing (2005): joint stock companies and limited liability companies above a certain size as well as all banks and other financial institutions shall have their financial statements audited in accordance with ISA and the IFAC Code of Ethics; Article 47 Business Organization Law (2003): all joint stock companies must have their financial statements audited prior to the general meeting of the shareholders; Article 69 Law on Banks (2004): independent external audit shall be

	conducted in accordance with the Central Bank guidelines and ISA.
Adoption of financial statements	Art 35.5 Business Organization Law (2003): the general assembly of the joint stock company shall adopt a resolution on the distribution of profit [and the adoption of the financial statements]
Publication of financial statements	Article 6 Law on Accounting and Auditing (2005): legal persons shall submit financial statements to the Central Registry of the Commercial Court no later than 30 June after the financial year together with the audit opinion; Article 28 para 7 Business Organization Law (2003): joint stock companies shall submit financial statements including the auditor's report Article 71 para 3 Business Organization Law (2003): limited liability companies shall submit financial statements within 2 months after the end of the calendar year.
<b>Sanctions</b> on fraudulent financial reporting	Article 90 Business Organisation Law (2003) any person who knowingly prepares or signs a financial statement with the intent to defraud shall be fined an amount of max Euro 25,000 or be liable to up to 5 years imprisonment.

9. **Most elements that are important for financial reporting have a solid legal basis.** However, the definition of components of financial statements, and the preparation of consolidated financial statements are not adequately covered. Although these elements may be partially covered by the body of IFRS, the lack of specific reference is not in line with the extant *acquis* on financial reporting. Furthermore, there is some overlap between different laws, for example on the audit requirement; some contradictions as to the period within which limited liability companies have to submit their financial statements to the Central Registry, and potential ambiguity, such as with respect to the Central Bank rules on audit.

#### A.2 Accounting and financial reporting requirements

10. The following table provides an overview of general financial reporting, audit and publication requirements for each type of entity as at October 2006.

Type of entity	Financial reporting framework for Individual financial statements	Financial reporting standards for consolidated financial statements	Statutory Audit (required by law)	Publication of financial statements
Limited liability companies	IFRS is required. If annual revenue < € 500,000 IFRS is required with cash based accounting.	Consolidation criteria not specifically addressed (Likely IFRS)	Only if 2 of the following criteria are met: 1) Total assets > € 2 million 2) Annual revenue > € 4 million 3) Average number of employees > 50	Yes. Central Registry of the Commercial Court
Joint stock companies	IFRS is required.	Consolidation criteria not specifically addressed (Likely IFRS)	Yes, irrespective of size.	Yes. Central Registry of the Commercial Court
Foreign company branches	IFRS is required.	N.A.	No	No
Banks	IFRS is required in combination with special regulations.	Consolidation criteria not specifically addressed (Likely IFRS)	Yes, irrespective of size.	Yes and also submission to Central Bank and Central Registry
Insurance companies	General Accounting Plan, Insurance Law	Consolidation criteria not	Yes, irrespective of size.	Yes. Central Registry of

	and Accounting Law (2004)	specifically addressed (Likely IFRS)		the Commercial Court
<b>Investment funds</b>	IFRS is required.	Consolidation criteria not specifically addressed (Likely IFRS)	Yes, irrespective of size.	Yes. Central Registry of the Commercial Court

11. **The 2002 Law on Accounting and Auditing required all companies to prepare and publish financial statements in accordance with IFRS six months after the end of the financial year.** The law included a list of specific IFRS and foresaw that the Institute of Accountants and Auditors of Montenegro (IAAM) would adopt and publish subsequent IFRS. The Law included an exemption option for entities with a turnover of less than €500,000 which could use either accrual- or cash-based accounting. The Law “delegated” regulatory authority to the IAAM for the following public tasks: to develop additional accounting standards and instructions; to develop model financial statements forms for legal persons (in conformity with IAS); to issue simplified accounting regulations for SMEs; to adopt and publish ISA; to determine education and working experience for the certification of bookkeepers, accountants and auditors; and to provide training to accountants and auditors and to keep the register of accountants and auditors.

12. **The new Law on Accounting and Auditing (2005) no longer specifies the body with regulatory powers on accounting and auditing, and currently there is no set of formally adopted IFRS.** Instead of mentioning the IAAM as the body with delegated regulatory powers, the new law refers to a “competent body” that will adopt and publish IFRS. The new Law also no longer contains specific IFRS. As a consequence, the extant regulatory framework lacks its fundamental basis of “endorsed” IFRS for the preparation of financial statements. In practice, the Serbian translation of IFRS as at 2004 is widely used (Serbian is the language used in Montenegro). Whilst the ROSC team fully supports the regulatory approach requiring the endorsement of IFRS, priority should be given to setting up the necessary regulatory infrastructure. The government has recently publicly tendered for the competent body on the basis of terms of reference but the outcome was not published at the time of this ROSC report. The ROSC team recommends synchronizing the adoption and publication of IFRS in Montenegro with the EU endorsement of IFRS. In addition to early orientation towards EU practices this would allow Montenegro to benefit from EU leverage with regard to the IASB and may (in the future) create synergies with the European Commission translation of IFRS. Montenegro should closely follow the official adoption and translation process of IFRS in Serbia before initiating a separate translation process for IFRS. The current Serbian translation of the IFRS handbook is widely used in Montenegro. The IASC Foundation will only authorize one translation in any language. The advantage of economies of scale and pooling of expertise validates a close involvement in the Serbian translation of IFRS.

13. **The Law on Accounting and Auditing (2002) fell short of complying with important elements of the fundamental *acquis* on financial reporting and auditing (the Fourth, Seventh and Eighth Company Law Directives).** For example the law did not include requirements on management reports, it used different size criteria for exemption from statutory audit and there were no requirements on the approval and registration of audit firms. Options within the *acquis* that would allow for proportionate financial reporting, such as limited disclosures for small and medium sized companies, were also not fully used. The *acquis* relating to financial reporting and auditing has evolved significantly in recent years. The new Law fails to comply with the *acquis* on a number of important issues, such as preparation of management reports (Fourth, Seventh and Transparency Directives), half year reporting for listed companies (Transparency Directive), electronic publication of financial statements (First Directive), the approval and registration of audit firms (Eighth Directive) and the preparation of consolidated accounts (Seventh Directive). The government should prepare a “transposition table” to identify gaps in the regulatory framework compared to the relevant *acquis*. This gap analysis could serve as a basis for policy decisions on

further developing the existing laws and regulations and set future implementation deadlines so as to ensure a dynamic alignment with the “emerging” *acquis*. At a minimum the law should include the amendments to the Fourth and Seventh Company Law Directives adopted in June 2006 (issuance of corporate governance statements, disclosures on related parties and off-balance sheet arrangements) and the amended Eighth Directive on statutory audit adopted in May 2006.

14. **The 2005 Law requires that all legal persons (approximately 14,400 entities) in Montenegro use IFRS for the preparation of their annual financial statements.** The required use of IFRS reflects a pragmatic policy choice for a small country aiming at an open market economy; however the current scope of application of IFRS is too large relative to the existing capacity to properly apply IFRS. The IFRS financial reporting framework has been developed for general purpose financial statements of listed companies and contains some complex accounting treatments and detailed disclosure requirements. In general, the cost of application of IFRS does not outweigh the benefits for SME companies, in particular when they are manager-owned. The IFRS financial reporting framework does not allow limitations to the preparation and disclosure burden for SMEs as do the accounting Directives. Only one of the current 27 EU Member States requires the use of IFRS for all limited companies. Montenegro should consider making full use of the exemption possibilities for preparation and disclosure of financial statements for small and medium-sized companies under the *acquis communautaire*. Eventual future expansion of the scope of IFRS financial reporting requirements should be flanked by parallel institutional and professional capacity building so that credible high quality financial reporting can be ensured and sustained.

15. **The 2005 Law requires that entities with less than €500,000 turnover are obliged to use cash-based accounting when stating their annual revenue.** The use of cash-based accounting conflicts with the IFRS framework, which makes it impossible for such companies to comply with IFRS. Montenegro should re-examine of the purpose of this requirement in the context of defining a proportionate financial reporting framework for SMEs properly linked to tax accounting and taking into consideration the emerging draft IFRS on SME financial reporting.

16. **The Business Organization Law (2003) includes sanctions on fraudulent financial reporting.** The Law defines penalties for preparing or signing false or misleading financial statements with the intent to defraud. The penalties include a fine of up to €25,000 or up to 5 years of imprisonment. Defining sanctions for fraudulent and improper financial reporting is in line with the *acquis* which requires effective, dissuasive and proportionate sanctions.

### **A.3 Audit requirements**

17. **The scope of the statutory audit requirement covers what can be described as public interest entities.** The Business Organization Law and the Law on Accounting and Auditing (2005), as well as various specific laws on banking and insurance, determine the business entities that are subject to statutory audit: all joint stock companies, all banks, all insurance companies, all investment funds and limited liability companies above a certain size.

18. **The types of thresholds for exemption of limited liability companies from statutory audit are fully aligned with the *acquis* (Fourth Directive).** The actual amounts are relatively high when recalculated on the basis of Purchasing Power Parity and have been used as a policy instrument for matching audit demand and supply. However, the latest *acquis* would allow a significant increase of the thresholds for statutory audit exemption if deemed appropriate in the Montenegrin environment. In general, the thresholds could be increased gradually as the economy grows.

19. **The new Law on Accounting and Auditing allows foreign qualified auditors to become licensed Montenegrin auditors.** Not only is this in line with the fundamental freedoms of the *acquis* but it

is also a reflection of a well understood self interest for matching audit supply and demand. However, the law does not define the necessary criteria for testing a foreign, qualified auditor's understanding of national laws relevant for statutory audit, such as company law, tax law, accounting law, etc. As a result, the law may be too liberal from a public interest point of view. It is therefore recommended that the regulatory framework be aligned with the *acquis* and that an aptitude test on relevant national laws be added as a condition for licensing.

20. **The Business Organization Law includes provisions for joint stock companies on the appointment and dismissal of the auditor.** The general meeting shall have a right to approve the appointment of the auditor for a maximum term of one year in the case of joint stock companies. There are no specific provisions for the dismissal of auditors of joint stock and limited liability companies. The general meeting of a joint stock company may dismiss the auditor before his term expires by a simple majority. The amended Eighth Directive on statutory audit prescribes that auditors may be dismissed only if there are proper grounds and that the authorities responsible for oversight shall be informed. The combination of appointments with a short term and relatively easy dismissal do not support safeguarding the independence of the audit from influence of the company or its management. In addition, the Business Organization Law does not include provisions on audit committees for public interest entities. Audit committees are an important safeguard for ensuring audit quality and keeping the auditor at arm's length from management. The Law should be aligned with the amended Eighth Directive which contains such a requirement.

21. **The Law on Accounting and Auditing (2005) provides many sanctions for improper audits.** The law defines sanctions with respect to audit reports signed by non-licensed auditors and with respect to audits not performed in accordance with the law, ISA and the Code of Ethics. Moreover, the Law on Business Organizations includes a prohibition on management interference with the auditor's powers or work.

22. **International Standards on Auditing (ISA) are legally required but the individual ISA have not yet been translated, officially adopted or published.** The government has planned the official adoption and publication of properly translated ISA to complete the regulatory framework. However, this is not yet a reality due to the pending decision on the body to which this authority can be delegated. In practice, member firms of international networks of audit firms use their global methodology, which is normally in line with ISA, and local auditors use the Serbian translation of the IFAC handbook. In addition, the Law on Accounting and Auditing requires the use of the IFAC Code of Ethics, which has not yet been translated or formally adopted. The advantage of economies of scale and pooling of expertise validates a close involvement in the Serbian translation of the IFAC handbook.

23. **The regulatory framework does not define the structure of the audit report or the types of audit opinion.** Audit reports are covered by the body of ISA (ISA 700), however, ISA have not yet been translated and adopted in Montenegro. Audit reports and opinions are the only publicly visible output of statutory audits, and they define the level of assurance and the aspects to be covered by the statutory audit. In that sense, audit reports and audit opinions define the audit work to be performed by the auditor. The format and content of audit reports can not be defined by auditors themselves and therefore this report recommends the definition in law of the type of audit opinions, and the structure of the report, as required by the *acquis* (see also Section IV).

24. **The basic rules on auditor independence are defined by law; however the regulatory framework on auditor independence is not complete pending the translation and adoption of the IFAC Code of Ethics.** There are significant inherent risks in a small country that family, business or financial relationships could impair the auditor's independence and objectivity. Independence risks may be aggravated in cases of insufficient accounting capacity as the auditor may become involved in the

preparation of financial statements. The Law on Accounting and Auditing takes a strict approach to auditor independence by prohibiting the provision of additional accounting and consulting services to audited entities and the performance of statutory audits in cases where the auditor is a shareholder or founding member of the audited company. In order for alignment with the *acquis* auditor independence should be enhanced for public interest entities by requiring key audit partner rotation within 7 years and cooling off periods of 2 years for auditors taking up management positions in audited companies.

25. **The regulatory framework does not address audit firms in sufficient detail.** The regulatory framework focuses mainly on individual auditors. Whilst this may be largely sufficient in Montenegro (32 licensed auditors in the whole country), audit firms do exist and regulatory safeguards should be in place. This is to ensure that ownership and management of audit firms do not impair the independence, objectivity and quality of the audits. Therefore the regulatory framework should be amended to include inter alia the approval and registration of audit firms on the basis of ownership and management criteria. Rules on independence and quality assurance should also be expanded to properly cover audit firms. This would bring the regulatory framework more in line with the *acquis*.

26. **The role of the statutory auditor does not require the reporting of suspected fraud or money laundering to the authorities.** Whilst the banking law includes a duty for the auditor to report unlawful activities and other irregularities by banks and their employees, there are no general requirements on reporting of suspected fraud. The auditor's role and responsibilities with respect to fraud and money laundering should be brought into line with the *acquis* on money laundering<sup>8</sup>.

#### **A.4 Publication of financial statements**

27. **The Business Organization Law and the Law on Accounting and Auditing (2005) regulate the publication of financial statements by joint stock companies and limited liability companies, but in an inconsistent manner.** The Business Organization Law requires joint stock companies to submit annual financial statements and the audit report to the Central Registry of the Commercial Court and the Law on Accounting and Auditing determines that this should be done within six months after the end of the calendar year. Limited liability companies are required to submit annual financial statements to the Central Registry of the Commercial Court within two months after the end of the calendar year (however, six months according to the Law on Accounting and Audit. Two months is not a sufficient period for preparing and publishing audited financial statements (where the limited liability company is not exempted from statutory audit). By comparison, the most stringent requirement on the timing of publication of financial statements is defined in the EU Transparency Directive as 4 months. The timing of publication of financial statements should be reconsidered in order to synchronize and align with the *acquis*.

28. **The Business Organization Law and the Law on Accounting and Auditing (2005) do generally define the responsibility for enforcing publication and include only limited sanctions for non-publication of financial statements.** The Business Organization Law defines a maximum fine of €15,000 for the entity and € 5,000 for the person – failing to submit financial statements to the Court on a timely basis. This is in line with the amended First Company Law Directive that requires appropriate penalties for failure to disclose financial statements. The institutional responsibility for enforcing the timely publication of financial statements lies with the “competent body” (Article 18 of the Law on Accounting and Auditing) which is the Ministry of Finance. However, during the period covered by this A&A ROSC there was no dedicated capacity systematically overseeing the publication of financial statements. By mid

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<sup>8</sup> DIRECTIVE 2005/60/EC of the European Parliament and of the Council of 26 October 2005 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing; published in Official Journal L 309 of Nov 21 2005.

October 2006 only 60% of the companies required to submit financial statements 2005 by the end of June 2006 had done so and no resulting fines had been issued.

29. **Responsibility for the publication of financial statements of all companies has recently been transferred from the Central Registry at the Commercial Court to the Central Bank.** This was done on the basis of a memorandum of understanding between the two institutions involved but has not been clearly communicated to the public at large. At the time of the due diligence mission, the responsible department of the Central Bank was actively working on inputting the paper-form financial statements into an electronic system which can also be used for statistical purposes (as was the case under the ZOP system in former Yugoslavia). Some corrections are made for inaccurate arithmetic reporting detected while migrating the data. Early 2007 the Ministry of Finance formally confirmed that the Commercial Court retains its responsibility for publishing financial statements as well as monitoring the timely submission and quality of financial statements as required by law. The financial statements must be made electronically accessible to the public if the Montenegrin practice is to be aligned with the amended First Directive.

30. **The Securities and Exchange Commission (SEC) of Montenegro is in charge of regulating and overseeing the issuing and trading of securities.** The SEC approves and supervises the public offering of securities, licenses securities exchanges, licenses authorized participants (brokers, dealers, investment advisers, and underwriters) and licenses investment funds. There are currently two licensed exchanges in Montenegro: NEX and the Montenegro Stock Exchange. Both have listed securities in A and B segments and an unregulated free market. The existence of two exchanges allows for regulatory arbitrage and therefore limits the role that the exchanges themselves can play in enforcing the application and publication of IFRS financial statements.

31. **The Law on securities does not contain specific provisions on financial reporting by listed companies over and above the requirements for joint stock companies.** Whilst the basic requirement for IFRS financial reporting by listed joint stock companies is in line with the *acquis*, the current framework falls short of meeting several requirements such as publication of “financial reports”, including financial statements, management report and audit report, within four months of the year end and publication of half year financial reports, including condensed financial statements and an interim management report (Transparency Directive). Moreover, there are recently adopted changes in the *acquis* requiring specific disclosure of off-balance sheet arrangements, and the issuance of corporate governance statements. Sound financial reporting is crucial for the Montenegrin securities markets in ensuring that the recent significant increases in share prices remain based on underlying real economic factors.

#### ***A.6 Financial reporting and auditing requirements for banks***

32. **The Law on Banks requires that banks must be founded as joint stock companies and thus must follow the requirements on preparation, audit and publication of IFRS financial statements for joint stock companies.** In addition, the Law adds some specific requirements such as maintaining business books in accordance with the chart of accounts prescribed by the Central Bank and special regulations, and the publication of a shorter version of the audit report in a national daily newspaper.

33. **The Central Bank of Montenegro licenses banks and other financial institutions.** The Central Bank also supervises payment systems, establishes criteria for bank asset classification and loan loss provisioning, and sets minimum capital requirements. The Central Bank issues official “Decisions” on accounting, auditing and prudential reporting matters. One such “Decision” requires the submission of reports to the Central Bank on a basis which is not fully IAS 39 compliant (e.g. measurement of financial instruments at amortized cost). The regulation of the calculation of reserves for potential loan losses is also not in accordance with IAS 39. At present, the reporting requirements (enacted in April 2005) differ from the published CEBS-guidelines establishing a standardized financial reporting framework (FINREP) for

credit institutions operating in the EU which limits the comparability of financial performance and financial position with banks from the EU.

34. **The Law on Banks requires banks to submit their IFRS financial statements within six months of the calendar year end to the Central Bank and to submit prudential reports to the Central Bank.** As banks are obliged to be joint stock companies, the financial statements and the audit report must also be made public; financial statements are submitted to the Central Bank within 6 months of the calendar year end. The appointment of the auditors of banks is subject to approval from the Central Bank. To date, the Central Bank has approved only three member firms, all of which are local member firms of the major international networks of audit firms. The statutory auditor of a bank is obliged to report to the Central Bank any unlawful activities or irregularities which is in line with the BCCI Directive.

#### ***A.7 Financial reporting and auditing requirements for insurance companies***

35. **Until adoption of the new law on insurance there was no dedicated insurance supervisor and the Ministry of Finance carried out that task with only three staff.** The Ministry of Finance carried out on- and off site inspections including a review of the financial statements, the management report and the audit opinion. A proposal for a new Law on Insurance was submitted to the Parliament in November 2005 and was adopted in December 2006 after the due diligence mission. The new law governing insurance entities is the Federal Law on Insurance of Property and People (1999). This Law sets no specific financial reporting requirements on insurance companies further to the general requirements of the Law on Accounting and Auditing. Thus all insurance companies must apply IFRS and are subject to a mandatory annual audit. The Insurance Supervision Agency shall also oversee the preparation of financial statements.

### **B. The Accounting and Audit Profession**

36. **The Law on Accounting and Auditing (2002) merged two existing bodies, the Union of Accountants and Auditors of Montenegro and the Montenegro Association of Workers for Accounting and Financial Profession, into one body, the Institute of Accountants and Auditors of Montenegro (IAAM).** Moreover, the 2002 Law equipped the new Institute with regulatory powers in addition to their role of representing the interest of the accountants and auditors in Montenegro. The revised Law on Accounting and Auditing 2005 does not specifically name the IAAM; instead it states that a competent professional body separate from the government may be entrusted with tasks of public interest in the area of accounting and auditing. As discussed in Paragraph 17 above, the government is currently tendering for the 'competent body' on the basis of defined terms of reference. The public interest tasks previously delegated to IAAM and envisaged for the competent body include adoption of IFRS and ISA, approving education programs and the curriculum, issuing Certified Accountant certificates, maintaining the register of licensed auditors, developing interpretations of accounting and auditing standards and preparing model financial statements.

37. **The IAAM is undergoing major turmoil. A 'new Institute' has recently been established and is residing at the premises of the 'old Institute'; however, the original Institute still exists but has not established a board following the split with the 'new Institute'.** There is an urgent need for the two professional organizations to come to a mutual agreement so one or both bodies can be equipped with the regulatory powers. The current regulatory vacuum undermines legal certainty for all stakeholders involved in financial reporting. The Ministry of Finance has insufficient capacity to fulfill the range of regulatory tasks identified in the Law.

38. **When the predecessor accounting body to the IAAM became an associate member of IFAC in 2000, the members decided to assume the title 'certified accountants' despite not having to**



**pass any examination.** This is not in accordance with IFAC guidance on accounting education. In order to raise the profile of the accounting profession and to create opportunities for better qualified accountants, the Law on Accounting and Auditing (2005) introduced the official title of certified accountant. Certification depends on meeting general qualification criteria, such as having a university degree, but also on passing examinations based on the International Education Standards of IFAC. Following the enactment of the Law, existing accountants are now officially qualified as “authorized professional accountants”. The existing accountants perceive this development as a depreciation of their accountant title and argue that they already are certified auditors.

39. **Montenegro has implemented a sound policy of re-examination of auditors to ensure the quality of the licensed statutory audit profession.** According to the terms of the Law on Accounting and Auditing of 2002, the 21 then-certified auditors obtained a temporary audit license which could be made permanent if they passed a re-examination. The government postponed the re-examination several times; however, the new Law on Accounting and Auditing of 2005 required the re-examination of certified auditors by 31 March 2006. Several auditors subsequently lost their license as they refused to participate in the re-examination. There are currently 32 licensed auditors in Montenegro. Furthermore, the government has decided to open up the right for foreign qualified auditors to become licensed auditors in Montenegro (see paragraph 26). In practice this will be very important for Serbian-qualified auditors and Montenegrin auditors who obtained their qualifications abroad (e.g. US, UK).

### **C. Professional Education and Training**

40. **High quality financial reporting and auditing relies of the provision of effective professional education and training in accounting and auditing.** In the former Socialist Republic of Yugoslavia, accounting was mainly associated with bookkeeping and reporting for taxation and statistical purposes; financial reporting did not address the economic value and performance of privately held companies. The challenge for the training and education of accountants in Montenegro is to equip existing and newly-qualifying accountants with the core skills and concepts related to accounting in privately owned companies, including principles-based accounting standards, modern auditing standards and techniques, management accountability towards shareholders and other stakeholders and advanced corporate governance.

41. **The overall qualification requirements for auditors defined in the Law on Accounting and Auditing are similar to requirements of the *acquis* and IFAC International Education Standards.** The qualification requirements include a university degree (in economics or business), three years of working experience (as an accountant) and two years as an auditor and the passing of a professional examination. However, a list of subject matters included in the *acquis* is not included in the Law.

42. **The number of students taking accountancy options in undergraduate degrees the new post graduate studies on accounting is increasing, which indicates a strong demand for accountancy education.** A USAID-funded study in 2005 emphasized the need for younger professional accountants to receive more modern market-economy based accountancy education in terms of curriculum content, delivery style and examination system. Over a thousand students have graduated in the last three years from the Faculty of Economics at the University of Montenegro, which teaches accountancy related courses, though it is not clear how many majored in accounting courses. Currently there are 46 postgraduate students in Accounting and Auditing, though none have completed the two year post graduate program as it started less than two years ago.

43. **The 2005 USAID funded benchmarking project on accounting and auditing education in Montenegro indicated that IFRS, ISA and the Code of Ethics, as well as overall skills, values and**

**attitudes relating to accounting were well taught.** Deficiencies were noted in education related to corporate governance, business ethics, financial markets, management and strategic decision making. The study advised developing an up-to-date accounting curriculum at the University of Montenegro, updating the outdated accounting text books in Serbian (currently a 2001 USAID-funded translation of an international accounting text book is used) and that the IAAM should develop a properly supervised practical training requirement for accountants and auditors.

44. **Currently there is no requirement for Continuing Professional Education (CPE) for auditors in Montenegro.** A requirement for continuing education should be introduced in line with international best practices (IFAC International Education Standards) and the *acquis communautaire* (per the amended Eighth Directive).

#### **D. Setting Accounting and Auditing Standards**

45. **The Law on Accounting and Auditing in Montenegro does not prescribe the setting of its own accounting and auditing standards but the use of IFRS and ISA for all relevant entities (see Section IIA above).** As discussed above, the decision nominating the regulatory body empowered to adopt IFRS and ISA has not yet been made and, as a result, Montenegro currently does not have a set of officially translated and adopted IFRS or a set of translated and adopted ISA. The Law on Accounting and Auditing (2002), that was repealed by the adoption of the new Law on Accounting and Auditing (2005), had authorized the IAAM to issue IFRS-based simplified accounting regulations for SME's and to issue explanations and guidance on the use of IFRS for financial reporting. However, no such simplified regulations for SMEs are currently authorized or in use.

#### **E. Enforcing Accounting and Auditing Standards**

46. **There is no effective enforcement of compliance with accounting standards in financial reporting of entities in Montenegro except for banks.** The Central Bank carries out enforcement of banks' prudential reporting, which is based on the general purpose financial reporting. The securities market regulator does not carry out any systematic quality control of the financial statements of the entities it regulates and the supervision of insurance undertakings, investment and pension funds has not yet been established.

47. **The Securities Act contains a general provision on the protection of investors but does not prescribe a specific role for the SEC regarding the enforcement of financial reporting by issuers.** The SEC, as an independent and autonomous body, can determine its approach to enforcement. Listing requirements for the A and B segments of the stock market require a company to have an unqualified (clean) audit opinion for the admission of its securities and their continued listing on the stock exchange; thus the SEC performs reviews of all audit opinions on the annual financial statements of companies listed on the A and B segments. The SEC provided examples of companies that were de-listed as a consequence of SEC findings of qualified audit opinions and audits performed by non-licensed auditors. However, the SEC does not discuss any issues with companies directly, nor does it perform on-site visits in order to follow up on qualified audit opinions or for any other reason. Enforcement by the SEC tends to rely solely on the external audit.

48. **The Central Bank of Montenegro enforces proper prudential reporting by banks through on- and off-site inspections.** As the Central Bank has few or no IFRS specialists, enforcement is mainly limited to the regulatory field of prudential reporting, though this is based on the IFRS financial statements with certain differing assumptions and measurement basis. The Central Bank places reliance on the audit opinion of the bank auditor for ensuring the correct application of IFRS. The Central Bank publishes only the prudential reports prepared by banks (balance sheet and profit and loss accounts) on their home page,

which can cause confusion as the financial statements available on the banks' websites are generally the IFRS statements and thus differ from those on the Central Bank website. At the time of the ROSC due diligence mission there was no dedicated insurance supervisor, and there was no enforcement of financial reporting requirements by insurance companies beyond the statutory audit.

49. **At present there is no regulatory requirement for external quality assurance of auditors.** Quality assurance is one of the responsibilities which it is envisaged will be delegated to a 'competent professional organization' once the government completes the delegation process. The absence of audit quality assurance is a key weakness as statutory audit is the first line of confirming proper application of accounting standards. Quality assurance enhances public confidence in the quality of the audit function and also allows and requires the audit profession to improve the quality of audits. A requirement for external quality insurance along the lines of the quality assurance provisions of the amended Eighth Directive on statutory audit is urgently needed.

50. **There is no requirement in the Law on Accounting and Auditing (2005) for public oversight of auditors and audit firms, as is required by the *acquis*.** The new Law does provide that the Ministry of Finance should oversee the implementation of the Law and can delegate regulatory activities to other bodies. However, there are no specific requirements for organizing public oversight similar to the requirements of the new 8<sup>th</sup> Directive on statutory audit.

### III. ACCOUNTING STANDARDS AS PRACTISED

51. **The ROSC team reviewed a sample of twenty sets of financial statements prepared in accordance with IFRS.** The sample included 5 SMEs, 9 large listed real sector companies, 3 banks, 2 insurance companies, and an investment fund. The ROSC team used judgmental sampling to select the financial statements. However, due to the small sample size, the outcome cannot be considered representative for all Montenegrin companies. Hence, the findings, although useful for indicating potential systemic problems in financial reporting, will pertain only to shortcomings found in the financial statements of specific companies.

#### A. Financial Reporting by SMEs

52. **All the SME companies reviewed used a standardized 'Set of forms for annual accounts' which do not fully comply with IFRS. In addition, there was a widespread lack of disclosure which resulted in further non-compliance with IFRS.** The standard forms used were described as 'The form prescribed on the basis of Article 3 of the Law on Accounting and Auditing (Official Gazette of the Republic of Montenegro No. 69/05) and Article 22 of the IV EU Directive No. 78/660/EEC'. These forms include standardized layouts for the income statement, balance sheet, cash flow statement, and statement of changes in equity. They also made reference to notes to the financial statements describing the applied accounting policies and analytical clarification of materially important balance sheet items. However, only two of the sets of accounts for SME companies actually included any of this information on policies and notes, and these two were merely a brief summary of policies.

53. **The problems with the standardized forms detailed above were compounded by errors in the completion of the forms.** Four out of six "standardized" financial statements contained arithmetic errors, reconciliation mistakes and inconsistencies between amounts included on the income statement and amounts included on the face of the balance sheet. Many of the financial statements showed inconsistencies and illogical amounts relating to taxation in particular. In two cases, the statement of changes in equity was missing and in one case there was no cash flow statement. Finally, one financial statement referred to the application of IAS 15 and 25 in its accounting policies, which do not actually exist. The impression was that most of the forms had not been carefully checked after completion and their informational benefit to

users was very limited. None of the financial statements included an audit report. Thus there was a significant compliance gap in addition to the possible inherent standards gap of the forms themselves.

54. **In conclusion, the level of compliance with IFRS of the SMEs' financial statements was low. This reflects SMEs' limited resources available to apply to such compliance, as well as the lack of demand for such compliance from users of the financial statements and the lack of consequences of non-compliance.** The findings from this review of SME financial statements appear to confirm the inappropriateness of the current body of IFRS for financial reporting by SMEs in general and in Montenegro in particular. The universal requirement for application of IFRS in Montenegro risks leading to a culture of accepting non-compliance, which may spread to larger companies and may undermine the country's reputation on financial reporting.

#### **B. Financial reporting by real sector listed companies**

55. **The State is either a significant (over 20%) or controlling (over 50%) shareholder in most of the listed companies in the sample reviewed for compliance with IFRS.** This indicates an overall large state interest in listed companies in Montenegro. Moreover, sometimes there were material transactions or financing arrangements that involved the State. In such cases it is probable that the company and the State are very familiar with the terms of the transaction and this may lead to the transactions being described in the financial statements without enough detail for a third party to fully understand them. An example is a company which canceled certain assets as a result of legislation and from information in the fixed assets note appeared to make a considerable loss. However the loss recorded in the income statement was substantially less. Another part of the financial statement refers to forgiveness of debt by the government which appears to have occurred after the year end but which has been recognized and appears to be the reason for the reduced loss. Without greater explanation in the financial statements the third party reader would have difficulty in understanding the connection (if any) between these two events and whether they are in fact part of a linked transaction.

56. **Only one of the companies disclosed related party transactions and none of them disclosed the key management personnel compensation, as required by IAS 24.** As noted previously, the State is a significant or controlling shareholder in many of the companies and as such many of the company's transactions with the State are more than the 'normal dealings' referred to in IAS 24. The main transactions with the State that were not 'normal dealings' should be disclosed, together with transactions and balances with any other related parties.

57. **The quality and level of IFRS compliance of the financial statements of listed companies reviewed was better than that of the SMEs' statements but issues remain (see paragraphs 72-81 below), particularly in relation to adequate disclosure.** The financial statements generally disclosed considerable detail in some areas going beyond what IFRS requires, but did not adequately disclose in areas where such disclosure is required under IFRS. Extensive disclosure was made on customer receivables and payables to suppliers, where the main customer and supplier names and balances were often set out. There was also considerable detail on items such as staff and other costs and inventory categories. This degree of detail may be useful but IFRS does not require it. This leads to an impression that knowledge of IFRS is not as extensive as could be expected.

58. **None of the financial statements reviewed were consolidated financial statements.** Only one of the companies appeared to have subsidiaries, associates or joint ventures (and it deemed them immaterial). For this reason, IFRS 3 'Business combinations' was generally not applicable and IAS 28 and IAS 31 on associates and joint ventures were also not applicable. Also most of the companies operated only in the home country and in one class of business; therefore IAS 14 'Segment reporting' was also generally not applicable. The absence of certain disclosures required by IFRS leads to the assumption that

transactions, events or situations that should have been recognized and disclosed under the IFRS financial reporting framework had actually not occurred. For example, none of the companies reviewed – although being listed - disclosed any share option schemes and this implies that they did not have any. None of the companies reviewed disclosed non-current assets held for sale or discontinued operations. A full list of standards that *have not been applied* by any of the companies subject to review is as follows: IFRS 1 to 6, IAS 14 27 – 31, IAS 34 and IAS 40 -41. Other standards were only applied by a number of the reviewed companies such as IAS 24, IAS 33 (if relevant), IAS 11 (if relevant), and IAS 19 (if relevant).

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

- **IAS 1 Presentation of financial statements.** None of the companies provided separate disclosure of the significant judgments and key sources of estimation uncertainty. Comparative figures were given by only one of the 9 companies for fixed asset movements on intangible assets. One company showed unusually low interest payable compared to its total debt and interest rates quoted which may raise the question as to whether it has accrued in full for interest payable.
- **IAS 2 Inventories** – In one company some of the inventory is stated as being at cost when it should be at lower of cost and net realisable value. In two other companies certain items of inventory are stated as being held at sale price with VAT included.
- **IAS 8 Accounting policies, changes in accounting estimates and errors.** None of the companies gave the information required about standards issued but not yet adopted and any known impact that these would have when adopted. One company has a qualified audit report because a prior year adjustment for liabilities for legal claims was adjusted against reserves rather than as a prior year adjustment.
- **IAS 11 Construction contracts.** One company has a qualified audit report because it has not recognized revenue under the percentage of completion method. The auditors were unable to quantify the effect. If the company has construction contracts as the auditors say then it also has not complied with all the other disclosure and measurement requirements of IAS 11.
- **IAS 12 Income taxes.** Tax disclosure appears to be a particularly weak area (unless there are no significant tax liabilities in the companies concerned). Examples include no taxation reconciliation, no tax line in the income statement no disclosure of taxation losses, and there are further specific issues relating to deferred taxation and timing differences..
- **IAS 16 property, plant and equipment and IAS 36 impairment of assets. There are some serious concerns on proper asset valuation including the lack of impairment tests.** In general, asset valuation in Montenegro is hindered by the lack of active and liquid markets for certain classes of assets. The review of audit engagements also identified asset valuation as a major area of concern; one of the companies had a qualified audit report due to a lack of impairment tests.
- **IAS 19 Employee benefits– Only two of the companies referred to the use of IAS 19 to account for jubilee awards and retirement severances.** The government is planning to legislate for pillar II pension systems implying that properly accounting for pension liabilities will become a very important financial reporting issue.

- **IAS 33 Earnings per share** Although all companies reviewed were listed, only one gave Earnings Per Share information (basic and diluted EPS) as required by IAS 33 for companies whose shares are publicly traded.
- **IAS 39/32 Financial Instruments, recognition and measurement and presentation.** Only one of the companies disclosed objectives and policies for financial risk management and fair values were generally not disclosed, although one company said that it was not possible to obtain them (probably in the absence of an active market). In most cases other disclosures, such as concentrations of credit risk were not made, and there was patchy disclosure of maturity of debt and other required disclosures.
- **IAS 38 and SIC 29 Intangible assets.** Several companies had intangible assets representing concessions. Fuller details of concession arrangements should have been given under SIC 29. This is particularly pertinent in the case of the company that made a large loss on surrendering assets back to the government.

### C. Financial sector financial reporting

The financial statements of 3 banks, 2 insurance companies and one investment fund were reviewed.

#### *Banks*

59. **The quality of the financial statements of banks, especially of foreign owned banks, was generally good.** None of the banks reviewed had an unqualified audit opinion. Furthermore the notes to the financial statements appeared to be presented with the required disclosures of IFRS, included informative risk-reporting and were therefore comparable to that of peers in the European Union. This can be largely attributed to the supervision by the Central Bank and the transfer of foreign knowledge to local banks.

60. **Only two of the financial statements of banks stated clearly that they comply with IFRS.** Two other financial statements stated that they were prepared in accordance with the Law on Accounting and Audit of the Republic of Montenegro ("Official Gazette of the Republic of Montenegro" No. 69/05) with a further explanation in the notes that the regulations of the Republic of Montenegro required the application of IFRS. Two financial statements (one of the insurance companies and the investment fund) stated that they were in compliance with the Law on Accounting and Audit of the Republic of Montenegro avoiding the explicit wording "International Accounting Standards" or IFRS.

61. **Banks are required to calculate provisions for potential loan losses in accordance with a methodology and matrix prescribed by the Central Bank.** This may result in an under- or overstatement of the loan portfolio as compared to IFRS. The rule requires banks to calculate impairment in the unsecured portion of loans and receivables. The calculation is based on a provisioning matrix that specifies a range of fixed minimum provisioning rates for each category which is dependent on period overdue and presented as a liability on the balance sheet. While this methodology may be adequate for prudential purposes, it does not comply with IAS 39, which requires that the allowance for loan losses be calculated as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate. Banks use these regulations not only for prudential reporting but also in preparing their IFRS financial statements.

#### *Insurance companies and investment funds*

62. **The scope limitations in the audit reports of the two insurance companies were so significant and material that they call into question the reliability of the financial statements and their compliance with IFRS.** The scope limitations in the audit of insurance companies included the following matters:

- Uncertainties of the value and quantities of the fixed assets of the opening balance.
- Uncertainties about the existence and measurement of liabilities and adequate provisions.
- Missing comparative data for the previous year, as required by IFRS 1 paragraph 36.
- Investments into capital available for sale were declared at the *acquisition* cost and the management did not conduct examination of these investments in accordance with the requirements of IAS 39 “Financial Instruments: Recognition and Measurement”.
- Insufficient availability of expense loading funds for covering the total expenses of insurance conduct.
- Irregularities in operations based on a conducted control of business operations of the Ministry of Finance of the Republic of Montenegro (e.g. high unauthorized expenses of insurance conduct, lack of adequate evidence of investment in related companies, declaration of high non-business expenses through provisions and write-offs).

63. **The notes to the financial statements of the insurance companies did not include a clear explanation of the use of IFRS 4 “Insurance Contracts”.** IFRS 4 requires disclosure relating to the recognition of amounts concerning insurance contracts as well as the nature and extent of risks arising from insurance contracts.

64. **The financial statements of the reviewed investment funds showed some non-compliance issues.** Under IAS 39, fair value gains and losses on assets available for sale must be taken to equity, but the fund recorded the fair value gains and losses in the income statement. “Emphasis of matter” paragraphs in the audit report drew attention to the fact that investments were made in unlisted shares for which there is no active market, and that management has made provisions for decreases in value and monitors investments on the basis of financial information received.

#### ***Financial reporting issue common across the financial sector companies reviewed***

65. **Only two financial statements stated that interest income and expense were recognized on the income statement for all instruments measured at amortized costs using the effective interest method.** All others have recognized loan or borrowing origination fees on the income statement when received or incurred; a methodology which is not in line with IAS 39 (measurement of financial instruments at amortized cost) because interest revenue or expense recognition does not reflect the effective yield.

## **IV. AUDITING STANDARDS AS PRACTISED**

**The purpose of this section is to perform the auditing *standard gap* analysis and *compliance gap* analysis.**

66. **ISA are defined in law as the national auditing standards.** However, as stated earlier, ISA have not yet been fully translated and adopted and therefore the standard gap could be considered as a gap of non-adopted ISA. To address the compliance gap, the ROSC team conducted onsite reviews of a sample of auditors and audit firms to assess the quality of their audit process and audit files against ISA. This

review was carried out with the full support of the Ministry of Finance and the IAAM; the IAAM considered the review as a proxy for the current lack of a system of quality assurance. This supportive attitude reflects the desire to improve audit quality in Montenegro.

67. **Overall, the statutory audit function does not appear to fully function; audit reports do not provide sufficient credibility to published financial statements.** The generally accepted practice in Montenegro is that auditors issue qualified audit opinions, disclaimer of opinions or add emphasis of matters paragraphs to their opinion, rather than management giving due consideration to the audit findings and adjusting financial statements. A qualified audit report should be a cause for concern and not accepted as normal practice. Moreover, some of the qualified audit opinions should be adverse audit opinions on the basis of ISA because of their materiality.

68. **The audit firms and audit engagements reviewed, for the most part, evidenced knowledge of, and a willingness to apply, ISA.** However, several significant weaknesses in application of ISA were observed which undermines the reliance that the user of financial statements can place on the audit process and resultant audit opinion. The purpose of the audit process and the role of the auditor appear in many cases to be not properly understood by the directors of audited companies and the auditing profession itself. The objectives of the ISA audit process, i.e. for the auditor to arrive at an independent and objective audit opinion and to issue a report on the financial statements that provides assurance to the shareholders of the company, and other stakeholders are often not being met.

69. **The audit Reports reviewed were generally not in compliance with ISA - 700 “The Auditor’s Report on Financial Statements” and ISA - 701 “Modifications to the Independent Auditor’s Report”.** The majority of audit reports reviewed included emphases of matter or disclaimer modifications/qualifications; they contained differences in structure and content, emphasis of matter paragraphs with respect to estimates and valuations, and did not permit users to ascertain if the financial statements give a true and fair view in accordance with IFRS, local law and regulations and were free from material misstatement.

70. **The audit processes reviewed appeared to be weak with respect to ISA 540 – “Audit of Accounting Estimates” and ISA 545 – “Auditing Fair Value Measurements and Disclosures”.** As a result, little reliance can be placed upon on the accuracy of valuation of and the appropriateness of measurement bases (in compliance with IFRS) of assets and liabilities in financial statements. The audit process and report provides little assurance regarding the reasonableness, accuracy and compliance with IFRS regarding judgments and estimates included in the financial statements (e.g. fixed asset revaluations and impairment reviews and provisions). The lack of objectivity in relation to fixed asset valuations (valuers receive a commission on value certified) undermines the credibility of the entire financial reporting framework. Auditors are accepting valuations without undertaking necessary procedures in accordance with the ISA to gain assurance on proper asset valuations, including impairment tests. Several asset valuations and provisions appeared not to be independently and properly determined in financial statements (property valuations appear inflated) but are not being challenged by auditors.

71. **The review of audit process indicated that, in some cases, sufficient and appropriate audit evidence was not always obtained in accordance with ISA 500 – “Audit Evidence”.** The audit processes reviewed comprised primarily arithmetic checks of the financial statements to the books and records of the company. Tests for completeness of assets and liabilities, correct presentation and full disclosure in the financial statements (as required by the ISA) did not appear to be properly undertaken and reported on as part of the ISA audit process. Internal controls were often documented in audit engagements but rarely tested and relied upon. As a result of the recent recertification of auditors, a number companies had changed auditors. In the case of new engagements reviewed, there was no evidence that the requirements of ISA 510 – “Initial Engagements – Opening Balances and Continuing Engagements” had been complied with.



72. **From the review, it seems that auditors did not provide formal communication of matters of governance interest and schedules of unadjusted errors to those charged with governance (in accordance with ISA 260 “Communication with Those Charged with Governance”).** ISA 260 requires the auditor to communicate such issues and to document compliance with this requirement in accordance with ISA 230 (Revised) – “Audit documentation”. As a result of this, those charged with governance (usually non executive directors) are not taking ultimate responsibility for the finalization of the financial statements and potential consequent impact on the audit report of their decisions.

73. **There is no requirement in law for listed companies to establish audit committees, in accordance with international best practice and the *acquis*.** An audit committee performs the role of recommending appointment of the auditor and considering reports from and in respect to the auditor, so that standards of independence and quality control are maintained. The role of the audit committee is one aspect of the amended Eighth Company Law Directive, which includes other requirements such as auditor rotation and transparency reports in respect of auditors of listed entities. In addition, there are regulations on ownership of audit firms, which are not implemented in Montenegro; one audit firm reviewed and a listed client of the audit firm had common ownership. These requirements of the Eighth Directive represent good corporate governance practices and facilitate the development of capital markets; such requirements should be implemented in Montenegro.

74. **The audit methodology as implemented by the audit firms review did not appear to be uniformly and consistently in compliance with international standards, specifically ISQC 1.** As noted above there are significant departures from full and proper application of the ISA in individual audit engagements. A fully ISA compliant environment could be facilitated by taking steps to require that:

- International Standard on Quality Control 1 (ISQC1) is implemented in all audit firms (internal quality assurance); and
- Audit profession implements an effective quality control and review system (external quality assurance).

75. **Progress has been made in balancing the supply of auditors with audits.** However, the number of audits required (c. 800) still exceeds the capacity of the number of licensed auditors (32 in 11 firms) to deliver. Capacity can only be developed through accessible education and training programs. A number of recommendations have been made in Section 2 to develop capacity.

## **V. PERCEPTIONS OF THE QUALITY OF FINANCIAL REPORTING**

76. Managers of companies and auditors seem happy to accept modified audit reports on a very large scale. This undermines the value of the audit function adding credibility to financial statements. Banks confirmed that they increasingly use financial statements for their lending operations and the assessment of creditor risks. However, perceived poor quality of financial reporting mainly due to low capacity of accountants and auditors, does not allow banks to place essential reliance on financial information provided by borrowers in the loan application process. Moreover, corporate governance does not seem to function optimally due to a lack of shareholder activism, the lack of audit committee's and the dominant role of the state in several companies reviewed for sampling.

## **VI. POLICY RECOMMENDATIONS**

77. **The recommendations of this ROSC are interrelated and mutually supportive and are designed to collectively improve the financial reporting environment in Montenegro.** 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. The table below provides an 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. The recommendations are clustered into the six major pillars of the accounting and auditing infrastructure. Each of these, in turn, plays a major role in shaping the overall accounting and auditing culture and environment: The indicative timeframes are: short term (approximately one year), medium term (one to three years), and long term (more than three years).

<b>MONTENEGRO ROSC ACCOUNTING AND AUDIT RECOMMENDATIONS</b>			
<b>Recommended Measure</b>	<b>Responsible Entity</b>	<b>Time Frame</b>	<b>Para. Reference</b>
<b>I. With regard to the Statutory Framework the following is recommended:</b>			
1. Translate and adopt IFRS, ISA and the Code of Ethics.	Institute of Certified Accountants	Short term	
2. Establish sustainable institutional arrangements for continuous adoption and publication of IFRS, ISA and the Code of Ethics.	Institute of Certified Accountants	Short term	
3. Align financial reporting framework with the <i>acquis</i> for the major issues identified in the ROSC report including the preparation of consolidated financial statements, the regulation of audit firms and electronic publication of financial statements	MoF	Medium Term	
4. Conduct a thorough examination identifying the gaps between the regulatory framework and the <i>acquis</i> relevant for financial reporting and auditing beyond the issues already identified in this ROSC report.	MoF	Medium Term	
5. Define proportionate financial reporting requirements for SME companies.	MoF	Medium Term	
6. Improve publication of financial statements.	MoF	Medium Term	
<b>II. With regard to Accounting Standards the following is recommended:</b>			
7. Translate and adopt IFRS.	Institute of Certified Accountants	Short term	
8. Reconsider financial reporting by SME limited liability companies.	MoF	Medium Term	
9. Issue alerts to accounting issues of a horizontal nature such as asset valuation and impairment, related party transactions disclosures, and pension accounting.	Institute of Certified Accountants	Medium Term	

<b>III. With regard to Auditing Standards the following is recommended:</b>			
10. Translate and adopt ISA and a Code of Ethics.	Institute of Certified Accountants	Short term	
<b>IV. With regard to the Monitoring and Enforcement of Accounting and Auditing Standards the following is recommended:</b>			
11. Reinforce SEC's enforcement of financial reporting by listed companies.	SEC	Short term	
12. Establish supervision of financial reporting of insurance undertakings, investment and pension funds.	Insurance Supervisory agency	Short term	
13. Introduce a system of external quality assurance on auditors and audit firms.	Institute of Certified Accountants	Short term	
14. Introduce public oversight over auditors and audit firms.	MoF	Medium term	
<b>V. With regard to the Development of the Accounting and Auditing Profession the following is recommended:</b>			
15. Resolve the current situation on the institutes.	MoF	Short term	
16. Increase the number of auditors.	MoF	Short and medium term	
17. Develop a generally accepted training for becoming certified accountant.	Institute of Certified Accountants	Short term	
<b>VI. With regard to Education and Training the following is recommended:</b>			
18. Develop an up to date accounting curriculum of the University of Montenegro; update the outdated accounting text books.	University	Short term	
19. Develop a properly supervised practical training for accountants and auditors and a system of Continuing Professional Education for auditors.	Institute of Certified Accountants	Medium term	

