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DEVELOPMENT OF ACCOUNTING REGULATION IN MONTENEGRO - FINANCIAL REPORTING STANDARDS AND THE REPORTING NEEDS OF SMEs

Abstract

The paper discusses development of accounting regulation in Montenegro by introduction of *International Standards for Financial* Reporting and how this standardization effects the economy and SME's performance. In 2015 International Accounting Standards Board issued International Standards for Financial Reporting (ISFR) for small medium enterprises (SMEs) which introduced few changes in reporting needs of SMEs. Changes that were introduced lessened the reporting needs for SMEs however new ISFR for SMEs were not introduced in Montenegro. The aim of this paper is to discuss how current standards supported by national legislation are affecting Montenegro as transition economy and if this standardization is enhancing the development of SME sector. Based on qualitative research and interview with executives of 150 SMEs in Montenegro we will present how standards are applied in practice and if they have increased the quality of reporting for SMEs.

***Key words*:** Accounting, Financial Reporting, Accounting Standards, International Standards for Financial Reporting for SMEs, Business Barriers, Entrepreneurship Accuracy of Reporting, Integrated Reporting (IR), Trends in Accounting development.

***JEL classification*:** M41, M48, G32

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1. Introduction of Accounting standards in Montenegro

Reform of Accounting and Auditing in Montenegro started in 2002 with introduction of *Law on Accounting and Auditing*. This law introduced changes in accounting and auditing because this is the first time that International Accounting Standards and International Standards of Financial Reporting developed by International Accounting Standards Board (IASB) became obligatory in Montenegro.

In addition to that new Law enforced the obligation of reporting by defining that auditing and presenting of financial reports need to be in accordance to International Accounting Standards that were adopted and published by Institute of accountants and auditors of Montenegro. First 18 standards were defined as obligatory but by 2004 all standards became obligatory[3]. Another important change that was introduced was the obligation that entities whose annual revenue is larger than 500 000.00 euro needs to use accrual accounting in reporting while companies whose revenue is less than 500 000.00 euro can use cash based accounting. The exception to this rule was the fact that SMEs were allowed to used simplified accounting procedures (accrual based accounting at the moment when obligation is created). After the World Bank Report in 2006 additional changes, based on recommendations, were introduced regarding: electronic reporting, consolidated financial reports, quarterly reporting needs for shareholders etc. When Montenegro became candidate country for European Union (EU) membership national authorities declared that national legislative will be in line with EU law and legislatives. New Law of Auditing from 2016 in paragraph 2 defines that all Financial Reports need to be in line with IAS and ISFR while paragraph 3 defines that Auditing is conducted by International Auditing Standards (IAS); New Law of Accounting from 2016 in paragraph 10 defines that " *All entities need to prepare financial reports and consolidated reports based on IAS and ISFR with the cutoff date of 31st December of working year, or the date of registration od statute changes like: mergers, acquisitions, separations or at the date of liquidation of legal entity*." The law distinguishes between legal entities in article 4 by providing making less reporting needs for SMEs. In the article 4. there is clear definition of which entities are considered as SMEs while in the article 10 is defined that micro and small companies need to prepare financial reports based on IAS and ISFR and to submit Balance Sheet, Income Statement and Statistical Annex to Tax Authority. Finally, micro and small companies are not obliged to prepare and submit Management Report.

[3] Report from Ministry of Finance

Business entities that are defined in the same Law as medium or large (more than 50 employees and annual revenue larger than 8 000 000,00 euro) need to prepare and submit to Tax authorities management report that contains: short description of business activities and organization structure, accurate development report, financial position report, results report with all financial and non-financial success indicators, information on management board members and members of various commissions, investment in environment protection, development plans, investments in employees education as well as in research and development, information about buyout of its own shares, information of business units, risk management information, goals and policies information, risk exposure information etc.

Goal of all above stated reforms and reporting needs are further improvement of accounting and auditing practice, increase of quality of financial discipline, transparency in doing business and easier access to information of all stakeholders like owners, shareholders, foreign investors etc.

2. What is the goal of standardization and how the standards are affecting economy and SMEs?

The IFRS Foundation was established in 1973 with a goal to develop high-quality, understandable, enforceable and globally accepted accounting standards and also to promote and facilitate the adoption of those standards. Foundation is non-profit organization and works for public interest as standard-setting body managed by International Accounting Standards Board (set in 2001). Table down shows number of countries in the world that have adopted IFRS:

The Board global mission and its vision hasn't changed since 2000 and it is: " *To develop, in public interest, s set of high-quality, understandable and enforceable global accounting standards that require high-quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions*."

With this vision in mind we understand that the Board's mission is to provide investors, lenders and others with relevant, transparent and comparable information. Each country that adopts IAS and ISFR is doing so to enable the same for foreign and domestic stakeholders. This is the reason why many international organizations like International Monetary Fund, World Bank, International Federation of Accountants, EU Council, European Parliament and others are supporting the introduction of standards.

Table 1: Table 1: The number of countries adopting ISFR based on region

	Number of jurisdictions pro led				
Region	**in the region**	**that require IFRS Standards for all or most domestic publicly accountable entities**	**that require IFRS Standards as % of total jurisdictions in the region**	**that permit or require IFRS Standards for at least some (but not all or most) domestic publicly accountable entities**	**that neither require nor permit IFRS Standards for any domestic publicly accountable entities**
Europe	44	43	98%	1	0
Africa	23	19	83%	1	3
Middle East	13	13	100%	0	0
Asia-Oceania	33	24	73%	3	6
Americas	37	27	73%	8	2
Totals	**150**	**126**	**84%**	**13**	**11**
As % of 150	**100%**	**84%**		**9%**	**7%**

Source:www.ifac.org (2017), About IFAC

IFRS Standards constitute a globally recognized set of prescribed standards for the preparation of financial statements by business entities:

- the items that should be recognized as assets, liabilities, income and expenses;
- how to measure those items;
- how to present them in a set of financial statements; and
- related disclosures about those items.

Based on previously mentioned misbalance between Montenegrin system and EU law and legislation the research question what would be the economy without standards and if all economic entities are benefiting from it?

Literature on this issue distinguish 2 set of consequences: financial-reporting consequences and expense related consequences (Milisavljevic, 2005); shown in the table down.

Table 2: Consequences of non- compliance with ISFR

Consequences of non-compliance with IFRS	
Financial-reporting consequences 1. Various bases for making the reports 2. Difficulties in translation of information 3. Difficulties in understanding financial info. 4. Difficulties in comparing based on financial reports 5. Difficulties in making economic decisions based on such financial reports	***Expense related consequences*** 1. High expenses for obtaining information 2. Law level of trust in financial information 3. High expense of capital

Source: Milojevic (2005).

As stated above without the standards SMEs as well as other business and public entities would present financial reports on different bases and the reports would be difficult to compare, understand, translate and it would be difficult to make decisions based on them. Obtaining information would be expensive as well as additional mechanism for controlling information would need to be present increasing the expenses even further. This situation would make economy risky as there would be high level of uncertainty on market (Milojevic 2005).

The goal of standards is to make information comparable and benefits are clear to both sides: those who present information as well as to various stakeholders that use financial information. IFRS are important to business managers because they need to make decisions based on financial information; if the reports are standardized, easy to understand, interpret and compare, management will make more efficient decisions. Users of financial information other than managers are various stakeholders: banks, regulators, owners, employees... For all external and internal users of financial information it is important to get the reliable information based on which they can track progress of business, compare, analyze, make the economic decisions about how to allocate the resources.

Specifically to SMEs standards enabled (*externally)* business ecosystem in which they can easily obtain the qualitative and comparable financial information on suppliers, clients, potential buyers. *Internally* SMEs benefit from tracking their performance and based on that making better decisions.

Accordingly to previously identified research gap we can set the following hypotheses H1: Adoption of ISFR will have positive effect on development of economy represented through growth of SMEs in number.

Analyzing the data from Montenegro statistics bureau (MONSTAT) we will see if this is the case with Montenegro and if standardization of accounting and financial reporting is contributing to creation of more businesses (attracted more capital into private sector and creating more companies).

3. How can we define SMEs in Montenegro and how big is their sector?

According to OECD "SMEs are non-subsidiary, independent firms which employ fewer than a given number of employees. This number varies across countries. The most frequent upper limit designating an SME is 250 employees, as in the European Union. However, some countries set the limit at 200 employees, while the United States considers SMEs to include firms with fewer than 500 employees. Small firms are generally those with fewer than 50 employees, while micro-enterprises have at most 10, or in some cases 5, workers." [4]

When it comes to EU the definition of SMEs is expanded with the turnover information, according to EU: "*The category of micro, small and medium-sized enterprises (**SMEs**) is made up of enterprises which employ fewer than 250 persons and which have an annual turnover not exceeding 50 million euro, and/or an annual balance sheet total not exceeding 43 million euro.*"

Considering the size of the market legislators in Montenegro decided to make distinction between: micro, small, medium and large size companies based on size in turnover and based on number of employees. Law on Accounting as well as Law on Auditing are grouping legal entities at small, medium and large based on following:

1. ***Micro business entities*** are businesses or groups of businesses that at the time when they are preparing their business sheets are fulfilling 2 of following criteria:
    1. Average number of employees during business year was less than 10
    2. Total revenue at the yearly level is less than 700 000. 00 euro
    3. Total Assets are less than 350 000.00 euro

2. ***Small business entities*** are businesses or groups of businesses that are fulfilling 2 of following criteria (at the day when they are presenting their

4 OECD, 2005, OECD SME and Entrepreneurship Outlook: 2005, OECD Paris, page 17

financial reports to the state):

4. Average number of employees during business year was less than 50
5. Total revenue at the yearly level is less than 8 mill. euro
6. Total Assets are less than 4 mil. euro

3. ***Medium business entities*** are businesses or groups of businesses that are fulfilling 2 out of 3 criteria:

1. Average number of employees during business year was more than 50 but less than 250
2. Total revenue at the yearly level is more than 8 mill. euro but less than 40 mil. euro
3. Total Assets are more than 4 mil. euro but less than 20 mil. euro
4. ***Large business entities*** are businesses or groups of businesses that at the day of preparing their balance sheets are fulfilling 2 out of 3 criteria:
   1. Average number of employees during business year is more than 250
   2. Total revenue at the yearly level is more than 40 mil. euro
   3. Total Assets are more than 20 mil. euro

According to national statistics SMEs in Montenegro make 99.8% of the market and the number of SMEs is growing yearly. While large companies are making only 2% of market share, their number is growing but not at the same paste only 1% growth is recorded.

Table 3: Presentation of active business entities in Montenegro based on their size

Period	**2014**		**2015**		**2015**	
Mark	**Number**	**%**	**Number**	**%**	**Number**	**%**
Small companies	23 051	98,9	25 698	99,0	27 954	98,9
Medium companies	221	0,9	220	0,9	268	0,9
Large companies	36	0,2	37	0,1	46	0,2
TOTAL	**23 308**	**100,0**	**25 955**	**100,00**	**28 268**	**100,0**

Source: Monstat (2016), Number and structure of business entities in Montenegro in 2016, Structure of business entities, page 5.

According to property ownership 99,3 % of business entities are in private property. When it comes to sectors: 33.8% of businesses are working in trade, 12% are working in hospitality (accommodation and restaurants), 10,6% in professional and science services and 10,4% in construction and the rest of businesses are split in various sectors (less than 10% in other sectors).

As we can see, statistic shows that SMEs are growing factor of Montenegrin economy and that that they are constantly growing making last year growth of more than 8%. We can conclude that business environment is favoring the creation of SMEs, therefore the accounting legislative needs to be adjusted to the SMEs needs.

Conclusions

Based on the research of implementation of financial reporting standard we can conclude that considering the market size and the needs of SMEs in Montenegro in order to help entities grow there is strong need to support further development of accounting, financial reporting and auditing.

Statistic shows that SMEs are growing in number but there is no evidence that business entities are growing in size and that the level of employment is growing. Contra-intuitive fact is that according to reports from *Employment Agency in Montenegro* the unemployment rate is actually growing and now it is 21.94% which is 0.65% more than it was in January 2017 and 5% more than it was in January 2016. While SMEs are growing in number this is not reflected in employment growth which should be final goal of economy. We can conclude that SMEs need to increase capacity to enable them to employ more people. Accounting can support this by enforcing qualitative and standardized financial reports that can be useful for making financial decisions. However, SMEs need to have the capacities to make qualitative financial reporting. World Bank report from march 2016 shows that this is still not the case in Montenegro. In order to comply to IFRS and other accounting legislative SMEs need to engage external accountant as they lack capacities to provide reports based on standards. Further research in the quality of accounting service providers and the main reasons for engaging them should be conducted in Montenegro.

Furthermore, there was specific need to define ***micro business entities*** in Law on Accounting (start-up companies with less than 10 employees). We concluded that the reason for this is because there is considerable number of those entities on Montenegrin market that Tax Authorities feel that there is a need to specifically define them. If their number is growing, then there will be future need to support their financial reporting needs with standards that are suitable to their size and capacity. However, this is hard to determine as there is inconsistency in defining SMEs in national legislative and national statistics bureau MONSTAT. We observed that MONSTAT doesn't recognize micro business entities in their reports. Moreover,there is no national statistic that can show if the number of micro business entities is growing and there should be initiative at the state level to further define SMEs and track their development in more detail way.

In general, we can conclude that accounting reform in Montenegro which started in 2002 has made considerable progress and that Montenegro managed to create good bases for market that is suitable for growth of businesses - national statistics confirms growth trend. However, further improvement of existing legislative and institutional framework needs to be supported by national authorities. The essential change that needs to be set in place is the lessening of reporting burden on SMEs and this can be done by introducing IFRS for SMEs. This way the financial reporting will be conducted with better quality and less time and this can enable SMEs to enter further development of reporting by creating integrated financial reports which is the trend on global market. Financial analyses based on integrated reports can lead to less uncertainty on market and to better economic decisions.

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