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Session 5: Implementing and enforcing international standards for financial reporting and auditing

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Implementation and enforcement of international standards for financial reporting and auditing

- Montenegrin experience and constraints -

Montenegrin Law on Accounting and Auditing was adopted in May 2002 and it is only from 2003 that companies are obliged to prepare their annual and periodical reports in accordance with the International Accounting Standards (IAS).

Although all International Accounting Standards have been adopted and an independent Institute of Accountants and Auditors, that is charged with application of the world standards from the area of accounting and auditing, was established, transparency and disclosure ranks amongst the weakest areas of corporate governance in Montenegro.

In this overview I would like to comment on the effect that the segmentation of the securities market after mass voucher privatization has on capital market development, on a need for different approach in regulating those segments and on a disclosure enforcement.

Segmentation of capital market

The capital market in Montenegro is developing as a follow-up to large-scale privatization of companies. Government of Montenegro prepared and conduct process of privatisation of all stately owned enterprises. As main methods of privatisation, Mass Voucher Privatisation and sale of companies through international tender are designed. About 430.000 adult citizen of Montenegro (more then 95% of all adults) took part in Mass Voucher Privatisation process.

The capital market in Montenegro is not developed to a level, at least as developed capital markets are, to serve one of the basic needs of companies – issuing securities and raising new capital. Like in many transitional economies the key players on the market have different objectives to those in developed economies and, therefore, their behavior is different.

The dominant feature of mass privatization programs is that many temporary shareholders are created who wish to sell shares at the first good opportunity. The situation of many selling and few buying on the secondary market will exist for a long time to come. The large supply on the secondary market will also have a strong negative impact on the primary market. The possibilities of issuing new shares after mass privatization are very limited.

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The main objective of secondary transactions with shares after mass privatization is ownership consolidation needed to improve corporate governance and support the restructuring of privatized companies.

The regulatory priorities (in the order of importance) for the development of transparent and fair market in the framework of mass privatization are:

- Protection of shareholders rights in privatized companies. This is essential in mass privatization dominated by insiders who have strong motives to prevent outsiders from exercising their rights on equal terms.

- Protection of small investors in privatization funds which accumulated most of the privatization vouchers and became the most important institutional owner after mass privatization.

- Protection of small shareholders in the ownership consolidation process following mass privatization.

- Protection of investors trading on the public markets with shares of public companies.

There are two possible approaches in regulation after mass privatization. The first approach is to treat all companies in mass privatization as if they were public companies traded on the public markets. This bottom-up approach has to be very liberal. Initially, regulatory standards are set at a minimum to accommodate all privatized companies. The development of the securities markets in this case starts at the lower end of the market. Gradually standards are increased to the international level and some companies and markets no longer qualify to be called public.

In the second approach, only a limited number of companies from mass privatization are treated as public companies that can be traded on the public markets. For public companies, high international regulatory standards are applied, while there is only limited regulation for trading and corporate control transaction for the remaining quasi public companies. The development of the market starts simultaneously at the lower end and at the higher end of the market.

This is a dual approach to regulation as the conservative rules are used for the public segment and more liberal rules for the quasi-public segment of the market. With the dual approach, it is possible to capture the advantages of the coexistence of public and quasi-public segment of the market after mass privatization.

Companies that are not controlled by insiders or have the ambition to raise additional finances by issuing new shares to the public should be encouraged to behave like real public companies, strictly following the international standards on accounting, auditing,

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regular reporting, disclosure of new information, listing requirements for the public markets and so on.

From the point of attracting foreign portfolio investors and selecting the privatized companies able to raise new funds on the market, it is clearly beneficial to have a separate high standard public market. At the same time, it is clearly advantageous for the companies that could never be public to remain under the liberal regime of the quasi-public segment of the market as long as required for necessary consolidation of its ownership structure.

Legal framework

Legal framework for disclosure and transparency of capital market participants in Montenegro consists of Law on Accounting and Auditing, Law on Business Organizations, Law on Securities, and Listing Rules, which are adopted by the Stock Exchange.

The Law on Accounting and Auditing was adopted in May 2002 and it is only from 2003 that companies are obliged to prepare their annual and periodical reports in accordance with the International Accounting Standards (IAS).

All International Accounting Standards have been adopted and an independent Institute of Accountants and Auditors, which is charged with application of the world standards from the area of accounting and auditing, was established.

Institute of Accountants and Auditors of Montenegro is established as an independent, self-regulating professional accounting institution. It is established on the basis of self-regulation trough commissions, committees and boards.

Main objectives of the Institute is to promote and upgrade the knowledge, abilities and skill of its members related to accounting and auditing;

Main activities that the Institute shall perform are:

- To implement application of the world standards from the area of accounting and auditing in compliance with the IAS and ISA issued by theInternational Accounting Standards Board (IASB) and the International Federation of Accountants (IFAC)

- To do research work of importance for accounting and auditing in order to comply with the latest achievements;

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- To apply the Code of Ethics for professionals in accounting that is published by the International Federation of Accountants (IFAC);

- To publish explanations and opinions relevant for accounting and auditing businesses.

The Securities Law provides, for a company, which proposes to issue securities to the public, to register with the Securities Commission as a reporting issuer. A reporting issuer is any company that issue securities, including companies that issued securities in the process of transformation of social ownership.

Although legal requirements for disclosure are generally high, in reality most of the companies do not fulfill them.

In the privatization context, the main objective of the managers in the companies issuing shares to the public is often to retain control of the company. Dissatisfied investors are not a major problem, as they do not represent a serious threat to the management. It is a common situation that companies privatized through public offering do not wish to be traded on the organized markets and to report to investors.

This is not simply a problem of law enforcement but a much deeper problem of completely different motivation on the part of key players.

Disclosure enforcement

Given the fact that segmentation of securities market exists after mass voucher privatization and that both Commission and Institute has limited resources, for practical reasons the focus of regulation and enforcement has to be put on companies that issue securities through a public offering.

A public offering of securities is a sale based on a public invitation to subscribe and/or pay for securities, which requires prior approval by the Commission.

For the approval of the issue, the issuer has to make publicly available and to submits to the Commission a set of documents, among which:

- Act on foundation;

- Statute;

- Copy of the Court registration of the company, and a license if required for foundation;

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- Prospectus draft;

- Balance Sheet and Profit and Lost Account for 3 previous years, and Auditor's Report.

Prospectus

Main document among above stated is prospectus. The issuer is obliged to prepare a prospectus that shall contain true and thoughtful information about the issuer as well as the rights attaching to those securities.

The prospectus must contain the information on following:

A) Securities being offered. Information regarding securities being offered is as follows:

   – Number and class of shares offered and the rights attached to them;

   – Price at which the securities are offered or, if appropriate, the procedure, method and timetable for fixing the price;

   – Period during which the offer of the securities is open;

   – The procedure for the exercise of any right of pre-emption attaching to the securities;

   – Any restrictions on buying securities;

   – The dividend policy of the issuer, and in particular whether it has paid dividends within the last 5 years (and, if so, how much and when), and whether the issuer expects to pay dividends over the next 2 years.

B) Issuer's legal status and capital, which are:

   – The name of the issuer, the address of its registered office and the date and location of incorporation;

   – Registration number with the Securities Commission;

   – Number of employees and their qualifications;

   – The amount of the issuer�behalf authorised share capital and any limit on the duration of the authorisation to issue such share capital;

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- An indication of the persons, who, directly or indirectly, jointly or severally, exercise or could exercise control over the 10%, 20%, 33% or 50% of issuer's capital and particulars of the proportion of the issuer�even's voting capital held by such persons;

- The number of shares of each class making up each of the authorised and issued share capital, the nominal value of such shares and, in the case of the issued share capital, the amount paid up on the shares; and

- If the issuer is controlled by another company, the name of its controlling company, or if issuer controls another company, the name of that company.

C) Issuer's principal activities. Information regarding issuer's principal ctivities has to provide rightful and objective picture of issuer's principal activities. This information is:

- A description of the issuer‛s principal activities and of any exceptional factors which have influenced its activities;

- With regard to specific regulations (banks, insurance, etc), most important financial data;

- A statement of any dependence of the issuer on patents or other intellectual property rights, licences or particular factors, where any of these are of fundamental importance to the issuer‛s business;

- Information regarding investments in progress where they are significant;

- With regard to risk factors or, list in order of importance the factors which the issuer considers to be the most substantial risks to an investor in this offering (e.g. untested products, cash-flow or liquidity problems, dependence upon a key supplier or customer, management inexperience, nature of business, absence of a trading market, etc.) and which constitute the greates hreat that an investment may be lost in whole or part, or not provide an adequate return;

- Information on any legal or arbitration proceedings, active, pending or threatened against, or being brought by, the issuer or any member of its group which are having or may have a significant effect on the issuer‛s financial position;

- The list of securities for which offered securities could be exchanged, ;

D) Issuer's financial position. Regarding issuer's financial position prospectus should

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contain information on assets, liabilities, and profits or loses as in annual report for last three business years, except if an issuer has not been in existence for the whole of the last three years. This information is:

- Comparable details from the Balance Sheet and Profit and Lost Account approved by the Auditor, for last three business years;
- Details from Consolidated Report, if any;
- Amount of the reserves accumulated in last three business years;
- Amount and structure of the taxes paid in last three business years; and
- Names and addresses of the auditors of the accounts.

E) Issuer's administration and management. Information on issuer's administration and management is as follows:

- Names and addresses of managers and board members (or any other person who performs an important administrative, management or supervisory function);
- A description (being his qualification or area of expertise or responsibility) of every director or proposed director and particulars of the principal functions performes.
- The interests of each director of the issuer in the share capital of the issuer, distinguishing between beneficial and non-beneficial interests, or an appropriate negative statement;
- Indication of any other directorship's held by each director or proposed director;
- Full particulars of any contract or arrangement existing at the date of the prospectus in which a director of the issuer is materially interested, or an appropriate negative statement;
- Nature of any family relationship between directors or proposed directors.

F) Recent developments in the issuer's business and prospects. Prospectus must contain information about recent developments in the issuer's business and prospects:

– Significant recent trends concerning the development of the issuer's business

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since the end of the last completed financial year of the issuer;

- Information on the issuer's financial and trading prospects for at least the current financial year of the issuer;

- The dates of and parties to all material contracts (not being contracts entered into in the ordinary course of business) entered into by the issuer and its subsidiaries within the 2 years immediately preceding the issue of the prospectus together with a summary of the principal contents of such contracts.

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Publishing the prospectus. Every new important fact or inaccuracy in the prospectus which could affect assessment of the security and which arises between publication of the prospectus and expiration of the period for subscription to and payment for securities, must be mentioned or corrected in a supplement to the prospectus, which must be accessible to the public in the same manner as the prospectus.

Listing requirements

Shares listed on the Stock Exchange are prestigious market segment. Only companies that fulfil certain criteria in regard of its financial position and disclosure can be listed on the Stock Exchange.

Although listing on the Exchange provides some benefits to the listed company and its shareholders, it brings very strict obligations. Having their securities being listed, the company is obliged to do business transparently and to disclose any relevant information in predetermined period of time (even more often if certain events has happened or are expected to happen).

Both Exchanges that operates in Montenegro divide market on segment "A" and segment "B". In addition to that, investment units of privatization funds are traded on separate market segment.

The issuer which is listed on list A or list B is obliged to inform the Exchange on important events and activities affecting his financial and commercial operations, as well as the price of securities. Furthermore, it shall submit the adequate documentation and explanations, and disclose required information.

The issuer is obliged to disclose data and information in the mass media available in the Republic of Montenegro, or in another adequate way.

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Conclusion

In October 2003, under the Stability Pact, the first phase of the formation of the network of regional Stock Exchanges was concluded. The informational link between exchanges is finalized and is launched at the Web Portal sem-on.net. Via that portal, it is possible to monitor real time transactions from seven Stock Exchanges from former Yugoslav republics.

Web Portal sem-on.net enhances and makes visible the fact that Montenegrin companies are operating on the international market, although most of them do not export.

For the Montenegrin capital market, the informational link of exchanges means a broadening of the market in terms of potential investors, as well as instruments available.

For Montenegrin companies, that means a direct comparison with other companies from the same industry, of a similar size, or by other criteria.

For Montenegrin investors, that means the possibility to choose between more telecoms, breweries, petrol companies, treasury bills, and privatization funds.

At the same time, this project clearly shows the importance of a country's competitiveness. Competitiveness -- as a place to start and operate a business. Competitiveness -- which is measured by legal and institutional infrastructure, their effectiveness and development to meet the needs of business.

If Montenegrin companies want to improve its international competitiveness and attract foreign investments, it is important to improve their governance and implement international standards of financial reporting.

The fact is that Montenegro is short of capital and investments. If a country wants to become attractive and competitive for investors to begin and operate businesses, it has to focus on policies that increase incentives for work, savings, and investments.

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