

Issues of Enhancing Corporate Financial Reporting

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I would like to express my appreciation for giving me the opportunity to take part in today’s roundtable discussion and express my opinion on the issues of enhancing corporate financial reporting.

I wanted to say a few words about some actions taken by FRC to enhance corporate financial reporting during the past two years, during which we worked for implementing our duties and functions (i.e. ensuring financial stability, regulating financial services, overseeing enforcement of relevant laws and legislation, and protecting rights and interests of investors and customers) set forward by the law, challenges that we are facing, and further actions that are required to be taken.

Implementing distant monitoring, as a risk management tool, through analysis of financial statements of professional institutions, including the Stock Exchange, Securities Clearing House and Central Depository, broker, dealer, and insurance companies, non-bank financial institutions, savings and credit cooperatives, and currency exchange centers, and oversight of adequacy of financial ratios is an important form of our operations.

In relation to development of the securities market and increase in demand, the issues of analyzing financial position of listed companies that are planning to raise investment sources through issuance of new stocks in the primary market and certifying valuation of assets have become more vital.

More than ever before, the issue of ensuring accuracy and transparency of corporate financial reporting has become extremely significant for reinforcing trust

of investors, savings account holders, and customers in the financial market and for developing the market steadily.

For this reason, we, representatives of the Mongolian financial and economic institutions, international financial institutions, and donor partners have come here today to discuss the challenges and identify possible solutions.

Last year, a working group of the World Bank evaluated accounting, financial reporting and auditing requirements that are followed in the financial sector in Mongolia and practical observance of these requirements and issued the relevant report. In this report, it is mentioned that in order create sound business environment with the possibility of preparing transparent financial data in accordance with the international standards it is required to enhance the legal framework, institutions, accounting and auditing professions in this sector and change the business culture and education structure.

It is suitable to address that challenges derived from the fact that the financial sector legal framework is behind the development speed of the market, does not meet the current needs anymore, international principles on corporate governance, international accounting and financial reporting standards are not fully enforced in the sector are affecting our operations negatively.

It has been long since the necessity to amend or revise the Company Law, Cooperative Law, Law on non-banking financial activities, Law on currency settlement regulation, and Securities market law has been raised, as these laws can no longer fully regulate relations in the respective markets.

A final version of a separate bill on savings and loan cooperatives was developed in September 2006, has been submitted to the relevant agencies, but has not yet been approved. This situation has caused uncertainty of the future trend of this sector. Unclear provisions of the Cooperatives law on financial reporting has

still been in force and increasing the likelihood of a risk to occur again in the market.

Regardless of the delay in the lawmaking activities, new relations are introduced and put into practice as the financial market expands and further develops. For instance, principles and bills on collateralizing fixed assets, debt notes with fixed asset guarantees, issuing securities, and securities with fixed asset guarantees have already been developed, but there has been a delay in the Parliament’s discussing the bills and passing the laws; this situation is negatively affecting the business of the Mongolian Ipotek Corporation that has already been established and started running its business.

One of the reasons why our central financial institutions have different data on the country’s development is that the unlawful act of preparing financial statements differently tailored for each user still exists even today. On the other hand, factors such as having no central consolidated database of financial information and weak liability mechanism on intentionally keeping accounting books incorrectly and preparing financial statements incorrectly, and setting too small amount for the relevant fines and penalties are also affecting.

According to the Company law, companies that are public interest entities and listed on the Stock Exchange bear the responsibility to prepare their semi-annual and annual financial statements in compliance with the International Financial Reporting Standards, file them with FRC and the Stock exchange, and publish for the general public; yet, the accountability mechanism for those who did not submit or publish financial statements is still missing... As for 2007, out of the 370 companies that are registered with the Stock Exchange, 78.9 percent, that is 292 companies, did not submit their financial statements to the relevant agencies and had not made filing of financial statements a regular practice. It is possible to say that financial statements had never been published for the general public’s interest.

According to the Company law, group companies with collective interest are required to prepare separate financial statements for each subsidiary company and also prepare a set of consolidated financial statements; however, there is no company that prepares such financial statements and there is no authority that monitors the activity. Because of this, it becomes too difficult to identify conflict of interest within the financial institutions, determine the relevant bodies, and control the cash flows.

Considering the fact that the state inspectors of FRC try to regulate the market even though FRC does not have the authority given by the law to supervise and stop such activities of non-compliance, authorities of the regulatory institutions should be enhanced significantly within the legal framework.

There is no other way than accepting the fact, mentioned by the World Bank, that there has been a delay in translation of the International Financial Reporting Standards, revision of the translation and development of other relevant guidelines and instructions.

Last year, the Financial Regulatory Commission developed national standards that are in compliance with the international financial reporting standards for the insurance sector, had the standards approved by the National Centre for Standardization and Metrology, and started introducing them to the insurance companies. It is required to translate reporting standards to be enforced in the operations of the capital market, non-bank financial institutions, and savings and loans cooperatives; have the standards approved; and put them into practice without much delay. Unless we receive support from international financial institutions in this respect and implement projects and programs, it is not possible to resolve the issue within the FRC budget.

The World Bank recommended that the Financial Regulatory Commission is to take the responsibility of implementing audit quality assurance.

There is a law stating that operations of audit firms shall be independent, auditors shall avoid being pressured by others and operate independently. Unfortunately, it has been quite popular for some of our auditors to perform their duties improperly, not to inspect financial documents completely, and to issue an opinion that meets the client’s request but does not comply with the requirements. We know that, because of this, this leads to the situation, in which the public does not trust the audit opinion, consequently in the audit firm, although the audit opinion has been issued at the professional level and in accordance with the approved standards.

It is possible to say that today a new phase of the capital market is commencing. Within the last two years, more than 10 companies issued their stocks in the primary market and built their source of financing. During this period, accuracy of asset valuation and financial reporting is more important than anything since this strongly affects investor’s decision. However, there have been cases of authorized asset valuation experts valuing assets of companies that are planning to offer stocks to the public on the capital market at a level that is too high, valuing assets of listed companies that are planning to change their status to LLC at a level that is too low and our auditors certifying financial reports that include such valuation mistakes without correcting them. It is time to pay attention to the issue as one incorrect audit opinion on financial statements may transfer the assets with the value of billions of togrogs built from issuing stocks to the wrong person, lead the public and the stock holders to a loss, and result in instability of the financial market that is not possible to restore.

The Law on Auditing requires all legal bodies that are regulated by FRC to have their financial statements certified by an audit firm. This is the right way because the stability of the financial sector depends on the trust level of the public and the public trust is made stronger by protecting the interest of the market

participants and providing them with complete financial information. This responsibility should be implemented through collective efforts of accounting professionals, asset valuation experts, auditors, and implementing agencies of government monitoring and regulation.

Therefore, in the future, ethical requirements for asset valuation and audit firms, as well as for asset valuation experts and auditors should be enhanced and an accountability mechanism should be realistically implemented. We are fully supportive of the ROSC recommendation of having FRC responsible for audit quality assurance and asset valuation of listed companies and financial institution. The reason is that results of these activities affect the day-to-day operations of FRC and become the basis of many important decisions made by the Committee.

In relation to this, we hope that a collective action will be taken at one of the institutions towards translation of international standards on asset valuation and auditing, development of national standards in compliance with the international standards, and enforcement of these standards; if these actions are overlooked the issue of providing financial market participants with complete and accurate information would merely remain as talk.

We think that inclusion of the issue of having auditors enrolled in compulsory liability insurance to decrease the amount of risk introduced by issuance of an audit opinion in the report was a good idea and accept the recommendation. FRC has conducted a study on expanding the coverage of compulsory insurance by the law and has submitted a draft law on driver’s liability insurance to the Parliament. In developed countries, there are 50-60 types of compulsory insurance required by the law and we, without much delay, also need to introduce types of compulsory insurance required by the law including liability insurance for professionals (i.e. for pilots, machinists, doctors, notaries, judges, auditors, valuation experts, etc.),

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insurance of operations that may damage the environment, and insurance for people who work with hazardous substances.

FRC thinks that, in its organizational structure, there should be a unit in charge of accounting, auditing, financial reporting, and valuation and is functioning with the plan to establish it in the near future. We expect the unit to be in charge of conducting detailed analysis on the financial statements of the institutions that are regulated by the committee, ensuring that the financial statements comply with the international standards, implementing risk management, providing quality assurance on asset valuation and auditing, introducing transparency of financial reporting, etc. For now, FRC has a lack of human resource and weak capacity; thus, we are paying more attention to having our employees enhance their expertise.

We hope that you, the participants of this roundtable discussion, will cooperate with us in the area of enhancing our staff’s qualifications/expertise and provide us support in having our staff enrolled in training and workshops organized in foreign countries as well as within the country; and this is what is required from us today.

Thank you for your attention.