

Report on Observance of Standards and Codes (ROSC) Accounting and Auditing in Mongolia

Main Findings and Policy Recommendations
Ulaanbaatar, Mongolia Workshop:
June 5, 2008

What is ROSC?

- This is a IMF and World Bank joint study
- The report provides an assessment of corporate sector accounting, financial reporting, and auditing requirements and practices within the enterprise and financial sectors in Mongolia
- This report sets out policy recommendations to enhance the quality of corporate financial reporting and foster a financial reporting platform conducive to sustainable private and financial sector growth, thus increasing access to global financial markets and other tools of the market economy

Statutory and Legal Framework

- Accounting Law
- Banking Law and Law on Non-Banking Financial Operations
- Securities Law
- Law on Auditing

Accounting Law

- Sets requirements for financial reporting and accounting in Mongolia
- Fiscal year-ends for all enterprises - December 31
- MOF mandated to regulate the accountancy profession
 - Not sufficient resource (staff or budget) to do so
- All entities required to adopt IFRS
 - Many users do not understand or value IFRS statements
 - Many entities still prepare F/S for tax purposes (i.e., cash basis of accounting)
 - Although required, group companies usually do not prepare consolidated financial statements

Banking Law and Law on Non-Banking Financial Operations

- Banking Law and Law on Non-Banking Financial Operations regulate the financial reporting of banks and Non-Banking Financial Institutions (NBFIs)
 - BOM and FRC issue separate accounting regulations for banks and NBFIs
 - These regulations are not timely updated nor in-line with changes made in IFRS
 - BOM and FRC focus on operational/regulatory compliance and not on accounting and reporting

Securities Law

- Securities Law requires listed companies to follow Accounting Law for accounting and financial reporting
 - Lack of public disclosure/transparency as this law is silent about Mongolia Stock Exchange (MSE) responsibility to disclose listed company F/S
 - MSE provides limited financial info. on listed companies
 - Central depository of F/S for listed companies is not available.
 - Investor unable to obtain sufficient info. to make investment decisions

Law on Auditing

- Regulates and sets legal basis for auditing principles and organization
 - All enterprises required to be audited.
Unnecessary for some SMEs and non-public interest entities
 - No limitation on audit firms performing non-auditing services – conflict of interest
 - Auditor independence required – but not practiced
 - MOF responsible for oversight – Insufficient resources to properly monitor

Accounting and Auditing Profession

- MICPA responsible for guiding development of the profession under MOF supervision
 - Mandate of MICPA focus on interest of the profession and does not specifically include serving public interests since membership, CPA examination and training fees finance operations
- CPA certification program takes at least seven years to complete the 3 stages of examination
- Exemption credit not given for legitimate courses taken elsewhere

Accounting and Auditing Profession

- Besides MICPA, other professional organizations of accountants – олон улсын ямар нэгэн байгууллагын жинхэнэ гишүүн байх шаардлагыг хангадаггүй (ОУНБХ болон only associate member of IFAC and AFA)
- Demand for auditing services is high compared to # of enterprises requiring audits
- In general, except for large entities, corporate sector does not have access to professionally qualified accountants:
 - Limits ability to prepare adequate financial statements
 - Cases of management shifting responsibility for preparation of financial statements to the auditors
 - Independence of auditors from audited entities is not effectively practiced

Accounting and Auditing Profession

- No system in place to ensure auditors' comply with updated IFAC Code of Ethics
- No provisions in law for significant penalties against auditors' negligence and no requirement for professional indemnity insurance
- Audit firms generally lack capacity and sometimes misrepresent their number of qualified auditors
- Due to poor professional performance, public lack confidence in auditors' reporting

Education & Training - Tertiary

- Accounting education and training lacks focus on relevant knowledge and skills for professional accountants and auditors
- Accounting curricula do not adequately prepare students in line with international good practices and IFAC's education standards.
 - Minimum curricula standards – but does not meet ongoing changes; no harmonization
 - Lack of focus on IFRS and ISA (focus on basic accounting and auditing technicalities and procedures)
 - Lacks adequate coverage on professional values and ethics
 - Limited involvement of professional accounting bodies in curricula setting and requirements

Education & Training - Profession

- CPA certification based only on MICPA accreditation of courses
- Practical training requirement for registered auditors needs strengthened
 - current system to check quality or compliance with practical experience needs to be revisit
- Continuing professional development programs do not adequately cover standards and ethics

Setting A&A Standards

- National Center for Standardization and Measurement (NCSM) solely responsible for approving and issuing all national standards, inclusive of accounting and auditing standards
 - NCSM does not develop standards – just approves and publishes them
 - NCSM does not have sufficient qualified experts on A&A
 - No guidance on practical application of standards

Enforcing Compliance with Standards

- Accounting Law - No effective mechanisms exists to enforce requirements for accounting, financial reporting and auditing by **corporate entities**
- BOM enforcement priorities are on prudential reporting by **banks** rather than general purpose financial reporting – technical capacity on accounting and financial reporting could be enhanced
- Financial statements reporting compliance by **listed** companies is not effectively monitored by MSE or FRC regulators due to limited capacities and emphasis
- MICPA just introduced arrangement for quality control review of **audit firms** – need regulatory backing or “government oversight-self-regulatory mechanism”
- The sanctions regime for non-compliance with applicable standards needs clarification
- Lack of implementation guidance is constraining full compliance of accounting and auditing standards

Accounting Standards as Practiced

Entities require to adopt IFRS - Actual implementation gaps

- Income Taxes – Deferred taxes new concept that is not used
- Property, Plant and Equipment – Residual and fair value assessments not done
- Intangible assets – Research costs incorrectly capitalised
- Related Party Transactions – Not tracked and not disclosed

Auditing Standards as Practiced

- ISA - compliance level by audit firms determined by Audit Manual developed in 2003
 - not been expanded or updated since issued
- Auditing environment in Mongolia is constrained by:
 - Lack of understanding of the audit process by corporate entities
 - Lack of practical experience and technical expertise for applying auditing standards and enforcing accounting standards
 - Limited role of governance structure among companies Absence of monitoring of compliance and effective sanctions
- Significant differences in audit quality exists across audit firms due to differences in technical proficiency, level of experiences, and resources
- Audit practices found to diverge from ISAs
- *Stakeholders perception*: Close relationship between some auditors and their clients limits application of appropriate audit procedures

Perceptions of Financial Reporting Quality

General Perceptions

- Financial statements in Mongolia are of low quality
- Banks and investors do not rely on the financial statements presented by potential borrowers in determining whether to extend credit or invest
- Entities have two sets of financial statements (i.e., one for tax and another for internal use)
- Financial statements of corporate entities are not readily available due to the perception that they are confidential
- *Audit profession's perceptions*: auditing is not highly valued

Policy Recommendations - Focus

- Modernise the statutory framework by revising and rationalizing laws with best international practices
- Capacity building for national institutions, professional accountants, auditors & regulators
- Regional integration of Accounting & Auditing profession
- Greater financial transparency through increased disclosure requirements and compliance in the corporate sector
- Gradually improve monitoring and enforcement of accounting & reporting of public interest entities

Statutory Framework - Laws

- **Revise the Accounting and Auditing Laws:**
 - Resolve differences with other Laws and clarify and harmonise accounting, reporting and auditing requirements and sanctions
 - Provide legal backing for the full implementation of IFRS and ISA for public interest entities and clarify SME thresholds for filing statements and statutory audits in law
 - Mandatory obligation to prepare and file consolidated financial statements
 - Develop an appropriate framework for monitoring and compliance and set out in the Laws, including clarification of authorities of regulators
 - Introduction of different financial year-ends for different entities depending on their business need and nature

Statutory Framework – Laws (cont'd)

■ (cont'd):

- Audit required of entity only when there is public interest and not because of entity's legal form (redefine the audit exemption threshold)
- Provide legal backing for establishment of effective arrangement for audit quality assurance system
- Auditing and non-auditing services clearly defined - Specifically prohibit auditor's involvement in preparing F/S of audit clients
- Auditor rotation requirements should be revisited

Statutory Framework – Laws (cont'd)

- (cont'd):
 - Effective harmonisation on accounting, auditing and financial reporting legislation with the tax framework
 - Introduce compulsory insurance for audit firms

Statutory Framework - Standards

- Create a sustainable accounting & auditing standard setting structure and processes
 - Establish a national standard setting body (National Accounting and Auditing Standards Committee (NAASC))
 - NAASC focus on full implementation of IFRS and ISA and provide reference guidance on application of standards
 - Government to prepare plans and allocate specific recurrent budget to carry out standard setting responsibilities and implementation guidance in a timely fashion
- Actual (as oppose to in law only) transition for full implementation of IFRS – review experiences of other countries

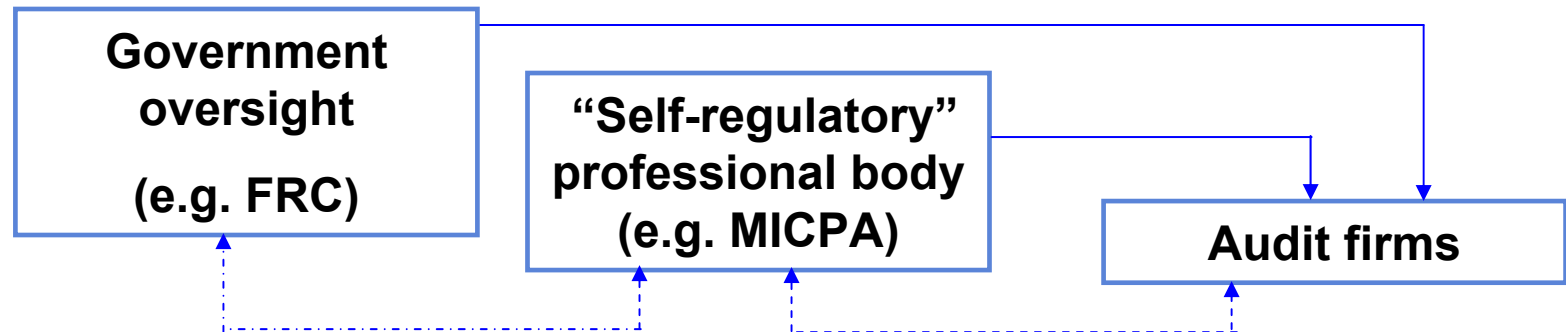
Statutory Framework - Enforcement

- Improve or establish systematic, institutionalised, monitoring and enforcement mechanisms to ensure compliance with accounting and auditing standards
- Government should evaluate what types of authority are provided to government (i.e., FRC) and self-regulatory agencies such as MICPA
- Set appropriate sanctions for violating applicable accounting standards, rules, and filing requirements

Statutory Framework - Enforcement

(cont'd)

- Government should evaluate what types of authority are provided to government (i.e., FRC) and self-regulatory agencies such as MICPA



Capacities & Integration

- Strengthen MICPA through twinning arrangements and regional integration initiatives
- Continue to strengthen the capacities of MNAO for high quality SOE audits
- Obtain IFAC membership (by MICPA)
- Strengthen audit firm quality assurance practices – Enforcement and sanctions of audit firms for lack of implementation in this area

Education & Training

- Enhance academic and professional accounting and training. Focus on:
 - Tertiary education - university curricula
 - Regulators
 - Corporate accountants and auditors
 - Continuing professional education
 - Train-the –trainers program
 - Update of library
- Enhance CPA examination and related education and training requirements
- Issue practical application guidance on IFRS, ISA and IFAC's Code of Ethics
- Introduce awareness programs for improving compliance with IFRS, IAS by entities
- Build Continue Education programs for the professions

Enhanced Auditing & Reporting

- Upgrade procedures for obtaining licenses by accountants and auditors engaged in public practice
- Clearly define in law - auditing and reporting requirements for all corporate entities
- Increase disclosure requirements for annual financial statements and audit reports; monitor compliance
- Establish governance mechanisms within public interest entities, (e.g. establish audit committees)

Thank you for your
attention

Mongolia ROSC – A&A