II. Accounting and Auditing in Mongolia

This chapter presents an overview of accounting and auditing arrangements in Mongolia. It provides context for the following chapters on professional infrastructure, accounting and auditing standards, accounting and auditing training, and government budgeting and accounting arrangements. The chapter comprises twelve sections, in two parts, as follows:

Part One: Accounting

1 – Introduction – identifies historical factors that have influenced Mongolian accounting arrangements.
2 – Issues and Responses since 1990 – examines the issues that faced Mongolia in 1990 when the transition process to a market economy began. It also summarizes the actions that were taken in response to these issues.
3 – The 'Mongolian Accounting System' – describes accounting arrangements. These include governing laws and regulations, accounting bases, asset management and internal-control systems, and accounting information systems.
4 – Financial Reporting – describes financial reporting requirements.

Part Two: Auditing

5 – Introduction – discusses the historical backdrop to the development of modern auditing arrangements in Mongolia.
6 – Governing Laws and Regulations – describes the laws that govern Mongolian auditing practices and audit requirements.
7 – Audit Requirements – describes the requirements for organizations to be audited.
8 – Auditor Qualifications – describes auditor qualification requirements.
9 – The State Audit Board (SAB) – describes the role and functions of the SAB, which is responsible for conducting public sector audits.
10 – Public Sector Auditing Issues – identifies issues which complicate the public sector auditing process.
11 – Supervision of Bank Audits – describes the responsibilities and qualifications of the Banking Supervision Department of the Bank of Mongolia.
12 – Public Accounting and Auditing Firms – describes the presence of domestic and international accounting firms in Mongolia.

Part One. Accounting

1. Introduction

Despite having been pioneers of some major economic advances – for instance, Kublai Khan introduced paper money to the world in the 1300s – Mongolia had no accounting infrastructure before 1922 when it adopted the communist system. Mongolia developed its accounting systems in parallel with the Soviet Union throughout the 1920s and 1930s. The 'Soviet accounting system' catered to the needs of central planning, in particular, the system provided statistical information, including financial information. It emphasized standardization and uniformity so that information could be compared across sectors and industries. Detailed instructions negated the need for professional judgment in the accounts-preparation process. Therefore, public accounting firms and an accountancy profession were never necessary. In fact, accountancy had a very poor reputation. One study of professions ranked accountancy at 91st place in terms of prestige on a list of 92 professional occupations in the Former Soviet Union.[11]

Mongolia's rejection of communism in 1990 placed it in the same position as other Soviet bloc countries concerning accounting arrangements. However, the Soviet accounting system created a sound basis on which to build. First, the system used many concepts of modern accounting including accrual measurement and double entry bookkeeping. Second, large numbers of bookkeepers were trained in these concepts and were proficient in their application.

2. Issues and Responses since 1990

In the decade since the beginning of the transition, Mongolia has made reasonable progress in terms of developing an accounting infrastructure suitable to the needs of a market economy. The magnitude of these accomplishments is best viewed by examining the 1991 situation. First, bookkeepers numbered in the tens of thousands but there were no qualified Certified Public Accountants (CPAs) let alone a professional accounting body. Second, financial information on the performance and position of organizations was not publicly available. In any case, this information did not meet international standards nor did it cater

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[11] Smirnova, Irina, Jaroslav Sokolov and Clive Emmanuel. 1995. Accounting Education in Russia Today, *The European Accounting Review.* 4(4). pp. 833-46.

to the needs of investors or lenders. Third, the users of financial information (e.g., investors and creditors) were unfamiliar with what they should demand from organizations. Fourth, financial information was not independently verified (audited) to international standards and could not be relied upon. Fifth, the entire legal framework was geared to central planning and specified exactly what information should be produced, how it should be produced, and to whom it should be provided. Finally, the regulatory entities that generally exist in market economies to oversee financial disclosure practices, such as securities exchange commissions, did not exist. Table 1 summarizes developments in accounting arrangements in Mongolia over the past decade.

Table 1: The Development of Mongolia's Accounting Infrastructure

1993	*Accounting Law* enacted which sets out responsibilities and procedures for accounting and auditing, and requires that International Accounting Standards be adopted for nongovernmental financial reporting (including by State-owned enterprises). The Mongolian Professional Accounting Council (MPAC) is established under the *Accounting Law 1993*. It is responsible for creating a competent accountancy and auditing profession. MPAC administers the inaugural Certified Public Accountant (CPA) examinations. National Association of CPAs is established.
1996	The Mongolian Institute of Certified Public Accountants (MICPA) is established and absorbs the membership of the National Association of CPAs.
1997	The *Auditing Law* tightens up the process for granting CPA titles. It also recognizes the existence of MICPA and specifies audit requirements for business enterprises and State-owned enterprises. The new law requires the use of International Standards on Auditing.
2000	MICPA is admitted to membership of the Confederation of Asian and Pacific Accountants (CAPA). MICPA advises that only about 500 of Mongolia's 30,000 organizations have fully implemented IAS. Moreover, public accounting firms are auditing only 80 percent of the 440 businesses listed on the Stock Exchange.

3. The 'Mongolian Accounting System'

Governing Laws and Regulations

The Ministry of Finance and Economy (MOFE) administers the *Accounting Law 1993* that regulates the maintenance of accounting records and the preparation of balance sheets by business entities and organizations in both the private and the public sectors. The Law makes the Minister for Finance and Economy responsible for providing professional and methodological direction to Mongolian accounting arrangements.

The *Accounting Law 1993* also sets out financial reporting requirements. These require that the Minister for Finance and Economy must approve standard accounting forms and methods for business entities and organizations.

Accounting Bases

The *Accounting Law 1993* allows organizations to maintain their records based on either single entry or double-entry bookkeeping. Article 3.3 requires that these must be consistent with International Accounting Standards (IAS).

Asset Management and Internal-Control Systems

The *Accounting Law 1993*, together with MOFE regulations, specifies criteria for asset management and internal-control practices. Organizations must record assets in standard registers; in general, these registers do not include details of location, purchase date or asset class and, in many cases, fixed assets are mixed with consumables, inventories, and tools. There is no capitalization cut-off point (some assets have values as low as T8 (i.e., less than one US cent).

Accounting Information Systems

With the exception of a few locally developed computerized accounting information systems, and a few foreign-developed computerized accounting information systems, private sector accounting systems are predominantly manual.

4. Financial Reporting Requirements

The *Accounting Law 1993* requires that financial reporting must conform to International Accounting Standards (IAS). However, the reporting guidance that is issued by MOFE in many ways reflects taxation considerations. Although this guidance is generally in accordance with IAS, it creates confusion about the purpose of financial information.

Financial statements are required to be prepared and certified quarterly by the **20th day** following the end of the quarter and submitted to the General Department of National Taxation. Annual financial statements for the year ended 31 December must be prepared, audited and submitted by **10 February** of the following year (i.e. within 41 days of the end of the year).

With the exception of externally enforced reporting requirements for government executing agencies (chapter VI refers), benchmarks, covenants and ratios are not mandated for reporting purposes.

Part Two. Auditing

5. Introduction

Auditing in the Soviet Bloc, including Mongolia, reflected the highly prescriptive nature of the underlying accounting system. It was primarily a verification exercise, with the final accounts being compared to the bookkeeping records by accountants from another enterprise within the same group. It is not surprising that a fully functioning and competent audit profession has not been created within the short time frame of 10 years. For instance, as Table 1 related, of the 440 businesses listed on the Stock Exchange, licensed accounting firms are auditing only 80 percent.

6. Governing Laws and Regulations

The MOFE drafted the *Auditing Law 1997* with assistance from Arthur Andersen.[12] The *Auditing Law 1997* is administered by the MOFE and MPAC and applies to the determination of auditing principles, administration of the process for registering auditing companies, and the process for

12 ADB TA No. 2390-MON: *Improving Accounting and Auditing Systems*, for $600,000 approved in September 1995.

granting CPA qualifications. The CPA qualification-process is described in chapter III.

7. Audit Requirements

Article 7 of the *Auditing Law 1997* requires that the following entities be subject to an annual independent audit:

- Banks
- Insurance companies
- Any other financial institutions
- Listed companies
- Companies intended to list
- Joint-venture enterprises
- fully- and partially-owned State enterprises, and
- Companies with capital of at least T30 million ($30,000) .

8. Auditor Qualifications

The *Auditing Law 1997* requires that licensed audit companies must conduct audits. The Minister of Finance and Economy is responsible for approving applications for licenses and relies on the recommendation of the MPAC. Qualified CPAs must staff audit companies.

9. The State Audit Board (SAB)

As its name implies, the State Audit Board (SAB) is responsible for conducting public sector auditing. The SAB is Mongolia's Supreme Audit Institution (SAI) and was established in 1995. In July 1996, the SAB joined the Asian Association of Supreme Audit Institutions (ASOSAI). The *State Audit Law* governs the operations and responsibilities of the SAB.

The principal functions of the SAB include monitoring and evaluating: budget allocations, government expenditure, the preservation and storage of government property, the expenditure of international aid and loans, and the ethical behavior of high-ranking public officers.

The Chairman of the State Audit Board (the Auditor-General), and its eight other senior members, are appointed by, and report directly to Parliament. Under the *State Audit Law*, the SAB is required to audit

Ministries, Agencies, capital city and *Aimags* (provinces), *Sums* (districts), authorized administrative bodies and local self-governing bodies.

The State Audit Board has 27 central staff. In addition, 22 Auditing Committees operate in each *Aimag* (province) and Ulaanbaatar with 150 staff. Of the 27 current staff in the center, no more than 18 are auditors/inspectors, operating in two divisions, while the other nine form the secretariat of the Board. Few of these staff have professional accounting qualifications or experience; rather they have been trained under the previous socialist regime to provide inspection or review services on government processes to ensure compliance with regulations.

10. Public Sector Auditing Issues

A review of public sector accounting arrangements, from an audit perspective, identified several potential issues as follows:[13]

- Budget organizations do not manage their own financial management information systems that are capable of providing the necessary information to produce financial statements. They will either need to develop their own capabilities or else continue to rely on sources of information that they do not control.
- Large portions of the transactions carried out in Mongolia (e.g. payroll) are cash-based rather than being made through the banking system and electronic means. While audit trails can be devised to provide audit assurance over cash-based systems, they are much more cumbersome and prone to error than electronic-based transaction systems. For example, auditors usually use bank transaction tapes and statements as a key part of their evidence for transaction flows. These reports are externally sourced, have a high degree of reliability and are comprehensive. Such evidence is less easy to obtain and is less compelling when most transactions are cash rather than electronic transfers or checks.

[13] Public Sector Performance (NZ) Ltd. April 1999. *Final Report on TA No. 2931-MON: Program Preparation for Governance Reforms: Report of the Accounting Advisor.* Volume IV(2). p. 8.

11. Supervision of Bank Audits

Mongolia's banking sector has been the source of significant economic and political problems over the past decade. Governments have collapsed over the issue of banking reform and the outcome has been a financial system dominated by rotten state banks and a welter of poorly supervised private ones. A recent political consensus has emerged that should enable the state to get out of banking, bring foreigners in, and improve supervision. In early 2000, the Bank of Mongolia forced the two worst performing State-owned banks - the Investment and Technological Innovation Bank, and the Reconstruction Bank - into liquidation. The latter possibly had the world's highest bad-loan ratio of over 95 percent.[14]

In the face of numerous difficulties, the Bank of Mongolia has made progress in improving the supervisory regime for the banking sector. ADB has been a major supporter of these improvements.

The Banking Supervision Department of the Bank of Mongolia is responsible for licensing bank auditors and reviewing the financial statements of banks. The Department does not, however, have any qualified CPAs. Moreover, while staff recognize their shortcomings in this area, and are attempting to address them through self-study, there has been only one formal training initiative in International Accounting Standards or on Reporting by Financial Institutions.[15]

12. Public Accounting and Auditing Firms

Mongolia has 41 registered public accounting firms of which Arthur Andersen is the only representative of the large international accounting firms. Auditing licenses are issued by MPAC as described in chapter III.

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[14] The Economist. 6 May 2000. *Betting on Mongolia.* p. 90.

[15] ADB TA No. 2964-MON: *Improving Accounting and Auditing Systems II.* For $688,000 approved December 1997.