Financial Management and Governance Issues in Mongolia

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Foreword

This report describes financial management and governance arrangements in Mongolia, identifies deficiencies in those arrangements, and presents recommendations to address those deficiencies. For the purposes of this study, financial management and governance arrangements are narrowly defined as being accounting and auditing arrangements and practices.

The report was prepared for the Asian Development Bank (ADB) by Barry Reid (International Consultant) with overall guidance from Francis B. Narayan (Lead Financial Specialist, ADB) under Regional Technical Assistance (RETA) 5877 – *Strengthening Financial Management and Governance in Selected Developing Member Countries*. G. Tserenkhand and D. Bayasgalan provided able research assistance. The contents of the draft report were discussed and debated with representatives from the Government, the private sector, and international organizations at a workshop held in Ulaanbaatar on 9 June 2000. The issues and recommendations were further discussed at an international conference at ADB headquarters in Manila on 16 -18 October 2000.

This report should be read in conjunction with the Summary Report, which identifies and examines selected issues in relation to financial management and governance.[1]

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[1] Narayan, Francis B., Ted Godden, Barry Reid, and Maria Rosa P. Ortega. 2000. *Financial Management and Governance Issues in Selected Developing Member Countries: A Study of Cambodia, People's Republic of China, Mongolia, Pakistan, Papua New Guinea, Uzbekistan, and Viet Nam*. Asian Development Bank.

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Currency Equivalents

(as at 4 November 2000)

Currency Unit	–	Togrog (T)
T 1.00	–	$0.00091
$1.00	–	T 1,096

The value of the Togrog has been determined using a floating exchange rate since May 1993.

Abbreviations

ADB	Asian Development Bank
BOM	Bank of Mongolia
CPA	Certified Public Accountant
CPE	Continuing Professional Education
GDP	Gross Domestic Product
IAS	International Accounting Standard
IFAC	International Federation of Accountants
IMF	International Monetary Fund
IPSAS	International Public Sector Accounting Standard
MICPA	Mongolian Institute of Certified Public Accountants
MOFE	Ministry of Finance and Economy
MPAC	Mongolian Professional Accounting Council
PARP	Public Administration Reform Project
PIP	Public Investment Program
RETA	Regional Technical Assistance
SAB	State Audit Board
SAI	Supreme Audit Institution
SOE	State-owned Enterprise
TA	Technical Assistance
UNDP	United Nations Development Program

Notes

(i) The financial year of all organizations, including the Government, ends on 31 December.

(ii) In this report, $ refers to US dollars.

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MONGOLIA
Provincial Capital
City/Town

Executive Summary

Background

Following independence from China in 1921, Mongolia became the second country after Russia to adopt communism in 1922. It remained closely tied to the Soviet Union until the end of the 1980s. In the period 1990-92, however, Mongolia moved away from a monopoly of political power by the communist party to free multiparty elections, a new constitution, and greater cultural and religious freedom with more emphasis on national Mongol traditions, as well as toward some elements of a market economy. Mongolia's transition to a market economy, which began in 1990, has proceeded satisfactorily, and the private sector is now the main producer of goods and services.

Mongolia's severe climate, scattered population, and wide expanses of unproductive land, have constrained economic development. Economic activity traditionally has been based on agriculture and the breeding of livestock. In past years, extensive mineral resources had been developed with Soviet support – total Soviet assistance at its height amounted to 30 percent of Gross Domestic Product (GDP), but disappeared almost overnight in 1990-91. Economic growth picked up in 1997 and 1998 after stalling in 1996 due to a series of natural disasters and declines in world prices of copper and cashmere. Real GDP growth in 1999 was estimated to be 3.5 percent. Mongolia's immediate challenges are reducing poverty and resolving the public sector imbalances that are the main barriers to growth and promotion of private sector activity.[2]

Challenges and Reponses

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. Consequently, public accounting firms and an accountancy profession were never necessary.

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[2] Asian Development Bank. 2000. *Asian Development Outlook 2000.* p. 66.

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.

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. In particular, a competent professional accountancy institute has been established, and, in broad terms, the legislative framework for the accountancy profession is sound.

Accounting and Auditing in Mongolia

The Ministry of Finance and Economy (MOFE) administers the *Accounting Law 1993*, which 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. It also sets out financial reporting requirements, which require that the Minister for Finance and Economy must approve standard accounting forms and methods for business entities and organizations. The *Accounting Law 1993* requires that accounting standards must be consistent with International Accounting Standards (IAS). 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.

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, of the 440 businesses listed on the Stock Exchange, public accounting firms are auditing only 80 percent. The *Auditing Law 1997* is administered by the MOFE and the Mongolian Professional Accounting Council (MPAC) and applies to the determination of auditing principles, administration of the process for registering auditing companies, and the process for granting Certified Public Accountant (CPA) qualifications. The *Auditing Law 1997* requires that licensed audit companies must conduct audits. The Minister for Finance and Economy is responsible for approving applications for licenses and relies on the recommendation of the MPAC. Qualified CPAs must staff audit companies.

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. The *State Audit Law* governs the operations and responsibilities of the SAB. The Chairman of the State Audit Board (the Auditor-General), and its eight other senior members, are appointed by, and report directly to, Parliament. Mongolia has 41 registered public accounting firms of which Arthur Andersen is the only representative of the large international accounting firms.

Professional Infrastructure

Because of Mongolia's state of development before 1922, and the ensuing seven decades of communism and central planning, Mongolia had no accountancy profession before 1992. In 1993, the National Association of CPAs was established and became the Mongolian Institute of Certified Public Accountants (MICPA) in March 1996. Three bodies are involved in the regulation and organization of Mongolia's accountancy profession: MICPA, MPAC, and the Accounting Division of the MOFE. The *Accounting Law 1993* gave MPAC the authority to administer the professional accounting examinations that qualify accountants as CPAs. MPAC administered the inaugural CPA examinations in July 1993, but these examinations were prepared and graded by non-CPAs. The syllabus, on which candidates were examined, did not include auditing. So, those CPAs who qualified between 1993 and 1997 did so under low criteria. The *Auditing Law 1997* tightened up the process for granting CPA titles and requires that accountants pass a three-stage examination. CPAs do not have to meet continuing professional education requirements to retain the title.

MICPA had 366 members as at 31 December 1999. Females and males are represented equally; 116 members worked in the public sector (Central Government, local government, and State enterprises), the other 250 worked in the private sector. Excluding honorary memberships (of which there are two), MICPA has only one membership category – that of CPA.

Accounting and Auditing Standards

Three organizations contribute to the development of private sector accounting standards: the Accounting Division of MOFE, MPAC, and MICPA. There is however, no formalized process for development, exposure, approval, and promulgation. Rather, drafts are circulated around selected organizations for comments.

Mongolian accounting standards are an integral part of a 'uniform accounting system' – based upon the former Soviet accounting system. In this respect, detailed accounting instructions and reporting formats are issued, of which accounting standards are an integral part. The accounting instructions also include taxation requirements. There are few differences between the 'Mongolian Accounting System' and IAS. The Fiscal Policy Department of MOFE has recently assumed responsibility for developing and promulgating accounting standards for public sector reporting. In 1998, as part of the Public Administration Reform Project, accounting policies were developed based on International Accounting Standards (IAS) and the (then unreleased) International Public Sector Accounting Standards (IPSAS).[3]

The *Auditing Law 1997* requires that auditors apply International Standards on Auditing (ISAs). Consequently, Mongolian auditing standards are a direct translation of ISAs.

Education and Training

Communism has left Mongolia with a legacy of high educational standards – particularly in the sciences – on which to build. Like many other countries in transition, Mongolia has a very large number of 'accountants'. The MOFE estimates that there are 4,000 to 5,000 public sector accountants and around a further 30,000 private sector accountants. In reality, most of these accountants are bookkeepers and producers of statistical information. Mongolia has moved away from the Soviet educational model in the past 10 years. Before 1991, accountancy was not taught as a major in universities and colleges. Five state institutions now offer undergraduate and postgraduate programs

[3] ADB TA No. 2931-MON: *Program Preparation for Governance Reforms*, for $967,000 approved December 1997.

in accountancy but, as these institutions are unable to meet demand, a number of private-sector accountancy training providers have emerged.

A recent United Nations Development Program (UNDP) study identified the following issues with respect to tertiary training:[4] (i) Teaching aids – the blackboard is the prime teaching tool due to budgetary constraints; (ii) Textbooks – there is a shortage of Mongolian textbooks, in terms of both quantity and range. Moreover, the quality of these texts is poor in terms of translation and their application to the Mongolian environment; (iii) Staff development – the faculty members that were interviewed in the UNDP study acknowledged that their accounting knowledge and skills base could be improved, but financial constraints limited further study opportunities; (iv) Teaching methods – these focus on the traditional lecture approach. To an extent, this is due to accounting lecturers being paid based on hours taught. Not only does this compromise learning effectiveness but lecture hours are very high at the expense of tutorials and research; (v) Academic association – accountancy lecturers do not have an association; and (vi) Training for academics – accountancy lecturers do not receive targeted training.

Government Budgeting and Accounting

Mongolia's public sector budgeting, accounting, and reporting arrangements represent a continuation of pre-transition central-planning systems. They are based on the Soviet model of accounting that dictates prescriptive rules and requirements. The information provided meets the needs of central planning but does not provide the necessary information to support transparent, accountable or efficient government operations. State-owned enterprises (SOEs) and the Bank of Mongolia are required to prepare financial statements in accordance with IAS. Government organizations use modified accrual accounting – aggregate government reporting is on a cash basis.

In 1996 and 1997, the Government identified a number of problems with public sector arrangements. In response, a program was formulated to address problems with: strategy formulation and resource allocation; budget execution; role clarity; performance objectives; accountability for performance; accountability information; and inter-governmental accountability. In December 1999, ADB

[4] International Management Consultants Ltd. April 2000. UNDP Governance and Economic Transition Programme: *National Training Strategy for Public Sector Accountants*. UNDP MON/97/141. p. 41.

approved a $25 million program loan, along with three technical assistances, to support the governance reforms. The objectives of the Governance Reform Program are to: (i) enhance aggregate fiscal discipline;
(ii) improve public sector's budget formulation and execution; (iii) strengthen public sector's operational efficiency; (iv) address social impact of the reforms and the financial needs under the Program; and (v) prepare the groundwork for continuation of the reforms. The overall goal of the program loan and the accompanying technical assistances is to lay the groundwork for enabling a successful implementation of the whole spectrum of reform of the public sector in its entirety, while at the same time, ensuring that the system which is implemented is consistent with that designed.

Donor Assistance

Three **ADB** program loans are directly related to supporting improved financial management and governance arrangements. First, the Financial Sector Program Loan I[5] supported strengthening of the banking system, including the legal and regulatory framework. Second, the Financial Sector Program Loan II[6] is intended to further strengthen governance arrangements in the sector, including further attention to legal and regulatory deficiencies. Finally, the Governance Reform Program loan is intended to support the Government's intention to pilot administrative reforms, including the adoption of IAS-based accounting, in five government agencies.[7] Furthermore, directly relevant TA projects include:

- TA No. 2390-MON: *Improving Accounting and Auditing Systems* ($600,000: 1996–1997). The activities under this TA included: preparing a training manual for accountants; preparing an auditing manual; developing a draft audit law; assisting the establishment of a national accounting profession (e.g., articles of association, by-laws, and code of ethics); and developing and delivering a training program on financial accounting, managerial accounting, and

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5 Loan 1509-MON: *Financial Sector Program*, for $35 million, approved on 16 December 1996.

6 Financial Sector Program II, for $15 million.

7 Loan 1713-MON: *Governance Reform Program*, for $25 million, approved on 2 December 1999.

accounts conversion. Additional courses on accounting information systems and auditing were also developed and delivered.

- TA No. 2931-MON: *Program Preparation for Governance Reforms* ($967,000: 1998–1999). This TA had three aspects: assisting the Government prepare the inputs for a possible Program loan on governance reforms; assisting in the development, refinement and communication of draft legislation (the Public Sector Management and Finance Law); and supporting the groundwork for the implementation of the reforms arising from the enactment of the draft legislation. With respect to the third aspect, this involved developing accounting policies and accounting guidelines for the public sector based upon International Accounting Standards (IAS) and International Public Sector Accounting Standards (IPSASs). It also involved assisting five pilot agencies to prepare annual financial statements based on these financial policies.
- TA No. 2964-MON: *Improving Accounting and Auditing Systems II* ($688,000: 1997–1998). The activities under this TA included: preparing 34 accountants for international standard CPA examinations and conducting these examinations (18 candidates passed the examinations), providing accountancy textbooks in Russian and Mongolian, and assisting MICPA.
- TA No. 3316-MON: *Initial Phase of Public Administration Reform* ($700,000: 2000–2001). The broad objectives of this TA are to move five pilot agencies to output-based budgeting. As part of this process, accrual-based budgeting and reporting will be entrenched in five organizations.

The **World Bank** approved the *Fiscal TA Project* for $5 million in June 1998. The intention of this project is to support the development of an efficient and transparent government financial management system, and the introduction of a value-added tax to strengthen the government's revenue base. The *Fiscal TA Project* will provide funding for: computerized government financial management information systems (including debt, cash, treasury management, whole-of-government consolidation, and organizational accounting); training in management development; training in accrual accounting, and budgeting; and development of attest auditing capacity. An earlier project, the *Accounting Development* Project, was implemented from July 1993 to September 1994. The project had the following aspects: converting the accounting systems of three State-owned enterprises to IAS; developing a strategic plan for improving accounting and auditing system; updating the accounting curricula for universities; and providing training in financial and management accounting for accountants of major SOE and tertiary institutions.

The **UNDP** is involved in financial governance issues through its Program for Accountability and Transparency (PACT). The *Accounting Training Project* ($76,000; 1999–2000) has involved the development and delivery of a training program to finance staff in government organizations (focusing on the requirements of the new public administration system). The **IMF** has provided three Technical Assistance on public expenditure management, although these TAs have not directly involved accounting or auditing. **AusAID** (Australia) is providing support to the State Audit Board in association with the ADB-supported governance reform program. **JICA** (Japan) is supporting the design and implementation of a Public Investment Program (PIP) Budgeting Process in the Ministry of Finance and Economy through the provision of consulting advice and training (1998–2001). **EU-Tacis** (European Union) is supporting the Academy of Management (AOM) to improve the effectiveness and efficiency of public administration through provision of short- and long-term training of public administrators. **GTZ** (Germany) is providing support to the State Audit Board through a project titled *Institutional Strengthening of the State Audit Board* (DM3 million: 1998–2001). The Project aims to improve state auditing (methodologies and technical skills) by providing equipment, training and short-term experts. Its project involves training (seminars and study tours) for staff from the SAB, MOFE and AOM.