



*The **AMERICAN CHAMBER** of Commerce in Mongolia*

# POSITION PAPER ON ALIGNING CORPORATE TRANSPARENCY WITH INTERNATIONAL STANDARDS & PRACTICES



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## POSITION PAPER ON ALIGNING CORPORATE TRANSPARENCY WITH INTERNATIONAL STANDARDS & PRACTICES

### Background

The Financial Services Working Group seeks to **initiate the policy process for alignment of corporate transparency in reporting of financial institutions and entities operating in other sectors (“corporates”) with international standards and practices through development, adoption and implementation of reporting and transparency guidelines** to enable both financial sector and corporate entities raising debt at lower costs, as well as attracting capital and strategic investors.

### Introduction

The Law on Accounting of Mongolia, effective from 1 January 2016, states that Mongolian business entities are required to apply International Financial Reporting Standards (“IFRS”) or IFRS for Small and Medium Sized Enterprises (“SMEs”), as defined by law.

However, in practice the level of application of IFRS varies significantly between different sectors and between entities within the same sector depending on willingness and ability to invest in good quality financial reporting. IFRS is not fully available in Mongolian language, and is incomplete and voluminous. The poor quality and reliability of financial reporting raises questions about the credibility of Mongolian entities and compliance with international standards such as OECD Principles of Corporate Governance, as well as AML Law and regulations.

Publicly available information on the websites of most entities, including those operating in financial sector, is very limited. Financial statements are not available to the general public through any official organization, unlike in other developing markets.

This document outlines the current situation regarding corporate transparency in Mongolia in respect of the abovementioned areas (financial reporting, annual reports, and publicly available information) and suggests further actions to gradually align local practices to international standards and practices.

### Financial Reporting in General

Entities operating in the financial sector and regulated by the Bank of Mongolia (“BOM”) and/or the Financial Regulatory Commission (“FRC”) are required to report under IFRS. Most corporates however prepare statutory financial statements in accordance with the Guidelines to prepare financial statements of the economic entities and related notes thereto as approved by the Resolution #77 of 2012 by the Ministry of Finance of Mongolia (the “Guidelines”). The Guidelines require that the financial statements are prepared in accordance with the recognition and measurement requirements of International Financial Reporting Standards (IFRS), but not its presentation and disclosure requirements. The Guidelines do not include all the information required to be disclosed by IFRS. Issues and suggestions related to reporting under these two frameworks (IFRS and simplified framework) are outlined below.

### Reporting under IFRS General

The quality and reliability of **financial reporting under IFRS** varies significantly between individual banks, other financial institutions and corporates. In some cases, certain IFRS principles are not applied, or required financial disclosures under IFRS are not included in the financial statements. This undermines the credibility of the whole financial sector and limits the ability to reduce cost of funding and attract capital and investors. For example, credit quality of receivables (including information on aging of receivables) is often missing. Further, in many cases accounting principles applicable under IFRS are not followed (e.g. provisions for litigations, receivables and inventories are not recognized), which makes financial statements unreliable.

### Reporting under IFRS Recommendation

We suggest the following actions to address the above situation regarding **IFRS reporting**:

- **Issuing new regulations and/or updating existing regulations, including accounting guidelines and manuals** that would enable entities to achieve IFRS compliance in terms of both recognition and measurement (i.e. accurate figures) and presentation and disclosures (i.e. sufficient and accurate information). In case of **banking sector**, such accounting regulations issued by the Bank of Mongolia (“BOM”) already exist, so suggested actions include annual



- updates of existing regulations for changes in IFRS standards and interpretations relevant to the Mongolian banking sector.
- The main forthcoming change relates to the introduction of IFRS 9 Financial Instruments, which is effective from 1 January 2018. In a separate policy paper we suggest implementing IFRS 9 as a single provisioning standard, instead of having two parallel standards (BOM asset and provisioning classification and requirements of IAS 39 Recognition and Measurement). **In case of insurance sector and non-banking financial institutions (NBFIs) and corporate entities**, we suggest developing and introducing such regulations (including detailed accounting guidelines and accounting manual) by FRC and MOF.
- **Strong enforcement of the abovementioned accounting regulations** by respective regulators (BOM, FRC, MOF) through accepting only financial statements of acceptable quality, setting deadlines for remediation and taking actions, including penalties, against the entities that do not comply with regulations. In order to ensure effective implementation, we suggest that regulators organize trainings and set realistic deadlines to entities for achieving compliance. Relevant measures would include training of officers of regulators, who would be subsequently checking financial statements of individual entities for compliance and monitor overall progress at the country/sector level.

Based on the international experience of more advanced emerging markets (such as Central Eastern European countries and Russia), the above mentioned actions would ensure consistency in the quality of financial reporting of financial institutions regulated by BOM and FRC, and of corporates reporting under IFRS. This would substantially improve credibility of financial sector as a whole and increase opportunities for growth. (IFRS and simplified framework) are outlined below.

### Reporting under Simplified Framework

Most corporates prepare **statutory financial statements in the format prescribed by the Ministry of Finance (“MOF”) in accordance with the Guidelines** (Resolution #77 of 2012 by the Ministry of Finance of Mongolia) (the “Guidelines”). The Guidelines do not include all the information required under IFRS. As a result, financial information presented to commercial banks and financial institutions by corporate entities does not have sufficient information for decision making. Further, financial statements submitted to the MoF are in many cases different from management accounts submitted to commercial banks and/or accounting principles are not followed (e.g. provisions for litigations, receivables and inventories are not recognized). Substantial additional work (e.g. consideration of management reporting) is usually needed by credit analysts for assessing and approving credit risk. This increases the cost and risk of lending. The Guidelines were planned to be replaced from 1 January 2016, but it is currently not clear when this change will take place.

As a result, the currently prevailing level of availability, quality and reliability of financial information disclosed by corporate and SME companies tends to be rather weak. Independent verification through auditors is not the current general norm or does not result in proper and reliable disclosure. As a result, past due and non-performing loans are higher than necessary which in turn increase the provisioning (and consequently cost of credit).

### Reporting under Simplified Framework

We suggest the following actions to address the above regarding **financial reporting of entities that do not report under IFRS:**

- **Preparation of clear action plan for the introduction of IFRS for SMEs and its implementation by MOF** within a reasonable timeframe (e.g. over a six month to one year period). This may include trainings, issuance of new regulations and eventual implementation by MOF using measures similar to those applicable for reporting under IFRS.
- **Improving quality of financial reporting under the Guidelines** until regulations on IFRS for SMEs become effective. We suggest regulator to accept only financial statements of acceptable quality, set deadlines for remediation and take further actions, including penalties, against the entities that do not comply. In addition, based on the feedback obtained from commercial banks and other financial institutions,



MOF may consider amending the current regulations and introducing additional disclosures as mandatory, which would enable effective analysis of credit risk by financial institutions. The quality and clarity of financial statements of corporates and other supporting documents provided to commercial banks should be on such level that enables commercial banks to assess credit risk and recoverability of loans on the basis of historical and future cash flows from corporates' business, as expected by international practices for credit risk management and asset quality reviews.

Based on the international experience of more advanced emerging markets, abovementioned measures would eventually decrease interest rates and stimulate growth of Mongolian economy.

## Annual Reports

In order to be effective from an investor's perspective annual reports need to contain all elements expected by stakeholders, proper quality and depth of information, and to demonstrate a consistent message.

We suggest that the regulator and other relevant institutions (such as industry associations, National Corporate Governance Center, Mongolian Stock Exchange etc.) play an active role in encouraging entities to prepare annual reports in accordance with international standards and frameworks such as OECD Principles of Corporate Governance.

This could be accomplished through trainings and conferences, by raising awareness and sharing experiences, organizing competitions and rewarding entities with best annual reports with publicly recognized awards for transparency. The participation of international financial institutions (e.g. World Bank, IMF, EBRD, ADB etc.) in this process would be essential.

Information disclosed on websites of Mongolian entities, particularly corporates, is very limited. We suggest that the above mentioned transparency initiatives related to the quality of annual reports also include encouraging other entities, which do not prepare annual reports, to improve the quality of information provided on their websites. OECD Principles of Corporate Governance could be used as a reference point.

Need for full corporate transparency includes full adherence to compliance and AML laws and regulations effective in Mongolia, as well as international practices on AML. This includes provision of all necessary information by customers to commercial banks to enable them to properly conduct know your client (KYC) procedures, including Ultimate Beneficial Owner, and other compliance procedures. Further, we suggest to the Government of Mongolia to create an official register of entities in Mongolia. This register would be available to the general public and anyone would be able to find the following information about all entities established in Mongolia. Company data:

- Establishment date
- Numbers of employees
- Business in which company is engaged
- Information about company's ownership (detailed data who owns company's shares, data related to changes in ownership, etc.),
- Financial statements of the company, whether company has overdue taxes or not, any other relevant information.

The above would allow the creation of a local rating agency (or agencies) which would be able to assign credit ratings. This would significantly improve situation in the market as companies would be able to easily make decisions whether their counterparties are reliable or not, whether their trading parties are experiencing financial burdens and whether it is worth doing business with them, etc. For banks it would be easier and faster to make decisions regarding granting credit.

Such registers are already in place in many European countries and are typically very user friendly. We suggest to Mongolia to follow international best practice.

## Way Forward

The **Financial Services Working Group stands ready to support the policy process** to improve corporate transparency and gradually align it to international standards and practices through communication with all relevant stakeholders and active involvement in initiatives described in this document.





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