

Mongolia's new Accounting and Auditing Laws



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Executive summary

As part of the Government's reform program, two new laws that impact companies came into effect on 1 January 2016, as follows:

- ▶ Accounting Law issued on 19 June 2015 and effective 1 January 2016
- ▶ Auditing Law issued on 19 June 2015 and effective 1 January 2016

These laws complete the financial reporting framework for companies, when taken together with the Company Law issued on and effective since 6 October 2011, and the Small and Medium Enterprises (SME) law issued on and effective since 27 July 2007.

This publication covers the key articles of the Accounting and Auditing laws relevant to for-profit entities as a quick reference guide, while referring to the Company and SME laws, when relevant.

In addition, we highlight certain sections of the Accounting Law that would appear to conflict with that law's requirement for companies to apply International Financial Reporting Standards (IFRS).

Quick reference guide

Accounting law

1. Accounting standard¹

The previous Accounting Law required companies to comply with International Financial Reporting Standards (IFRS). The new Accounting Law now gives companies the choice to follow either IFRS or IFRS for small and medium entities.

- a) The following types of entities must follow IFRS:
 - i. Any joint stock companies listed in a local or international stock exchange
 - ii. A company that has applied for a listing in a local or international stock exchange
 - iii. Entities that hold licenses stipulated in Articles 15.2, 15.3, 15.4; 15.10.5, 15.10.6 and 15.10.13 of the Law on Licensing of Business Activities
 - iv. State or locally owned entities and entities in which they have ownership participation
 - v. Public service entities that supply electricity, water or heating
 - vi. Political parties and non-governmental organisations performing governmental functions on a contractual basis in accordance with Article 19 of the Law on Government of Mongolia
 - vii. A business entity operating in the sectors of commercial banking, as a special purpose company or investment funds
- b) The following types of entities should follow IFRS for SMEs² if they are duly registered as SMEs with the central state administration organization in charge of small and medium enterprises³:

Industry	Number of employees	Annual turnover (revenue)
Entities or citizens who work under contract or labor agreement	<=199	<=MNT1.5 billion
Wholesalers	<=149	<=MNT1.5 billion
Retail sales	<=199	<= MNT1.5 billion
Service enterprises	<=49	<=MNT1 billion
Manufacturer and commerce	<=19 in total <=9 in charge of manufacturing	<=MNT250 million

2. Accounting language and currency⁴

All entities operating in Mongolia should prepare their bookkeeping in the Mongolian language. Unless consent is received from the respective authorities (Ministry of Finance), the currency in which companies record and report their accounts should be the Mongolian tugrug. This is a new requirement, which may conflict with how some companies currently record their accounts and which we discuss further below.

3. Consolidation⁵

A business entity with one or more subsidiaries is required to prepare the Consolidated Financial Statements. In the case of a chain where the subsidiaries have subsidiaries then the ultimate parent company will prepare the Consolidated Financial Statements. If the ultimate parent company is registered in a foreign country, then the ultimate parent company registered in Mongolia will prepare consolidated interim financial statement based on its subsidiaries.

This is a new requirement and effectively prevents Mongolian intermediate holding companies from taking advantage of the exemption in IAS 27, from having to prepare consolidated financial statements if their ultimate parent company does so.

The Company Law⁶ defines a subsidiary as:

“An independent company shall be deemed to be a subsidiary of a company if another (parent) company solely or jointly with its affiliated entities, holds more than 50 percent of the total common shares issued by the company.”

The Law also requires that a subsidiary company shall separately issue its financial report, and its parent company shall issue a consolidated financial report with the subsidiary company.

The previous Company Law had no specific requirements in this area, leaving companies to abide by the requirements of IFRS in determining whether they needed to prepare consolidated financial statements and which entities should be included therein. We discuss below whether this may now result in conflict between the Laws and IFRS.

4. Financial reports submission deadlines⁷

Entities reporting under IFRS should submit their financial reports to the state administrative organization supervising financial and accounting affairs by 10 February of the following year. This financial report does not need to be audited. This is unchanged from the current requirement.

Entities required to prepare Consolidated Financial Statements should submit their financial reports to the state administrative organization supervising financial and accounting affairs by 1 March of the following year. This financial report does not need to be audited. This is unchanged from the current requirement.

5. Storing accounting documents and financial statements

Business entities are required to keep the accounting documents and financial statements for no less than 10 years unless otherwise stated in the Law on Archives.

1 Accounting Law Article 4

2 Small and Medium Enterprises Law Article 5.1

3 Small and Medium Enterprises Law Articles 6.6

4 Accounting Law Article 7

5 Accounting Law Article 8.3

6 Company Law Article 6

7 Accounting Law Article 10

Auditing law

1. Restriction on the length of service period⁸

An audit firm cannot provide auditing, reviewing or any other assurance services to the same business entity for more than 5 consecutive years. After the service period of 5 years, an audit firm cannot provide auditing, reviewing or any other assurance services to that business entity for at least 3 years. The above law does not apply to entities reporting under IFRS for SMEs and IFRS for the state sector.

The previous Auditing Law had a three year rotation requirement, and hence the new law extends this by two years.

2. Providing other services⁹

Audit firms may provide certified tax consultancy services, subject to obtaining the relevant license. Unless otherwise stated in the law, audit firms may conduct asset evaluation, finance and accounting consultancy and training services. However, the law prohibits the audit firms to audit the financial statements of entities, for which asset evaluation, consultancy, tax and/or accounting services were provided during the period audited.

This clarifies the independence rules for auditors, while allowing audit firms to resume offering tax consultancy services, which they had been unable to do so since the Law of Certified Tax Advisors that came into effect in January 2013. However, as most audit firms had set up sister tax consultancy firms to meet the requirements of that law, it is unlikely to have much practical impact.

3. Entities that are required to be audited by an independent audit firm¹⁰

- a. Business entities and organisations required to report on (full) IFRS;
- b. Business entities and organisations subject to preparing consolidated financial statements;
- c. Business entities and organisations going through a restructure and liquidation or proposing to sell all of its assets through an auction;
- d. Foreign invested business entities and organisations;
- e. Funds stated in Article 36.2 of Civil Code;
- f. Other business entities and organisations required to procure auditing for their financial statements according to the laws and international treaties of Mongolia.

Entities listed above should have their financial statements audited by the following deadlines¹¹:

Type of entities	Deadline to complete financial statement audits
Entities listed on Mongolian Stock Exchange	No less than 2 weeks prior to the annual shareholder's meeting, which should be convened by 30 April of the year following the financial year end ¹¹ .
Entities under the restructure and liquidation or proposing to sell all of its assets through the auction	1 month prior the commencement of such actions
Banks and entities regulated by Financial Regulatory Commission	By 31 March of the following year
Other business entities	By 30 April of the following year

8 Auditing Law Article 8

9 Auditing Law Article 9

10 Auditing Law Article 10

11 Company Law Article 59.4



Interpreting Mongolian Company and Accounting Laws within the context of IFRS

Consistent with the previous Accounting Law, the new law requires all companies in Mongolia to prepare their financial statements in accordance with IFRS. This has had the great benefit for Mongolian companies of providing a comprehensive accounting framework that is internationally recognized and accepted. Unfortunately, the new Company Law and Accounting Law (collectively the “Laws”) also contain specific accounting requirements that may give rise to potential conflicts with the requirements of IFRS. This could have the unfortunate consequence of making the financial reports of Mongolian companies unacceptable to foreign investors and financiers, and impose additional costs on Mongolian companies of having to prepare two sets of financial reports, one for local reporting and one for international reporting.

Two areas of conflict are discussed below.

1. Consolidation

The Laws require that a company with subsidiaries must prepare consolidated financial statements. This differs from IFRS 10 *Consolidated Financial Statements* which requires a holding company to prepare consolidated financial statements covering its controlled entities. As explained above, a subsidiary company is defined in the Company Law, as a company where another company (either on its own or with affiliates) holds over 50% of the issued shares. IFRS 10, in its definition of controlled entities, focuses on the capacity of one company to control another, rather than a particular level of shareholding. We discuss two situations in which inconsistent treatment may seem required in order to comply with both Mongolian law and IFRS.

a. Controlled entity not a subsidiary company

In this case, a company controls another company but does not hold over 50% of the issued shares. Such control may be exercised through controlling the board of directors, for example. Under IFRS, this controlled entity should be included in the consolidated financial statements. The controlled entity does not meet the definition of a subsidiary according to the Company Law Article 6.4. It would thus appear that it should not be included in the consolidated financial statements required by the Accounting Law.

b. Subsidiary company not a controlled entity

In this case the parent company has a subsidiary according to the Company Law Article 6.4 (parent company owns more than 50% of the company), but the subsidiary does not meet the definition of a controlled entity per IFRS 10. This might be because the subsidiary company’s charter requires board of director decisions to be approved by a two thirds majority and the parent company only appoints three out of five directors.

The Accounting Law, Article 4.1 requires companies to comply with IFRS and so provides authority to interpret the Company Law requirement to prepare a consolidated financial statement in a way that is consistent with the requirements of IFRS, and, in particular, to follow the mechanisms specified by IFRS for consolidation of controlled entities and for equity accounting for non-controlled entities. Hence, each of the above situations needs to be carefully interpreted based on the facts of the case to see if a solution can be found that meets the requirements of both the Laws and IFRS. The Laws do not prescribe the method whereby subsidiaries are to be consolidated and are silent on how to account for a controlled entity that is not a subsidiary, whereas IFRS provides different methods depending on the nature of relationship between parent company and subsidiary company as well as clear rules on accounting for companies in which a parent company holds 50% or less of the shares. Hence, it is important to obtain suitable professional advice in addressing each situation to see if a solution can be found that satisfies all requirements.



2. Functional currency

According to Article 7.2-3 of the Accounting Law, any company operating in Mongolia should record and report all its transactions in Mongolian tugrug unless it receives permission from the respective authorities to use a different currency. On the other hand, IFRS through IAS 21 *The Effect of Changes in Foreign Exchange Rates* requires companies to prepare their accounts in their functional currency. In rare situations, there may be cases where companies operating in Mongolia determine that their functional currency is other than the Mongolian tugrug. IAS 21.9-10 states the following:

The primary economic environment in which an entity operates is normally the one in which it primarily generates and expends cash. An entity considers the following factors in determining its functional currency:

- a. the currency:
 - (i) that mainly influences sales prices for goods and services (this will often be the currency in which sales prices for its goods and services are denominated and settled); and
 - (ii) of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services.
- b. the currency that mainly influences labour, material and other costs of providing goods or services (this will often be the currency in which such costs are denominated and settled).

The following factors may also provide evidence of an entity's functional currency:

- a. the currency in which funds from financing activities (ie issuing debt and equity instruments) are generated.
- b. the currency in which receipts from operating activities are usually retained.

In our experience, Mongolian companies, including subsidiaries of international companies, operating in the natural resources sector and selling into export markets may determine that their functional currency is not the tugrug. In such cases, they will need to apply to the Ministry of Finance for permission to record their accounts in their functional currency in order that they can comply with IFRS. Such companies can still report their financial statements in tugrug as IFRS allows a company to present its financial statements in any currency by translating them from the functional currency.

As such, when facts and circumstances of a company point to a functional currency other than the Mongolian tugrug, management should reach out to the respective authorities and work on obtaining the permission in accordance with Accounting Law Article 7.3. In doing so, we encourage companies to obtain professional advice to help with preparing their submission and explaining their circumstances.



Contact us

Peter Markey

Managing Partner, Mongolia
Mining and Metals Leader
China and Mongolia

+86 21 2228 2616
peter.markey@cn.ey.com

Adrian Chu

Partner, Financial Services
Ernst & Young Hong Kong

+852 2629 3146
adrian.chu@hk.ey.com

Altansukh Ganbaatar

Chief Executive Officer
Ernst & Young Mongolia Audit LLC

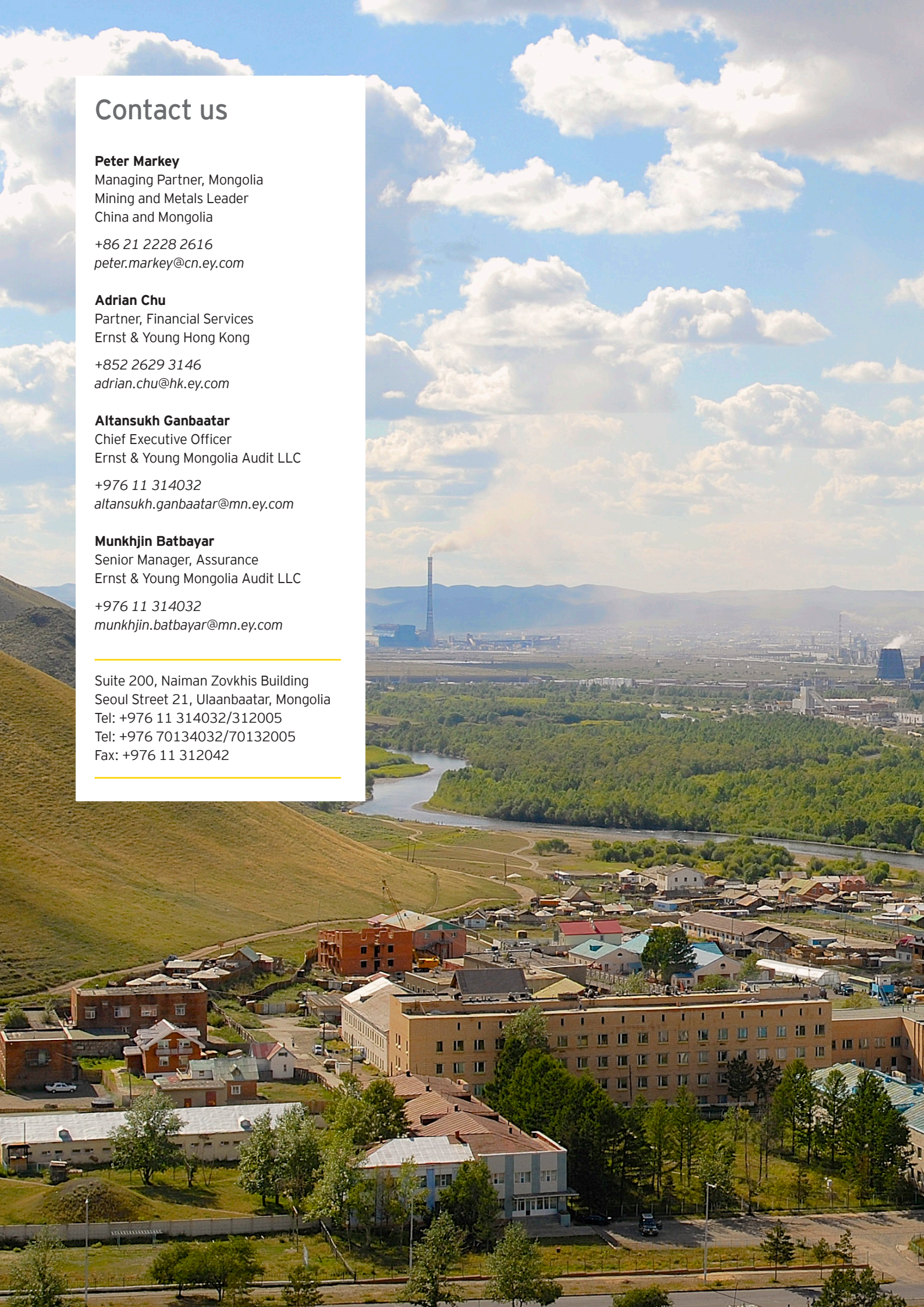
+976 11 314032
altansukh.ganbaatar@mn.ey.com

Munkhjin Batbayar

Senior Manager, Assurance
Ernst & Young Mongolia Audit LLC

+976 11 314032
munkhjin.batbayar@mn.ey.com

Suite 200, Naiman Zovkhis Building
Seoul Street 21, Ulaanbaatar, Mongolia
Tel: +976 11 314032/312005
Tel: +976 70134032/70132005
Fax: +976 11 312042





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