

I N T E R - A M E R I C A N D E V E L O P M E N T B A N K

# FINANCIAL DISCLOSURE

**A First Step to Financial Market Development**

**Kim B. Staking and Alison Schulz, Editors**

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# **Financial Disclosure: A First Step to Financial Market Development**

Kim B. Staking and Alison Schulz  
Editors

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## **PREFACE**

Since its founding, the Inter-American Development Bank has been involved in the development of financial markets as part of its overall strategy for supporting economic development and alleviating poverty in Latin America and the Caribbean. In the implementation of its strategies for supporting this development, the Bank Group has approved a considerable number of operations to provide resources for strengthening and reforming financial systems. In particular, the Bank Group has financed reform in twenty-four of the twenty-six borrowing member countries through loans and grants that cover most aspects of financial and capital markets. To supplement these operational experiences, the Bank Group has also produced a series of publications and organized several conferences to gather and disseminate best practices and to raise awareness of the Latin American and Caribbean region on important issues. This book forms a part of those efforts.

In recent years, the Bank Group has been targeting the efficiency and effectiveness of domestic financial and capital markets. Well-functioning financial and capital markets, perhaps even more than other economic activities, depend on information. In order to achieve an effective allocation of scarce resources, investors, entrepreneurs, and intermediaries all need information to evaluate the risk and expected return to potential investments. Likewise, ongoing disclosure of financial information is required for secondary markets to thrive and develop.

Recognizing the need to improve the quality of financial disclosure by private sector firms in Latin America and the Caribbean, the Inter-American Development Bank sponsored a conference in 1997 entitled *Financial Disclosure and the Development of Financial Markets: The Impact of the Adoption of International Accounting Standards and Auditing Practices*. The conference provided information on recent agreements regarding international accounting standards and was intended to generate support for the adoption of high-quality accounting and auditing standards by countries of the region. As often happens, the Inter-American Development Bank, as an institution, gained great insights from the conference participants, both those participating in the program and those attending the conference. Many of the participants expended considerable time and effort working with these difficult issues, and I would like to thank them on behalf of the Bank.

This volume includes a selection of the papers commissioned for the conference. This book constitutes only a first step in the Bank's efforts to support the implementation of accounting standards and the development of adequate information environments. It forms part of the program to implement the overall capital and financial market development strategy. Over the next several years, we plan to commit considerable resources to support the efforts of policymakers, external auditors, securities exchanges, and others in assuring that the information environment in the region truly reflects international standards.

*Antonio Vives*  
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## INTRODUCTION

In supporting economic development throughout Latin America and the Caribbean, the Inter-American Development Bank has focused significant resources on the development of financial markets in this region. One of the primary building blocks of efficient and effective financial markets is the existence of and access to reliable information regarding the financial situation of individual firms. Without reliable information, investors are unable to analyze the risks and calculate the expected returns to investment opportunities. The cost of capital for companies will be higher, and many otherwise attractive investments will not take place.

One of the key tools for improving the quality of and investor confidence in financial information is the adoption by the private sector of high-quality accounting and auditing standards. To be fully effective in reducing the cost associated with uncertainty, the standards adopted must provide information that is comparable to international standards. Recognizing the importance of high-quality accounting and auditing standards, the Inter-American Development Bank, in association with the International Accounting Standards Committee and the Inter-American Accounting Association, organized a conference entitled *Financial Disclosure and the Development of Financial Markets: The Impact of the Adoption of Internationally Acceptable Accounting Standards and Auditing Practices*, held at the headquarters of the Bank in Washington, D.C., from September 29 to 30, 1997. This book offers several papers that the Bank commissioned for the conference.

The first chapter, by Kim B. Staking and Alison Schulz of the Inter-American Development Bank, presents the economic justification of high-quality accounting standards, which provide the basis for well-functioning financial markets and the allocation of investment resources. In addition, the chapter reviews the program to prepare a core set of high-quality accounting principles for cross-border listings of securities by the International Accounting Standards Committee (with support from the International Organization of Securities Commissions) and reports on a survey of accounting principles in Latin America and the Caribbean. The second chapter, by Fred Choi of New York University, develops a theoretical justification for better financial information and examines the impact of improved disclosure via stronger accounting standards on valuation of firms. Dr. Choi's analysis, using a variety of measures, indicates a strong relationship between improved disclosure and firm value.

The next two chapters provide case studies of countries in the process of reformulating their accounting standards to provide greater disclosure. In chapter 3, Armando Murguía, president of the Mexican Accounting Standards Institute (Instituto Mexicano de Principios Contables), discusses the process by which Mexico is attempting to bring its accounting standards in line with international standards while recognizing the unique characteristics of the Mexican economy. Mr. Murguía notes the progress that has been made to date, while recognizing that the economic and political resources needed to complete the process are difficult to come by. Alberto Krygier, in chapter 4, reviews the situation in Venezuela, a country that has not yet undertaken a reform of its accounting system. Mr. Krygier outlines some critical weaknesses in the country's current set of accounting principles (especially related to inflation and foreign exchange translations) and the loss in investor confidence that has resulted from the use of substandard accounting principles; it also offers suggestions for undertaking a comprehensive reform of accounting

standards in Venezuela. Both case studies recommend an orderly transition in which a broad consensus is reached by preparers and users of financial statements, government financial market regulators, and members of the accounting profession.

In chapter 5, Alvin Carley of the Wharton School of Business, University of Pennsylvania, notes the importance of establishing a comprehensive transition plan aimed at adopting international accounting standards as well as international standards for external auditors. Professor Carley presents a variety of alternatives for making such a transition and discusses the benefits and costs of each approach. He strongly recommends that the transition be complete and accomplished over as short a time as possible and that all of the critical groups (external auditors, firm managers, investors and other users of financial information, and financial market regulators) be actively involved in the design and implementation of the transition process.

The authors of the individual chapters, as well as other participants in the conference, put significant time and thought into issues surrounding the adoption of internationally acceptable accounting principles and auditing standards. This book highlights some critical issues associated with the transition to high-quality, globally acceptable accounting principles and the value associated with improved financial disclosure. We hope that it will encourage the countries of Latin America and the Caribbean to begin the process of adopting and implementing comprehensive, high-quality accounting principles and auditing standards consistent with international practices. By highlighting both the benefits of such a transformation and the costs of inaction, the Inter-American Development Bank hopes that this publication, and the conference on which it is based, contribute to this important topic.

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## **LIST OF ABBREVIATIONS**

AcSB	Accounting Standards Bureau (Canada)
AICPA	Association of Certified Public Accountants
CNBV	National Banking and Securities Commission
COSRA	Council of Securities Regulators of the Americas
FASB	Financial Accounting Standards Board
FCCP	Federation of Associations of Public Accountants
FCCPV	Venezuelan Federation of Accounting Principles
GAAPs	Generally Accepted Accounting Principles
GAASs	Generally Accepted Accounting Standards
GATT	General Agreement on Tariffs and Trade
IAA	Interamerican Accounting Association
IASC	International Accounting Standards Committee
IASs	International Accounting Standards
IFAC	International Federation of Accountants
IMCP	Mexican Institute of Public Accountants
IOSCO	International Organization of Securities Commissions
MASC	Mexican Accounting Standards Committee
MERCOSUR	South American Common Market
NAFTA	North American Free Trade Agreement
NASDAQ	National Association of Securities Dealers Automatic
SAS	Statements on Auditing Standards
SEC	U.S. Securities and Exchange Commission

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# IMPROVED FINANCIAL DISCLOSURE AS A PREREQUISITE TO FINANCIAL MARKET DEVELOPMENT

KIM B. STAKING AND ALISON SCHULZ

Financial markets are developed to facilitate the allocation of scarce resources to the best investment opportunities in a given economy. This requires substantial information regarding the set of investment opportunities, their expected returns, and the risks associated with each project. Only with this information can projects be priced and investment allocated efficiently. When information is not readily available, or the information is not credible, financial markets are unable to operate effectively. The cost of capital assigned to a specific project will be higher than necessary, and many otherwise acceptable projects will be rejected. Because of these information requirements, it is often said that financial markets live on information.

One of the most striking observations about the emerging markets of Latin America and the Caribbean is the lack of quality information, inefficiencies in the allocation of investment resources, and the high cost of investment capital. If the region's financial markets are to work effectively, it is critical that financial disclosure be brought up to global standards. The region's firms compete in the international market for capital as they do for other inputs. If the quality of information provided is considered inadequate compared with what is provided by firms in other regions of the world, where will capital flow? The firms of Latin America and the Caribbean will be at a comparative disadvantage in gaining access to capital and be forced to pay a higher price.

This chapter reviews the value of financial disclosure and analyzes the decisionmaking problems that arise when investors are faced with asymmetric information. It then discusses three methods of reducing information problems: (1) the adoption of global accounting principles and auditing standards, (2) the implementation and enforcement of these standards, and (3) the establishment and enforcement of minimum disclosure requirements based on global standards. The discussion focuses on current circumstances in Latin America and the Caribbean. Finally, the chapter presents some examples from Latin America and the Caribbean in which information problems contributed to financial crises (and had to be addressed to resolve them) or improved disclosure increased the value of the firm.

## **The Value of Financial Disclosure**

The multilateral development institutions have long supported improved disclosure of macroeconomic information by the emerging economies and improved disclosure by financial intermediaries in the attempt to impose market discipline and limit banking

crises (Lindgren, García, and Saal 1996).<sup>1</sup> Nevertheless, improved disclosure remains on the forefront of development needs. In August 1997, during a meeting of economists and government officials in Jackson Hole, Wyoming, Alan Greenspan, chairman of the U.S. Federal Reserve, citing the recent currency upheaval in Thailand and the 1994 financial crisis in Mexico, noted that the release of timely and accurate data is key to financial stability. "I don't know what the appropriate amount of disclosure is, but it's pretty clear, in both the Mexican and Thai experiences ... [that the] level we now have is too low" (quoted in Vicente 1997).

As emerging economies are further integrated into international markets, the need for financial and economic disclosure will become even more critical. Moreover, the need for disclosure will expand beyond government-issued macroeconomic statistics to encompass disclosure of private financial data, market prices, trading activity, company-specific financial information, risk exposures, and management strategies. The private sector will take a progressively active role in promoting improved information environments.<sup>2</sup> A new paradigm for financial disclosure is needed, one that recognizes the partnership among governments, private firms, the providers of investment capital, and the capital markets themselves.

This new paradigm is reflected in recent changes in emerging financial markets, the growth of pension funds and other institutional investors, and the associated development of equity, bond, commodity, and derivatives markets. These information-dependent markets and institutions are the vanguard of a regionwide transformation from the bank-centered systems that dominated financial markets of Latin America and the Caribbean in the past. More complete, deep, and liquid capital markets provide greater flexibility in matching investment needs with available resources. Firms with access to these markets are better able to adopt the capital structure that they perceive to be optimal. These firms are able to use markets to hedge risks and, in the process, lower their cost of capital. Nevertheless, access to these markets depends on information. Only those firms that are able to provide sufficient quantities of credible financial information will gain access to markets. Moreover, the perceived quality of information is a function not only of the information provided by individual firms but also of the information environment in which a firm operates.

Significant externalities are created from economywide efforts to improve the quality of investor information. The creation of information-rich markets, as needed for a modern information environment, will require a sustained effort by the emerging economies. To be successful, information disclosure must be at levels comparable to that available internationally. Three components will be required. First, private sector participants will need to recognize the importance of improved disclosure and be willing to provide information to the public. Second, countries will need to improve their accounting and auditing standards, bringing them in line with global standards. Third, securities exchange commissions in the region will need to strengthen their ability to monitor and enforce information disclosure rules and accounting and auditing standards in order to ensure market transparency.

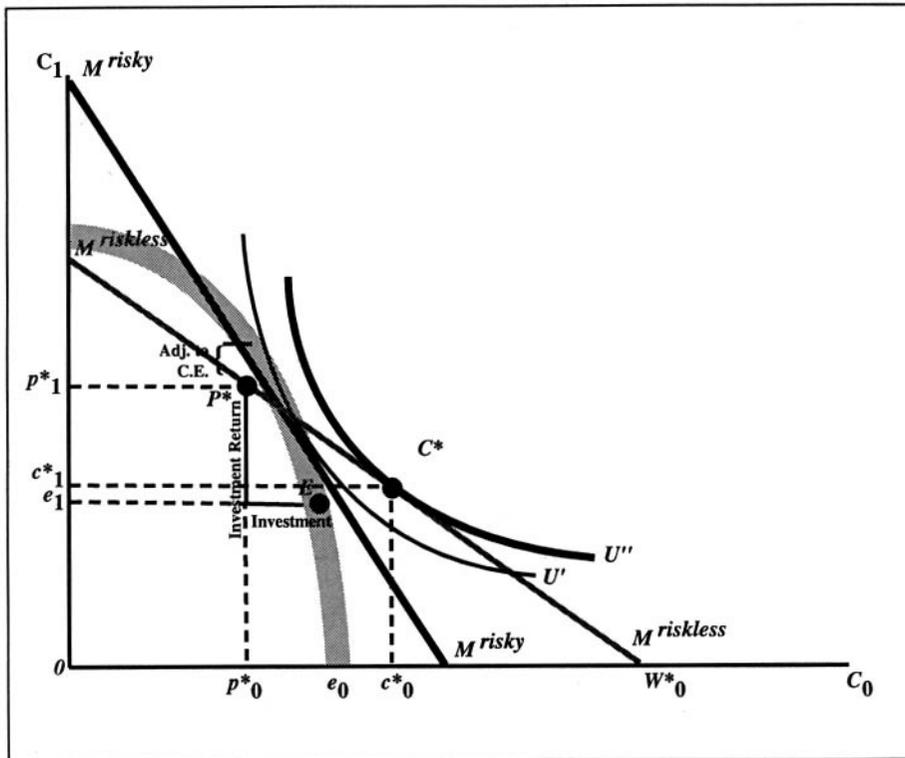
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<sup>1</sup> This extension to the banking sector may be related to a recognition of the special nature of banks and the fact that governments are often forced to bail out banking systems, resulting in a negative impact on the macroeconomic stabilization program.

<sup>2</sup> The International Monetary Fund, in its justification of the need for improved macroeconomic disclosure, cites the quantity and quality of financial information available in and demanded by the private sector in international markets.



Figure 1.2. Investment/Consumption Decision with Risky Production and Information Asymmetries



decision by producing at  $P^*$  and then moves along the market line, selecting the combination of present and future consumption that maximizes utility.<sup>3</sup>

The ability to separate the investment decision from the consumption decision is critical to common models of investment because it allows us to ignore individual preferences. Nevertheless, the standard model is flawed in that it does not account for risk (including the risk of uncertain information). Few investment projects are riskless, and the level of risk in the set of possible projects varies dramatically from the very safe (generally delivering low returns) to the highly speculative (usually promising high returns). Indeed, the search for the “best” investment could be restated as a search for investments that promise the highest returns on a risk-adjusted basis. This can be thought of as superimposing on each production possibility frontier a distribution of returns. This has two impacts. First, from the perspective of the individual risk-averse investor, risk has a cost. If the future returns are risky, future consumption is also risky. The investment

<sup>3</sup> This is a simplified representation of the standard Fisher separation theorem. Fisher (1930) provided the original derivation. Hirshleifer (1970) extends the model to a multiperiod setting, incorporating market imperfections and uncertainty. The central questions of financial economics, which developed as a separate field of study over the past thirty years, relate to how uncertainty can be dealt with in the investment consumption decision. Ingersoll (1987) provides a more complete development of the theory of how intertemporal consumption and investment decisions are made under uncertainty.

decision will not be based on expected returns, but on the certainty equivalent associated with the risky outcomes. Second, from the perspective of the market, the added risk requires the use of a higher discount rate.

Together, the steeper market line and the individual's perception of risk will change the optimal investment decision. In figure 1.2., investment and consumption fall significantly due to the combination of a steeper market line and a downward shift in investment, reflecting the individual investor's adjustment for risk (to the certainty equivalent of the investment). The risky production and consumption optimals are moved to  $P^*$  and  $C^*$ . The greater the perception of risk, the steeper the market line and the greater the risk adjustment by the individual investor.

### ***The Role of Risk Diversification***

For the individual investor facing a specific investment possibility, the impact of risk on the investment decision will depend on both his perceptions of risk and his degree of risk tolerance. Nevertheless, modern portfolio theory has shown that for the market as a whole or for the investor who is able to create a portfolio of investments, much of the idiosyncratic risk can be diversified. Only the remaining systemic or nondiversifiable risk will be priced. However, one fallacy that is often associated with a naive application of portfolio theory to the formation of a diversified investment portfolio is the notion that risk does not matter because it can be diversified away. Although it is true that random price fluctuations will be diversified away, the perception of risk has an impact on the discount rate that the market uses to set equity prices.

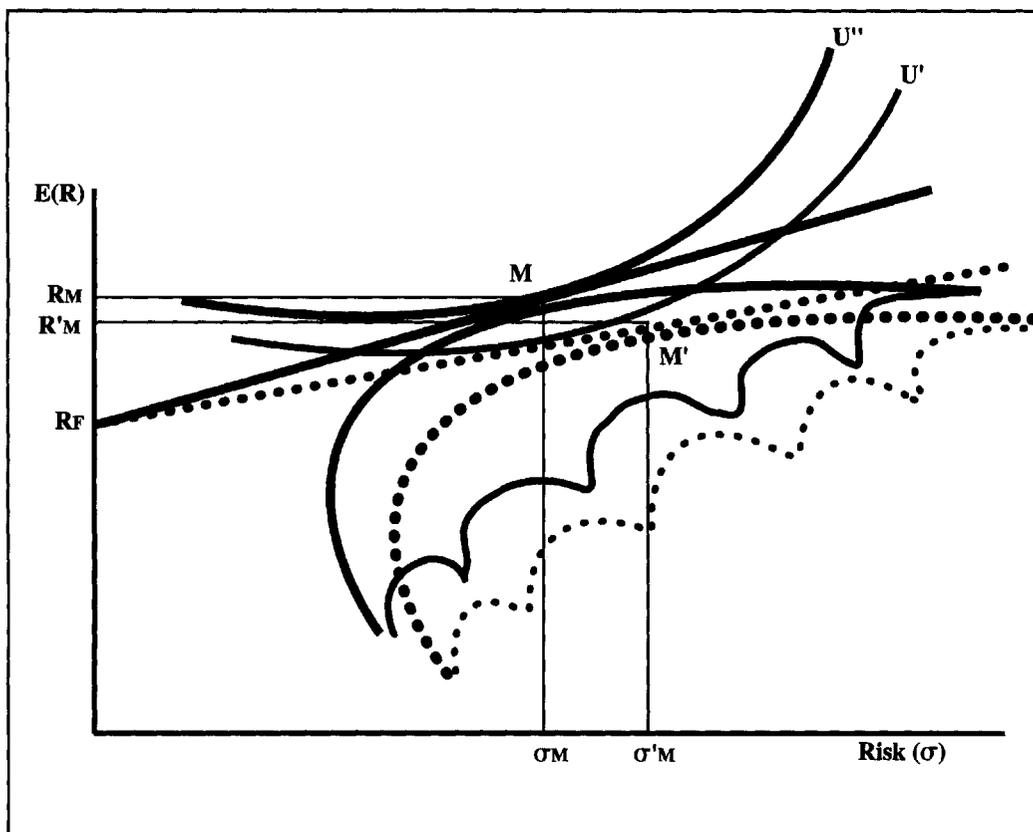
Asset pricing theory separates the investment from the consumption decision, with the investor holding a combination of the market portfolio and the risk-free asset. All idiosyncratic risk is eliminated through diversification. However, the standard model, the capital asset pricing model, is based on expected returns and estimated variance (based on changes in the price of traded securities). Poor information or the existence of information asymmetries will keep prices low and volatility high. The theoretically efficient frontier associated with the capital asset pricing model will therefore be lower for a market with poor-quality information than for a market with good-quality information (see figure 1.3).

### ***The Role of Information***

Financial markets need information to function effectively and efficiently. Markets thrive on information, and individuals who have access to better information or who are able to interpret available information more quickly or more accurately will have a comparative advantage in their investment decision. This creates an enormous demand for information and information processing. There is, likewise, a strong motivation for firms to provide information to potential investors in order to minimize the variance in the estimated value of the firm and lower the cost of capital for the firm. Those firms that are able to provide better, more credible information will be rewarded in financial markets, while those that provide more opaque information will be forced to pay a higher cost of capital or may be excluded altogether from financial markets.<sup>4</sup>

<sup>4</sup> The value of information is related to its impact on shareholder value. Improving disclosure is costly and will only be undertaken as long as the marginal value associated with providing better information (improved share price or reduced cost of borrowing) exceeds the cost of providing information.

Figure 1.3. Asset Pricing Model: Poor Information



The work of Dr. Frederick Choi provides an interesting glimpse into the development of financial economics by examining the role of information in pricing over the past two decades (Choi, chapter 2 of this volume). His early work paralleled that of other analysts who were looking at the determinates of value and how better information leads to better investment decisions. The finance profession moved away from this focus because they were working largely with U.S. financial markets. Available databases allowed financial theoreticians to test their models of market efficiency (based on the assumption of perfect information) in this information-rich environment. Today, as the focus of the investment community (and, perhaps a bit slower, the academic community) turns to international markets, and especially to emerging markets where full information is not available, analysts are returning to critical questions regarding the impact of different information standards that Dr. Choi is exploring.

### *The Role of Asymmetric Information*

Risk, or at least the perception of risk, associated with each investment opportunity can be thought of as the distribution of outcomes and their related probabilities. Unfortunately this distribution is never known with any degree of certainty because it depends on factors as diverse as the current or potential value of a firm's assets (based on how well

used they are); the firm's competitive environment; the vision and direction set by a firm's board and senior management; the quality and efforts of management (including management's depth and ability to innovate); relationships with workers, customers, and suppliers; the perception of other investors or creditors; technologies owned or under development by the firm; the economic, legal, and regulatory environments; exposure to catastrophic risks; the liquidity of the primary and secondary markets in which a firm's debt and equity are traded; and even the ability of the firm to expropriate value by changing its capital structure once an investment has been made. The financial analysts that are evaluating the firm as an investment must estimate each of these.

The individuals with access to the best information about the value and risk associated with investment opportunities are often insiders who, due to possible conflicts of interest, may not be perceived as fully credible. This information asymmetry is a critical problem for financial markets. If information cannot be communicated in a credible fashion, market incentives are distorted and investment will decrease. In some cases, positive net present value investments will not be made because potential investors will not be willing to provide funds. In other cases, entrepreneurs with limited funds will be unable to invest in otherwise acceptable projects due to the high cost of available capital. Figure 1.3 presents an investment decision in which the market rate is far steeper than necessary because the true risk (known to the investor) cannot be credibly communicated to the market. When the information asymmetries are sufficiently severe, markets fail altogether (Rothschild and Stiglitz 1976).<sup>5</sup>

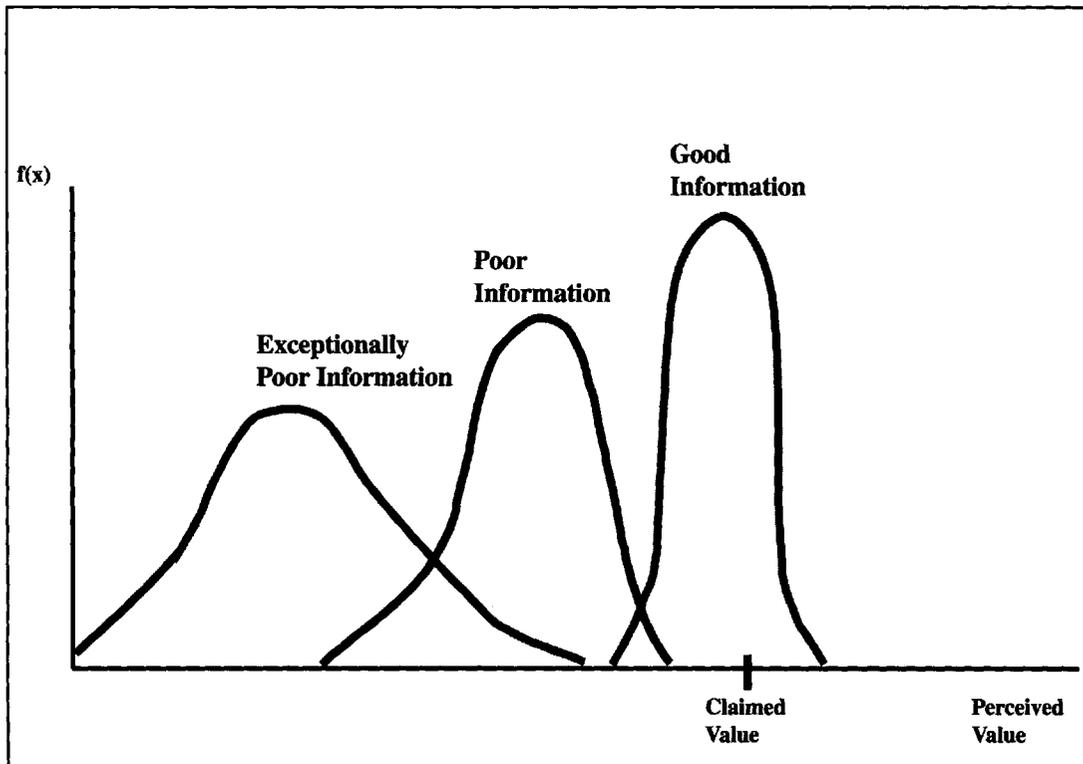
### ***Methods of Reducing Information Asymmetries***

Reducing information asymmetries is one of the most effective ways of ensuring that optimal investment decisions are made. The information that is available to insiders, if they could communicate it credibly, would be of great value to the investment community and would be reflected in the value of the firm's shares and other securities. A number of mechanisms have been developed to communicate insider information effectively and credibly. Most of these are related to the notion of signaling, that is, a firm's insiders take actions that provide a clear signal to the investment community regarding the value of its investments and investment alternatives.

With small, closely held firms or venture capital projects, such signals are often related to the investment of the owners (both in absolute terms and as a percentage of individual wealth). A major investment signal is not only the entrepreneur's belief in the value of the project but also his commitment to it. Investors can use this signal to decide which competing projects they should support (Leland and Pyle 1977). Among larger firms, the choice of capital structure, the level of capitalization, the use of hedging activities that reduce the incentives of the firm to increase risk and expropriate value from existing creditors, and the use of rating agencies provide similar signals for creditors and other claims holders (Herring and Vankudre 1987; Smith and Stultz 1985). However, larger firms whose ownership is more diverse and whose shares are traded in active secondary markets have a similar need to share information with both existing and potential equity holders. Information flows create liquidity in secondary markets that, in turn, enhances firm value.

<sup>5</sup> Insurance markets can collapse in the presence of information asymmetries, as can other financial markets that face information asymmetries.

Figure 1.4. Probability Distribution Investor Estimates of Firm Value



When information asymmetries are large, investors will place less trust in that information because they will naturally assume a higher variance of expected outcomes. Good information disclosure will lead to a perception of value that is closely related to the information provided. Poor information disclosure will result in a wider range of estimated values, which are generally inferior to the information provided. If information is considered to be of especially poor quality, investor estimates will deviate significantly from the information provided. This is shown in figure 1.4. Higher perceptions of information uncertainty will thus be costly to the firm because both debt and equity costs will be higher.

One of the critical determinants of how well a firm is able to maximize its value is its ability to eliminate information asymmetries. This requires a commitment by the firm's owners and management to provide investors and potential investors with needed information on a timely basis. Complete information should be provided in annual financial statements, but additional information that relates to significant changes in the financial condition of the firm (both positive and negative) should be released to the public throughout the year. In some countries, the public disclosure of financial information is mandated by law, but the willingness of the firm to provide complete information is often taken as a signal of the quality of the information.

### **Adopting Global Accounting Principles and Auditing Standards**

Perhaps the most important tool for reducing the gap between claimed and perceived value is to improve accounting principles and auditing standards. Although an accounting model is of necessity an abstraction of a firm's true value, when the standards are well known and consistently applied, the investment community is able to interpret properly the financial position of the firm (as demonstrated by the tight distribution shown in figure 1.4.). If Latin American and Caribbean firms wish to obtain the benefits of a modern information environment, they must assure investors that their disclosure standards are equivalent, if not identical, to global standards. Any deviations from these standards will increase the uncertainty within the investment community and prevent firms from realizing the potential lower cost of capital.

As the pace of globalization accelerates, companies, investors, regulators, and auditors alike recognize the merits of improving financial disclosure. Demand for accurate financial information is fueled by the need to raise capital in overseas markets, diversify investment options, ensure the safety and soundness of domestic financial markets, and prepare and audit financial statements. These activities are generating a strong interest in developing and applying globally acceptable accounting standards to provide meaningful, comparable, and reliable financial and economic information on enterprises worldwide.

Changes in the market create new demands for financial information; the environment in which accounting standards have been historically developed is therefore being challenged. Accounting standards traditionally have been conditioned by national factors, reflecting the economic, legal, political, and cultural environment within which they operate. For example, the structure of financial markets, whether historically dominated by the banking system or capital markets, has influenced domestic financial reporting systems by favoring the information needs of creditors versus investors. Similarly, different legal systems, which may require that accounting standards be established by law or through a private sector rulemaking body, affect the standard-setting process and content of a country's accounting principles. Furthermore, national economic conditions greatly influence the development of accounting standards, as has been the case with inflationary pressure and price fluctuations in Latin America and the Caribbean.

Although national factors are likely to continue shaping accounting standards and practices, it is recognized more and more that promulgating globally acceptable accounting standards can facilitate cross-border transactions and enhance the quality of accounting in an increasingly integrated economic environment. The international harmonization of accounting standards should improve the comparability of accounting information around the world and reduce the confusion that often arises in cross-border financial reporting. Many important accounting areas are difficult to reconcile on an international basis, including goodwill, depreciation, deferred taxes, discretionary reserves, foreign currency transactions, fixed asset valuations, pensions, leases, consolidations, and financial disclosure requirements (Anderson 1993). Greater comparability of accounting standards worldwide would lead to better analysis of financial statements and improve the decisionmaking of investors and creditors. Furthermore, globally acceptable accounting standards should save time and money for corporations seeking capital in international financial markets because they would no longer have to prepare multiple sets of financial statements to enter foreign capital markets.

The International Accounting Standards Committee (IASC) is dedicated to harmonizing accounting standards. A private sector body, the IASC was formed in 1973 by an agreement between leading professional accounting organizations from ten countries. It is charged with formulating and publishing international accounting standards (IASs) and procedures relating to the presentation of financial statements. These standards and procedures, which are expected to be transparent, comparable, and accepted worldwide, are not legally binding but are intended to be adopted by interested parties. The IASC now represents more than 120 accounting bodies in eighty-nine countries, including sixteen countries in Latin America and the Caribbean.<sup>6</sup> Several countries that do not belong to IASC also use IASs. Additionally, approximately 370 multinational companies and international financial institutions use IASs in their annual reports, and most of the world's stock exchanges accept them for cross-border listings (except the major exchanges of Canada, Japan, and the United States). Of those business enterprises that use IASs in preparing their financial statements, eleven are from Latin America and the Caribbean.<sup>7</sup>

To date, the IASC has issued thirty-three standards that deal with topics affecting the financial statements of business enterprises, including a core set of standards that may be used for reporting in cross-border securities offerings (table 1.1.). According to IASC's 1997 work plan, additional issues under review by the IASC as part of its standard-setting process include agriculture, discounting operations, employee benefits, recognition and measurement of financial instruments, impairment of assets, insurance accounting, intangible assets, interim financial reporting, leases, and provisions, contingent liabilities, and contingent assets (IASC 1997b).

Currently, the IASC is working to establish a core set of international accounting standards, which it expects to issue by the end of 1998. Since 1995, the technical committee of the International Organization of Securities Commissions (IOSCO), representing securities market regulators from around the world, has been working with IASC to develop its core standards. The work program agreed to in 1995 sets forth the areas that the IOSCO believes that the IASC must address in order to complete the core set of standards. The IASC is seeking the endorsement of IOSCO for its core standards for cross-border offerings and listings in capital markets. The intent is for this endorsement to secure the subsequent acceptance of the core standards by securities regulators from leading capital markets that do not already permit cross-border listings using IASs: namely the United States, Japan, and Canada. Furthermore, IOSCO's approval of the standards would encourage their acceptance by national accounting standard-setting boards and the global business community.

Several regional political entities have lent their support to the IASC to improve coordination among national standard-setting bodies within a particular region and to promote the global harmonization of accounting practices. For years the European Union (EU) Commission has been working through a process of mutual agreement to harmonize the accounting standards of its member countries. However, in 1995 the EU Commission adopted a new policy regarding harmonization. Recognizing the economic inefficiencies and the potentially lengthy time requirements of setting regional standards, the commission announced that it would not issue any new directives on accounting matters or

<sup>6</sup> Latin American and Caribbean countries with professional associations that are members of IASC include Argentina, Bahamas, Barbados, Bolivia, Brazil, Chile, Colombia, Dominican Republic, Ecuador, Jamaica, Mexico, Panama, Paraguay, Peru, Trinidad and Tobago, and Uruguay (IASC 1996).

<sup>7</sup> According to the IASC (1997a), eleven enterprises in the Bahamas, Barbados, Brazil, and Mexico report using IASs.

**Table 1.1. IASC Standards, by Topic**

ISA number	ISA topic	ISA number	ISA topic	ISA number	ISA topic
IAS 1	Presentation of financial statements	IAS 12	Income taxes	IAS 23	Borrowing costs
IAS 2	Inventories	IAS 13	Replaced by IAS 1 (July 1998)	IAS 24	Related party disclosures
IAS 3	Replaced by IAS 27	IAS 14	Segment reporting	IAS 25	Accounting for investments
IAS 4	Depreciation	IAS 15	Information reflecting the effects of changing prices <sup>a</sup>	IAS 26	Accounting and reporting by retirement benefit plans <sup>a</sup>
IAS 5	Replaced by IAS 1 (July 1998)	IAS 16	Property, plant, and equipment	IAS 27	Consolidated financial statements
IAS 6	Replaced by IAS 15	IAS 17	Accounting for leases	IAS 28	Accounting for investments in associates
IAS 7	Cash flow statements	IAS 18	Revenue	IAS 29	Financial reporting in hyperinflationary economies
IAS 8	Profit or loss for the period, fundamental errors and changes in accounting policies	IAS 19	Retirement benefit costs	IAS 30	Disclosures in financial statements of banks and similar financial institutions <sup>a</sup>
IAS 9	Research and development costs	IAS 20	Accounting for government grants and disclosure of government assistance	IAS 31	Financial reporting of interests in joint ventures
IAS 10	Contingencies and events occurring after the balance sheet date	IAS 21	Effects of changes in foreign exchange rates	IAS 32	Financial instruments: disclosures and presentation
IAS 11	Construction contracts	IAS 22	Business combinations <sup>a</sup>	IAS 33	Earnings per share

<sup>a</sup> Indicates IASs not considered part of the IOSCO "core" standards for cross-border capital transactions and listings.  
Source: IASC 1997a.

establish a European accounting standards board. Instead, the commission would work to harmonize current directives with the IASs and lend greater support to the IASC. Last year, in a similar vein, the Business Forum of the Asia Pacific Economic Cooperation (APEC) countries agreed to support the use of IASs for general purpose accounting guidelines in all APEC countries. More recently, the Arab Society of Certified Accountants, representing professional accountants from twenty-two countries, announced its support for the adoption of IASs for financial reporting in all of its member countries by 1998.

### ***Implementing and Enforcing Global Accounting Standards***

The adoption of globally acceptable accounting standards alone is no guarantee that countries will improve transparency and disclosure. Efforts must be made to ensure that those accounting standards are interpreted and applied correctly and consistently and that the proper forum to assess concerns over alternative treatment of accounting standards is established. Recognizing this need, the IASC established a standards interpretation committee in 1997 to review accounting issues that are likely to receive “divergent or unacceptable treatment in the absence of authoritative guidance” and to reach a consensus on the appropriate accounting treatment of IASs. The challenge before the committee, among other items, is to ensure that these international standards are generally acceptable, such that the accounting community is thoroughly conversant in the principles and is in agreement with their application.

Providing authoritative support for accounting principles, an important element in the implementation process, will also require strong support from the local standard-setting and auditing communities and other stakeholders. Countries introducing new standards into their financial reporting systems will need to educate both preparers and users of financial statements in the new standards by addressing different cultural, legal, and linguistic approaches to implementation. The international auditing practices committee of the International Federation of Accountants (IFAC), the global organization for the accounting profession, which is responsible for preparing international standards on auditing, has a key role to play in this process.

The same is true of IFAC's education committee and other groups that promote education and training for the accounting profession. Similarly, efforts to incorporate a monitoring system for the practice of accounting as a profession, such as the self-regulating method used by the American Institute of Certified Public Accountants (which monitors auditors' conformity with professional standards and ethics through a peer review program), should be carefully considered. Policies and programs such as these will help to ensure that globally acceptable standards are interpreted consistently and fairly, thereby contributing to the efficiency of the capital formation process, and that the standards are enforced properly by the regulatory community to protect the public interest.

Along with the activities of the standards interpretation committee, the IASC plans to address differences between international and national accounting standards, determine what role the IASC should play in education related to accounting standards, and consider the particular needs of developing countries and smaller or nonlisted companies. The IASC working group charged with these activities is expected to issue a report in 1998.

Recognizing the merits of globally acceptable accounting standards, many public and private institutions support efforts to develop global standards. At their 1996 meeting in New Orleans, the finance ministers of countries participating in the Summit of the Americas agreed to “promote efforts to develop, revise, and raise national [accounting] standards to reflect important market innovations.” In addition, they agreed to “support ongoing efforts by securities regulators and the accounting profession to develop high-quality standards that are acceptable on a global basis” (Joint Communiqué, Summit of the Americas, May 18, 1996).

In a recent survey on financial disclosure and global accounting standards in Latin America and the Caribbean, conducted by the Infrastructure and Financial Markets Division of the Inter-American Development Bank, most countries in the region signaled

their support of efforts to develop and use globally acceptable accounting standards of some type, whether it be their complete adoption or their adoption in combination with local standards.<sup>8</sup> When asked whether they considered the accounting standards in their countries to be strong enough to assure the fair presentation of the financial position and operating results of companies, only individuals in a couple of countries responded affirmatively without qualification. The majority of respondents stated that their countries' local accounting standards, in principle and in particular for certain types of firms (financial institutions or public companies), were sufficient but that, in practice, weaknesses existed. Respondents cited problems with implementation due to a lack of, or weak, interpretative capability and regulatory infrastructure and problems with the enforcement of proper usage and consistent application of accounting and auditing standards. Furthermore, several individuals noted that local standards were less detailed than either the IASs or the U.S. generally accepted accounting principles (GAAPs) and that international markets therefore preferred financial statements prepared according to U.S. GAAPs or the IASs.

To strengthen their accounting systems, many countries have incorporated, or are considering incorporating, globally recognized standards, such as the IASC's international accounting standards or U.S. GAAPs, into their own domestic standards, but only a few expect to replace domestic standards with globally acceptable standards.<sup>9</sup> More than half of the respondents commented on changes being proposed to strengthen global accounting standards and noted several issues of great concern, including accounting for financial instruments, asset valuation, deferred taxes, depreciation, and inflation accounting, among others. Similarly, they expressed concerns regarding the interpretation and enforcement of global standards, especially for countries requiring legal changes to incorporate them. When asked whether the users of financial statements express scepticism regarding the quality of accounting standards in their countries, most respondents replied negatively; however, approximately one-fifth stated that international investors and creditors question the use of a few accounting principles, while others question the accuracy with which local and foreign or international principles are applied.

Many respondents emphasized the need for flexible accounting standards to meet their countries' particular operational environment, while simultaneously recognizing the economic and financial benefits of adopting global standards. A few respondents, however, noted that global standards should be strengthened and that alternative approaches made available through interpretation should be reduced. Nearly all of the countries re-

<sup>8</sup> Approximately 400 surveys were sent to senior officials in both public and private sector organizations in twenty-three countries throughout Latin America and the Caribbean. The Inter-American Development Bank received responses from eighty-seven individuals in more than twenty-one countries. Responses were drawn from diverse institutional settings, with viewpoints (not necessarily official) coming from government (regulators of banks, pension funds, and securities markets as well as officials in the finance ministry and the central bank); accounting standard-setting bodies and other related professional or academic associations; external auditors; and businesses (banks and other financial institutions as well as the energy, transportation, and service sectors).

<sup>9</sup> Countries reporting complete adoption of the IASC accounting standards include the Bahamas, Guyana, and Trinidad and Tobago. The territories of the Organization of Eastern Caribbean States, which do not maintain their own local accounting standards, use either foreign standards (promulgated in Canada, the United States, or the United Kingdom) or the IASs, depending on the standards enforced by the foreign or international organization of which statement preparers are members or the foreign market a business entity is attempting to enter. Three countries (Costa Rica, El Salvador, and Venezuela) also report using aspects of Mexico's GAAPs to support their local accounting standards.

sponding to the survey underscored the importance of harmonizing global standards to facilitate comparability of financial statements; strengthen communication among analysts, investors, auditors, and companies; improve investor confidence; increase local investment and access to overseas markets; and enhance the efficiency of the auditing and regulatory communities. Many persons responding to the survey stressed that the benefits outweighed the costs of making such a transition to global standards, while recognizing that the costs, at least in the short term, could be significant. Several respondents noted that the education process for the users and preparers of financial statements alike would be great. The same is true of revising existing (or developing new) information systems to accommodate the changes brought about by new standards. In addition, a few individuals noted that such changes might reveal an undesirable financial picture for companies restating their financial statements under revised accounting standards and might place a burden on small companies that do not usually prepare information in as much detail as expected under globally acceptable standards. Both scenarios would likely result in some level of political resistance to such a transition.

Recognizing the benefits of improved accounting and auditing standards, countries throughout the region are considering or are already in the process of taking the following steps to implement change: introducing legal reforms to establish or reform standard-setting bodies and securities regulatory agencies; establishing public registries that maintain information on companies and external auditors; revising accounting and auditing standards and practices; providing education programs on new standards to regulators, auditors, and the business community; strengthening enforcement mechanisms through legal liability standards; and enhancing harmonization activities related to standards among regional economic groups (such as MERCOSUR and the North American Free Trade Agreement) and international organizations. Through greater cooperation among regulators, national standard-setters, and the business community, benefits arising from these legal, institutional, and educational changes are expected to be realized by the countries committed to improving their accounting policies and auditing practices, in particular, and financial disclosure, in general.

### ***Adopting Globally Compatible Disclosure Requirements***

The adoption and implementation of globally accepted accounting standards are only the first steps in the creation of an enabling information environment. Global standards provide consistent rules that improve the ability of boards of directors and senior management to manage a firm. When presented to the market, improved information also enables external financial analysts to interpret the financial information they use to recommend investments or the extension of credit. For those decisions to be effective, the information must be made publicly available. It is not sufficient that management, regulators, or rating agencies have access to complete information. The information must be available to the markets, to current and potential investors, to current and potential creditors, and to others who use financial information to make important decisions with respect to the firm.

Although there is an important line between information owned by the firm and other information whose disclosure might hurt a firm's competitive position in general, the requirements for information disclosure in Latin America and the Caribbean are well below global standards. For example, in the United States, firms are required to disclose detailed information regarding pension commitments, market and credit risk concentra-

tions, transactions with related parties (including loans to directors and employees), and information regarding short-term debt and credit lines. Similar disclosure requirements do not exist in most countries in the region.

### **Impact of the Information Environment in Latin America and the Caribbean and Obstacles to Improvement**

There are numerous examples where incomplete information or the lack of credible information on an economywide basis had a negative impact on virtually all firms in a country. Although the precise impact of information problems cannot be separated from the impact of other economic problems, there is no doubt that information problems added to the crisis. In Latin America and the Caribbean, informational asymmetries have exacerbated financial crises. Likewise, there is preliminary evidence that improved information disclosure has lowered the cost of capital.

In Mexico, following the economic crisis of 1994, there was considerable uncertainty regarding the value of bank assets. Mexican accounting rules at that time allowed banks to account as “past due” only the payments that were past due, not the entire loan. In addition, there was a common practice of rolling over loans—lending a problem creditor just enough money to make the interest payment. Foreign analysts estimated that, on average, past due loans needed to be tripled to account for these two practices (compared with U.S. standards). Using this rule of thumb, at the time of the crisis, calculations showed that nearly all banks had estimated past due loans well in excess of shareholder equity. Liquidity for the banking system dried up. Although some banks were indeed in trouble and needed official assistance to survive, banks that had been managed more prudently were unable to convince markets that they were in acceptable financial condition because of the poor information environment. A change in accounting standards, including the adoption of global standards for the treatment of past due loans, was required.

Venezuela is one of the few countries in the western hemisphere that is in the process of harmonizing its accounting standards with global standards. Unlike many of the countries that are being pushed toward adopting global standards by policymakers or professional accounting bodies, in Venezuela, the private sector is pressing for changes in accounting standards. The corporate sector is limited in its ability to obtain external financing because the information environment is not considered credible. Recognizing that improved information, along with more rational macroeconomic management, is critical for rebuilding confidence among foreign and domestic investors, it appears that policymakers may support the corporate sector’s desire to see accounting and auditing standards improve.

A few years ago, Argentina’s stock exchange initiated a voluntary program of conducting open discussions between local financial analysts and firm managers. Participating firms have, on average, noted a risk-adjusted increase in price following the meetings. It is still too early to tell if these changes are permanent enough to reduce market volatility, but the tendency is promising.

This chapter makes several strong claims regarding the value of improving disclosure through the adoption of global accounting principles and auditing standards. Their adoption will reduce the cost of capital for an individual firm, allow financial markets to function more effectively, and help allocate funds toward investment opportunities that promise the highest return on a risk-adjusted basis. Why, then, have countries and firms

not already adopted these standards? Several reasons are cited. First, the adoption of global accounting and auditing standards is costly. More particularly, the transition costs associated with moving to new standards (including implementing standards; educating managers, auditors, and investors regarding the new standards; developing or modifying information systems; and so forth) are high. The costs may appear particularly high to those firms whose shares or debt instruments are not currently traded on financial markets. The transition may also be perceived as particularly expensive for firms that might be in violation of some loan or bond covenant, whose income would be reduced significantly or whose level of capitalization would be reduced (or disappear altogether) under global standards.

Second, firms that deal with the public (especially banks and other financial institutions that are still recovering from crises) may be hesitant to reveal their true financial condition because of the ensuing lack of confidence. Third, many countries (especially those that have suffered long bouts of inflation or are facing other conditions particular to their economic, legal, or regulatory environments) believe that they need to develop their own standards. Fourth, there is little incentive to move toward global standards when international financial markets are closed and, in many countries, standards do not keep up with international changes.

Related to the last point, government financial institutions tend to develop when financial markets are closed (to counter the result of claimed “market failures”). To the extent that these institutions do not make decisions based on purely financial criteria, the incentive for providing good information disclosure is reduced. Finally, until the IASC began the process of upgrading its standards, there was no “international” standard. There were only country standards—some better than others—and few countries were willing to fully adopt the standards of another country.

The development of high-quality international standards provides the opportunity for countries to move forward rapidly. The existence of open markets, the need for new investment funds, and the demands of investors for greater disclosure are encouraging companies to provide more and better information. The multilateral community can assist in this process by financing some of the transition costs and helping government policymakers and leaders in the private sector to understand the long-term benefits of these changes.

## **Conclusions**

The creation of an information environment is part of a virtuous cycle of growth and development. The availability of high-quality, timely, and credible financial information is a prerequisite to the development of liquid and deep financial and capital markets, which leads to a lowering of the cost of capital, the possibility of more optimal capital structures, and ultimately higher levels of investment. This, in turn, leads to higher levels of economic growth and new types of markets and innovations, all of which have new information requirements. The cycle repeats itself as investors and firms together continue to exploit the synergies associated with reducing information asymmetries. Much of the Latin American and Caribbean region is in the early stages of this cycle.

Firms in the region need better access to capital markets. They need to improve their ability to manage risks. This ability to manage risk and access capital markets is premised on a functioning information environment that is based on disclosure requirements set at international levels. Achieving this will require firms, other market partici-

pants, and government policymakers to recognize that they will have to work together. The Inter-American Development Bank conference was organized to highlight the need for better information, to examine the steps that various groups are taking, and to receive feedback on increasing these efforts to improve financial disclosure and the role that the multilateral community can play in supporting these changes.

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# CORPORATE FINANCIAL DISCLOSURE AND FINANCIAL MARKET DEVELOPMENT

FREDERICK D. S. CHOI

*Increasing disclosure of information by means of general publication must be accepted as the essential prerequisite of the maintenance and further development of any efficient capital market and should be the chief aim of any legal and institutional policy. [Newbould 1967:47]*

Given the strategic role that capital plays in the economic development process, activities that *facilitate* and *improve* the flow of capital both within and between national boundaries are essential. Underlying this viewpoint is the premise that both economic development and economic welfare will be improved if impediments to the accumulation and free flow of capital are reduced. If capital resources are not provided to industries capable of increasing productivity, economic growth rates will inevitably suffer (Baumol and Blinder 1982).

## **Information and Efficiency**

In a consumption-oriented society, the process of capital formation consists of (1) postponing current consumption and (2) allocating resultant savings to productive users of such resources. The ultimate motivation behind this process is to increase consumption streams in the future.<sup>1</sup>

In a planned economy, this transfer of savings from consumers to producers is largely determined by government edict. In a free enterprise system, however, individuals decide whether to spend or invest their income. In view of this, two major conditions must hold for capital formation to occur: first, an environment that encourages individuals to save and, second, forces that assure that these savings are channeled to their highest and best use (Bodie, Kane, and Marcus 1996). The fulfillment of these conditions is facilitated by the emergence of financial markets that provide investors with liquid claims on the returns of the enterprise in which savings are invested and that create a process for assuring that the prices of these financial assets are related to changes in the prospects of the borrowing entity.<sup>2</sup> The latter, in turn, is related to the notion of market efficiency.

<sup>1</sup> Although capital formation essentially sacrifices current consumption for greater future consumption, in a money economy this process inevitably involves intermediate exchanges of money or its equivalent. To an individual, the act of investment involves the exchange of current for future money income.

<sup>2</sup> In its broadest sense, the term "financial markets" refers to all of the institutional arrangements and instruments through which savings are pooled and made available for real investment (such as physical capital investment).

Financial markets can help to achieve efficiency in the allocation of an economy's scarce capital resources by assuring that savings are directed to investors who promise to use them effectively. They also contribute to operational efficiency by assuring that the allocation of capital is carried out with minimal costs of transfer (West 1981).

### ***Information and Allocational Efficiency***

The link between financial information and allocational efficiency is the price of a firm's financial assets. At any point in time, the price at which funds are exchanged between consumer-savers (investors) and corporate issuers is determined by the forces of supply and demand. As demanders of financial assets (securities), investors entertain different expectations of the financial returns to be gained from securities of different qualities. The prices of particular securities rise or fall under the influence of these expectations. And securities prices, which reflect the receptivity of market participants to a firm's security offerings, establish both the volume and cost of capital raised (Ross and others 1996).<sup>3</sup>

If a firm's economic prospects appear promising, buyers will bid up the security's price. To the extent that the offering prices of new securities are dependent on the current level of the firm's outstanding shares, higher prices of current shares will enable the firm to realize larger proceeds from subsequent issues for any given level of promises inherent in the security offering. And, to the extent that the price-to-expected-earnings ratio is increased, the firm will experience a reduction in its cost of capital. For the economy as a whole, higher security prices will increase the net proceeds of a security offering, thus making possible a higher rate of capital investment, growth in national income, and economic welfare.

Security prices are a function of investor expectations, and rational expectations depend on available information regarding the financial and economic prospects of the issuer. Information, an essential ingredient of investor expectations, thus assumes an important role in financial markets.<sup>4</sup> By assuring that security prices are, in part, a reflection of a firm's past and expected performance, financial information helps to ensure that capital will be more abundantly and cheaply available to corporate issuers who show promise of putting it to its best use and will be denied to inefficient ones.

### ***Information and Operational Efficiency***

To obtain the greatest level of capital formation from a given reservoir of consumer savings, the capital market structure must be such that capital market institutions do not siphon off too much of the pool of investible savings for performing their role and that investors are not overly rewarded for providing the money capital.<sup>5</sup> Failing this, a less-than-optimal amount of investible funds will be available to be converted into physical capital.

Competition among capital market participants assures the first requirement. Two conditions help to assure the second. First, the investor must be free to forgo or postpone

<sup>3</sup> For firms that finance their capital requirements internally, the willingness of shareholders to defer dividend returns in the expectation of realizing higher returns via capital appreciation of their shares establishes both the volume and cost of the capital raised.

<sup>4</sup> Accounting information also plays a validating role by allowing investors to compare actual with expected results and to revise and sharpen their forecasts going forward.

<sup>5</sup> Overly rewarded means more than would be necessary to encourage the investor to invest if he were provided with what he considers to be all available information regarding the investment.

consumption for intervals of time that are shorter than the lives of the physical assets in which the borrowing entity invests. This is accomplished by the development of secondary trading markets that provide liquidity to investors. Second, investors must be relatively free from undue risk resulting from the lack of information, fraud, or deception on the part of those responsible for the stewardship of their contributed savings. Unlike persons in a firm's employ, external investors in a firm's securities are seldom in a position to observe whether their interests are being promoted or prejudiced.

As outsiders, security investors cannot economically gather the information necessary to judge a security's merits. The result is that either investors will not search out the necessary information to invest in financial assets or they will search only to the extent that the perceived benefits from doing so exceed the costs incurred.<sup>6</sup> Such benefits would be manifested in higher expected returns demanded by prospective security holders. The costs to corporate issuers of securing external funding would increase as a result.

From an economy's standpoint, the overall effect would also be less than optimal. The absence of external financing or its availability at excessive costs would mean that firms would have to turn down what would otherwise be acceptable capital investments. This would tend to lower aggregate investment with all the attendant consequences for economic growth and welfare.

Belief in the implicit value of information about corporate issuers for security investors and the economy as a whole has prompted capital market institutions in most countries to require that information regarding the economic features and financial policies of borrowing enterprises be made accessible to the investing public. To help assure that such representations are not fraudulent or deceptive, most capital market institutions also require that the integrity of such information be attested to by independent auditors.

### *Financial Information via Enterprise Statements*

Many types of information influence investor expectations: information regarding capital market institutions, the characteristics of various types of securities, the state of the nation's economy, international trade balances, and the political climate. Information about a firm's industry is also relevant, as is information on dividends and interest paid by a firm in the past together with data regarding the past and present market prices of its securities. However, these data are not sufficient to make informed investment choices because investors are ultimately interested in individual firms. They need to know whether a firm's record of past performance and its present position will enable it to benefit from whatever conditions they expect to arise in the firm's industry and country. To cite just one example, analysts often use the ratio of a firm's profit margin— $\text{income/sales}$ —to forecast future earnings. Because sales are correlated with certain macroeconomic variables such as a country's gross national product (GNP), government-supplied forecasts of GNP enable analysts to project future sales and, hence, earnings. However, an accurate earnings projection depends on the makeup of a firm's expenses. A preponderance of fixed versus variable costs will typically result in an income forecast that increases more than proportionately with a given increase in sales.

To summarize, the process of security analysis involves the continuous synthesizing of data inputs that describe the state of the economy and the state and trends of the

<sup>6</sup> This search would also involve recourse to other sources of information about a firm, which are seldom costless.

industries of specific firms and of the firms themselves. Security analysis also involves formulating expectations of future returns to be received from investment in the firm's equities. Regardless of the analytical tools employed by the investor and whether he makes his own analysis or hires a professional, the set of economic facts available at the time of choice are essential ingredients with which to formulate expectations for the future.

Disclosure of financial information, via published financial reports, is imperative for financial markets to meet their acknowledged economic functions effectively. In its absence, investors would have to resort to indirect means of acquiring data regarding a firm's financial performance. There would then exist the strong possibility that security investors would buy and sell on the basis of rumor, guesswork, or the tactics of market manipulators rather than on the substantive capacities of security issuers. Alternatively, they will not invest at all. If securities are not valued on the basis of the capitalized value of a company's expected return streams, it is unlikely that investors will be in a position to distinguish rationally between potentially successful and potentially unsuccessful firms. If this situation prevails, then only by chance will capital funds be channeled to their most productive employment.

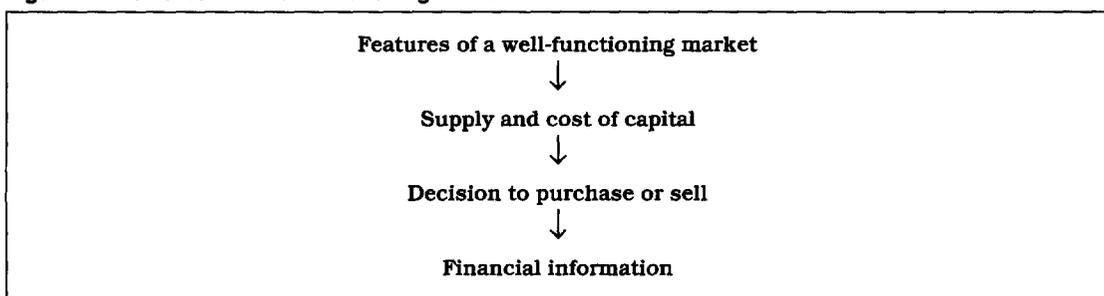
### **Financial Disclosure and the Development of Broadly Based Financial Markets**

We have established that the institutional requirements of financial markets are premised on the notion that an efficient capital market is dependent on a well-informed investor. However, the activities of capital market institutions indicate that they are interested not only in securing a given amount of information for investors but also in increasing the quantity and quality of information whenever possible. Part of the reason is that financial markets are dynamic. The fortunes of business enterprises are constantly changing. Updated information is required because the quality of securities is dependent on appraisals of company fortunes in the future.

There is another reason for seeking improved financial disclosure. Implicit in this viewpoint is the conviction that the performance of capital markets, in terms of access and cost, will improve if corporate financial disclosure improves.

Before proceeding, it is important to set forth several definitions. First, *financial disclosure* is defined as the publication of any economic information, quantitative or otherwise, relating to a firm, quantitative or otherwise, that facilitates the making of investment decisions. *Economic information*, in turn, is any datum that reduces uncertainty about the outcome of future economic events. Finally, *improved disclosure* involves an increase in the quantity and quality of economic information disclosed by a firm via its financial statements. The relationship between improved disclosure and a well-functioning financial market is depicted in figure 2.1.

**Figure 2.1. Features of a Well-Functioning Market**



The following discussion argues that a well-functioning financial market depends on trades in securities that are in volume and from diverse investor groups. In such markets, funds are abundantly and cheaply supplied to firms promising to make the best use of them. The cost and availability of funds are, in turn, the outcomes of investment decisions that, if they are to be rational, must be based on the information used. Moreover, the quality of investment decisions depends on the quantity and quality of the information provided. The relationship between improved financial disclosure and well-functioning financial markets is specified via the effect of improved disclosure on a firm's capital costs. That specification begins with a discussion of the investment decision process and the effect of improved disclosure on those decisions.

### ***Investment Decisionmaking***

To conceptualize investor decisions in an uncertain world, this section sets forth several assumptions describing the perceptions and attitudes of security investors toward choices involving risk (Sharpe 1985).<sup>7</sup>

- Returns from acquiring a share of stock (or bond) are viewed as a combination of the periodic dividends,  $d$ , the investor is entitled to receive each period of his investment horizon and the price,  $v$ , at which he could liquidate the security at the end of that horizon.<sup>8</sup>
- Because the liquidating value of a security is functionally related to expected dividends beyond the holding period, a security's returns are ultimately a function of future dividends.
- Because of uncertainty, the investor sees these returns as expected values of the subjective probability distributions he forecasts.
- The investor uses some measure of the dispersion of a security's expected returns, that is, the standard deviation of expected dividends,  $\sigma_d$ , the standard deviation of liquidating share price,  $\sigma_v$ , and the correlation of these returns with those of other securities as measures of risk associated with the security (Choi 1973).<sup>9</sup>
- Investors generally prefer a higher expected return for any given level of risk and a lower level of risk for any given expected return.
- The investor values a security on the basis of expected dividends.
- The distribution of expected dividends is dependent on the distribution of the firm's expected income stream,  $y$ .
- Whatever the variance of the conditional distribution of dividends given income is, and whatever it is a function of, the distribution of dividends will become less disperse as the distribution of expected income becomes less disperse.

<sup>7</sup> The following draws on contributions in the area of investment behavior under conditions of uncertainty.

<sup>8</sup> The term *dividends* refers to any monies paid to the holder of a security as a consequence of ownership. This money stream may include things such as regular cash distributions that bear some proportion to the size of the investment commitment, liquidations of dividends or interest, and whatever else the firm decides to pay or is obligated to pay the holder now and in the future.

<sup>9</sup> In the case of a single security, the standard deviation of a security's expected return is commonly used as a measure of a security's riskiness. Portfolio theorists argue that such may not be the case when a security is placed in a portfolio of securities that emphasizes the covariance of a security's return with that of another security or portfolio of securities. In another piece, I show that (1) the value of a security in the context of capital asset pricing can still be related to its own standard deviation of returns,  $\sigma_d$  and  $\sigma_v$ , (2) the value of a security in the context of capital asset pricing is inversely related to  $\sigma_d$ , and (3)  $\sigma_d$  and  $\sigma_v$  are important.

Expectations of a firm's income,  $Y$ , are a function of several kinds of data. These data relate to the performance of the company,  $I_i$ , the industry of which a firm is a part,  $I_N$ , and general economic factors,  $I_E$ . Moreover, the distribution of income in the mind of the investor is dependent on a set of distributions of these data. Since the value of a firm's shares is a function of investors' expectations about the firm's performance, and the latter is a function of information regarding the individual firm and its environment, the value of the firm can be redefined in terms of the information used. Thus, the predisclosure value of firm  $i$  can be expressed as a function of the distribution in the mind of investor  $j$  of all of the previously mentioned information vectors. Symbolically,

$$(1) \quad {}_jV_{IN} = K({}_jI_i, {}_jI_N, {}_jI_E).$$

### **Information and Value**

The relative weight that an individual places on each of the information variables in equation 1 in assessing the investment value of a security is presumed to be dependent on the confidence he places in each type of information. Thus, if an investor is suspicious of firm  $i$ 's accounting data,  $I_i$ , but is quite confident of the validity of industry data,  $I_N$ , then he places more weight on industry data to guide his investment behavior with respect to that firm. In contrast, if he is convinced that the firm data he receives are very good relative to the data of the industry, he can be expected to be less concerned with industry statistics than with information about the firm. Consequently, in appraising the future performance of the enterprise, an investor probably relies less heavily on industry information than on firm information if his confidence in the former is less than his confidence in the latter.

When a firm improves its disclosure, data about itself should become more reliable. An individual can thus place greater weight on such data in making judgments with respect to the firm. Consequently, if a firm is better than the industry average and knows that the information released is better than industry statistics, then it would always be in its favor to increase the weighting that investors place upon  $I_i$  relative to  $I_N$ . In short, it would be to the competitive advantage of a company that is better than the industry to distinguish itself from the average firm comprising that industry.

Now, say that a better-than-average firm increased its disclosure and that the information revealed was close to what people expected. Although such information may not be surprising in that it is close to the mean of everyone's expectations, investors are now less uncertain about their decision variables than before. That is, the variance of their subjective distributions is lowered, which would, in terms of our earlier discussion, exert a positive bias on share valuations.

The additional effect of a reduction in the dispersion of investors' subjective estimates, however, is that such individuals would now place greater credence on these estimates than before. The more credible the information, the more weight would be placed on it. Investors would thus place a higher value on the shares of firm  $i$ , which is above the industry average.

### **Effect of Improved Disclosure on Financial Markets: The Evidence**

According to the foregoing model, improved firm disclosure will entice an individual to alter the amount paid for a given security. Higher security prices, for example, would

mean that a primary security issue could be priced higher and, other things remaining the same, would increase the net proceeds available to the firm. Or, for any given price, the investor would be willing to purchase a larger number of shares given his present stock of investible funds. In either case, the firm would experience larger receipts from a given issue and hence experience a lower cost of capital.

In earlier work on this subject, I examined whether there is any empirical support for the notion that improved disclosure facilitates a firm's access to external financing or lowers its cost of capital (Choi 1973). The setting selected as a test environment was the Eurobond market, which is relatively unregulated and, during the study period, was the low-cost source of corporate funding (Choi and Levich 1990). Because investors participate in security transactions that represent for them foreign assets, ultimate claims against borrowing firms are typically made outside the legal jurisdiction of the security holder. The wide geographical coverage of the market, arising from the international syndication and distribution of Eurobonds, makes the concept "market of issue" quite vague. It also renders impractical attempts to control the market.

Arguing that there is a competitive value to voluntary corporate disclosure, I hypothesized that continental firms vying for access to this relatively unregulated and competitive international market would significantly increase their financial disclosure on entry. The concept of disclosure was operationalized by means of a disclosure index quantifying the types of data disclosed by corporate borrowers that are deemed relevant to investors. Improved disclosure was defined as positive changes in the quantity of corporate data disclosed.<sup>10</sup>

Measured increases in disclosure in the sample of Eurobond entrants were examined three years prior to and a year after market entry relative to changes in the disclosure practices of a control group of reporting entities that did not enter the market. Firms were matched according to their relative size, industry, and national origin to ensure that observed improvements in disclosure were not influenced by extraneous factors.

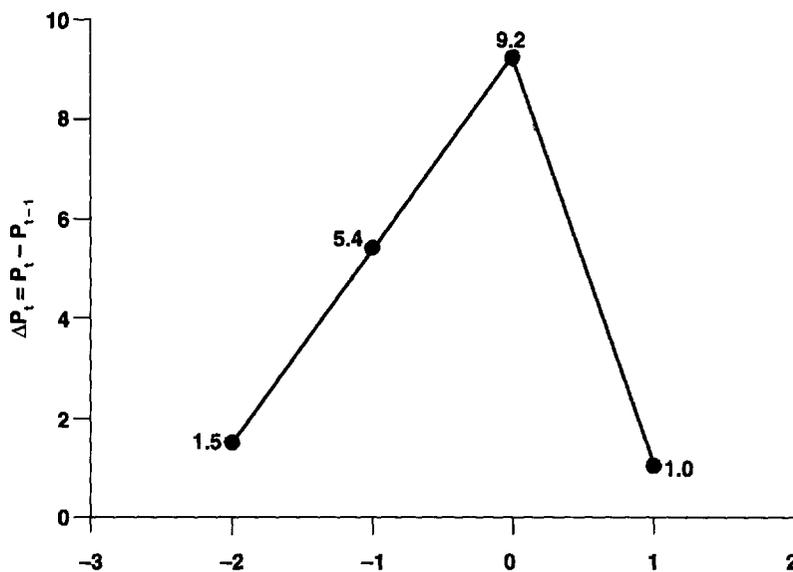
Firms entering the Euromarket significantly increased their disclosures upon entry (that is, their positive changes in disclosure were significantly greater than those of the control group of nonentrants). Positive changes in disclosure were related to performance forecasts, geographic disclosures, capital expenditures, both past and planned, research and development activities, foreign currency translation methods, earnings per share statistics, funds and cash flow statements, and financial and operating trend statistics. The pattern of changes in disclosure is also interesting. As illustrated in figure 2.2, positive changes in disclosure on the part of Eurobond entrants started prior to—and generally peaked during—the year of entry.<sup>11</sup> Disclosing firms apparently considered successful entry of such importance as to begin selective improvements in their financial communications with the investing public prior to entering this international financial market.<sup>12</sup>

<sup>10</sup> The disclosure index contained a listing of accounting and related information about a firm and its reporting environment that is deemed relevant to international investors. Items selected for inclusion in the index were obtained in the following manner: (1) disclosure criteria were first derived from an investor decision framework, (2) these criteria were then applied to existing disclosure indexes published in the accounting and finance literature, (3) the disclosure criteria were also applied to accounting numbers and other corporate data revealed in a sample of foreign annual reports, and (4) a company's report was given a numerical score that was a function of the items contained in the index that also appeared in the firm's annual report.

<sup>11</sup>  $P_t$  = disclosure score of Eurobond participant's annual report in period  $t$ .  $P_{t-1}$  = disclosure score of Eurobond participant during the previous accounting period.  $\Delta P_t$  = observed change in a Eurobond participant's disclosure score during period  $t$ .

<sup>12</sup> Changes in average disclosure scores of Eurobond participants over and above their nonparticipating counterparts demonstrate a similar pattern.

Figure 2.2. Changes in the Disclosure Scores of Eurobond Participants



Meek and Gray (1989) reach a similar conclusion, but in the context of the equity market. Employing a similar disclosure measurement methodology to examine twenty-eight continental European firms with shares listed on the London Stock Exchange, they find that the sample companies exceeded the exchange's disclosure requirements through a wide range of voluntary disclosures. In some cases, the additional voluntary disclosures were substantial. These results suggest that firms find it in their interest to provide additional financial disclosure in the hope of improving the price of their shares, reducing their cost of funds, and competing with other firms for capital in the international market. In addition, firms seem to display national patterns in what they choose to disclose and not disclose. Meek and Gray highlight forecast information in Sweden, changing price information in the Netherlands, employee disclosure in France, and social reporting in Germany as particular areas of concern to firms.

More recently, Choi and Levich (1990, 1996) conducted two surveys to find out directly from financial market participants whether, and to what extent, differences in financial disclosure practices, along with differences in accounting principles and auditing practices, affect their market decisions. In the first study, they conducted interviews with fifty-two institutional investors, corporate issuers, investment underwriters, market regulators, and ratings agencies in Frankfurt, London, New York, Tokyo, and Zurich. Those interviewed had direct responsibility for decisions; that is, they were actively engaged in international investment, funding, underwriting, regulatory, and rating decisions (Choi and Levich 1990). The broad range of findings is summarized in table 2.1.

As can be seen, response patterns were not uniform among respondent categories. More than half of the institutional investors interviewed felt that accounting differences hindered the measurement of their decision variables and ultimately affected their investment decisions. Comparisons between Japanese and other companies were cited as especially difficult. Coping mechanisms among institutional investors included restating

**Table 2.1. Responses of Capital Market Participants to the Question: "Does Accounting Diversity Affect Your Capital Market Decisions?"**

Type of participant	Yes	No	Not applicable	Total
Institutional investors	9	7	1	17
Corporate issuers	6	9		15
Investment underwriters	7	1		8
Market regulators	0	8		8
Rating agencies	2	1		3
Total	24	26	1	51

Source: Choi and Levich 1990.

foreign accounting numbers to the reporting principles of the investor's country of domicile or to a set of internationally recognized standards. In terms of differences in disclosure, coping took the form of attending analysts meetings with reporting entities, attending corporate road shows, classifying low-disclosure firms as speculative as opposed to investment-grade securities, and varying their investment practices. Active stock picking involving heavy reliance on firm-specific information was adopted by some for firms providing good disclosure. A passive investment strategy was adopted for firms providing minimal disclosure. In the word of one investor:

I think that if the investor could be convinced that there is more reliable information available, he would take a more active approach and rely on individual companies. At present, this is not the case and may be why so many investors have taken a passive approach and just invested in the index. Such a development would allow analysts to come up with more reasonable forecasts. ... Within a country, if no reliable information is provided, then we stick to the well-known companies in that country and do not consider the second- or third-tier companies. (Choi and Levich 1990)

For the nine institutional investors whose decisions were affected by differences in financial reporting, such diversity did result in capital market effects. Table 2.2 reports the number of this response set (the nine institutional investors) whose decisions were so affected. These effects are reported separately for financial disclosure and accounting measurement differences.

As can be seen, financial market effects relate to the location of market activity, the types of companies invested in, and the pricing of international securities. Because of the size of the institutions surveyed, the costs of information processing were generally not considered significant. However, this was not the case for all investors. One investor described the link between differential corporate financial disclosure and market effects in this manner:

Share prices in the local market tend to be affected by local investors. Therefore, as long as local investors accept local disclosure practices, local share prices will not be affected one way or the other by disclosure differences. But, it does make a difference to the international portfolio manager. He will be fairly

**Table 2.2. Financial Market Effects of Accounting Diversity According to Nine Institutional Investors**  
(Number of investors responding)

Type of effect	From GAAP differences	From disclosure differences
Geographic spread of investments	3	3
Types of companies or securities selected	7	6
Information processing costs	2	5
Required returns or valuation	8	8

Source: Choi and Levich 1990.

nervous about a company that has limited disclosure. Consequently, their interest in those companies will be low. It's really a reliability/credibility problem. International portfolio managers, who have a limited knowledge of the local scene, will tend to favor those companies which are more forthcoming in terms of their disclosures. (Choi and Levich 1990)

In their second survey, Choi and Levich polled corporate issuers and institutional investors across Europe on the theme of accounting diversity as a barrier to the integration of European equity markets (Choi and Levich 1996). Sponsored by the Royal Institute of International Affairs and the European Capital Markets Institute, the survey consisted of questionnaires sent to 400 of the largest institutional investment firms across Europe, yielding ninety-seven completed responses. A similar questionnaire was sent to all financial corporations listed in the Financial Times 500 index, yielding eighty-eight completed responses.

Roughly two-thirds of European investors replied that accounting information was very important for selecting stocks, and large investors and those with extensive foreign investments were more likely to make this response. Many investors (85 percent) claimed to make cross-country comparisons, and those investors with greater experience or centralized operations were more likely to respond in this fashion.

As in their first survey, Choi and Levich found that European investors cope with European accounting diversity in various ways. These investors often respond to differences in financial reporting by assigning a higher risk rating, requiring a higher expected return from companies with less disclosure, or avoiding investing in them. Such responses imply a capital market effect because shortfalls in financial reporting may reduce the demand for these shares.

To round out the evidence on the positive attributes of improved financial disclosure, Dullum and Stonehill (1982) provide a case study illustrating the benefits of sourcing outside the confines of a segmented national capital market. They first argue that a firm sourcing in a segmented and illiquid market is likely to have a higher cost of capital than if it had access to international markets.<sup>13</sup> At the other extreme, a firm having access to a fully integrated capital market enjoys a lower cost of capital because it may reflect the international price of risk. The latter is based on empirical studies showing that, if eco-

<sup>13</sup> A segmented market is one in which required returns on securities traded in that market differ from those on securities of comparable return and risk traded in other national markets.

nomic activities are less than perfectly correlated among countries, investors can improve their portfolio performance by diversifying internationally. Adding foreign securities to domestic portfolios reduces that portfolio's systematic risk (Beta). Thus, required returns on internationally traded securities should reflect their higher value to internationally diversified portfolios, rather than just their value to local investors in the company's country of domicile.

This was the situation facing Novo, a Danish multinational firm producing industrial enzymes and pharmaceuticals. The shortage and high cost of equity capital resulted in a higher cost of capital (a price/earnings—P/E—multiple of around 5) than rival firms Eli Lilly (United States), Gist-Brocades (the Netherlands), and Miles Laboratories (a U.S. subsidiary of Bayer, Germany). A major obstacle to funding outside the Danish market was a disparity in Novo's information base. Having been a closely held firm for many decades prior to going public in Denmark, Novo was essentially unknown in international investment circles. To overcome this, it widened and deepened its financial and technical disclosure in both Danish and English. This effort was facilitated with the aid of a British stock brokerage firm that started to follow and write about Novo's stock. The information gap was narrowed even further by floating an international bond issue in the Eurobond market in 1978 with the aid of Morgan Grenfell & Co., a leading U.K. investment bank. In connection with the offering, Novo listed its shares on the London Stock Exchange, conforming to its disclosure requirements, to facilitate conversion and gain further visibility among the financial community. Unaware of these events, Danish investors continued to value Novo's shares at five times earnings. Because biotechnology began to attract the interest of U.S. investors, Novo planned a primary stock offering in the United States. This was preceded by a meeting in 1980 with forty journalists and U.S. analysts that sparked growing interest in the company's shares. Within a year, Novo's share price was trading at a P/E multiple of 16. To improve the liquidity of its shares held by U.S. investors, Novo next decided to sponsor an American depository receipt system early in 1981. This allowed U.S. investors to trade evidence of Novo's securities and receive dividends in dollars instead of kroner, transfer their securities in the United States, and avail themselves of a source of periodic information, because firms with American depository receipts must make available to U.S. investors whatever base of information they supply to investors in their home market (Sanford 1997).

Later that year, Novo engaged in a full U.S. share offering with a full U.S. Securities and Exchange Commission (SEC) registration (that is, financial reporting standards consistent with U.S. generally accepted accounting principles [GAAPs]) and a listing on the New York Stock Exchange. On July 1981, Novo became the first Scandinavian company to sell equity through a public issue in the United States. Its shares were offered for Dkr1,400 each (\$36), rising to \$50 per American depository receipt by the end of the year, a far cry from its original trading range of under Dkr300 in 1977.

### **Disclosure Standards on an International Level**

In a practical sense, it is difficult to separate the issue of financial disclosure from the issue of accounting measurements. In the absence of disclosure, accounting measurements serve no useful purpose. Yet, disclosure cannot take place until the information has been developed. Thus, financial disclosure and accounting measurement are intertwined and give corporate financial reporting its substance, which is evident in the discussion that follows.

### ***Forces Triggering Interest in International Standards***

Interest in increased corporate transparency is not new. What is new is the intensity of efforts to achieve an internationally accepted threshold of disclosure. Several developments are contributing to this state of affairs (Wyatt 1997).

Advances in information technology and communications have facilitated cross-border financing. Investors interested in sampling the equities of foreign companies are eager to understand their risk and return profiles. On the other side of the coin, corporate issuers interested in attracting offshore investors must now communicate with an audience that is accustomed to providing capital on the basis of a different set of reporting norms. Furthermore, companies are increasingly able to shift environmental risks (currency, interest rate, and commodity prices) to others, thus placing the burden of assessing credit risk on the shoulders of individuals who may be located thousands of miles away.

Regional economic groupings, such as the European Union, are striving to remove internal barriers to the movement of labor and capital among member countries. Harmonized legal and economic policies are seen as contributing to a more integrated economic union, including more uniform financial reporting and disclosure practices.

The privatization of former state-owned enterprises around the world, most notably in Eastern Europe, is also contributing to the pressures for international disclosure norms. Although the transformation of enterprises from state ownership to private ownership will evolve over time, changes in accounting and reporting must be in place to provide data useful in effecting such change.

The phenomenon of global competition is also transforming the economics of production and distribution. Today, more and more production is going to firms that can do the job (or parts of the job) best, regardless of their size and location. In this context, joint ventures and strategic alliances between manufacturers, suppliers, and customers are replacing adversarial relationships of the past. Financial reporting standards that reduce the chances for misunderstanding and misinterpretation are critical in this regard.

Another force contributing to the heightened interest in international reporting standards is the emergence of the International Organization of Securities Commissions (IOSCO). Securities regulators and stock exchanges around the world find alternative reporting practices a hindrance in judging the merits of foreign issuers or listers. The recent accord between IOSCO and the International Accounting Standards Committee (IASC) suggests that international standards are no longer a pipe dream.

### ***The Major Players***

International reporting standards are not the province of any single institution. International organizations, in addition to IOSCO, that are interested in influencing the disclosure practices of reporting entities include, but are not limited to, the following:

- *United Nations.* The U.N. Center on Transnational Corporations, an information-gathering agency of the U.N. Economic and Social Council, is charged with building a comprehensive information system on transnational enterprises to facilitate monitoring of their economic and social activities in host countries.
- *Organization for Economic Cooperation and Development (OECD).* This twenty-four-nation body provides a framework for harmonizing national policies in many fields, primarily among the more industrialized countries. In the past, it has issued voluntary

disclosure guidelines for multinational entities operating in the jurisdictions of member countries (OECD 1976).

- *European Union (EU)*. Interested in harmonizing economic, social, fiscal, and monetary policies among its member countries, the EU has issued numerous accounting directives that are binding on member states to which they are addressed with respect to the results to be achieved. Accounting directives that have proved influential include the fourth (form and content of financial statements), seventh (consolidated financial statements), and the eighth (auditor qualifications).
- *International Accounting Standards Committee*. IASC is a private organization whose membership comprises approximately 100 professional accounting organizations worldwide. Its major objective is to formulate and publish accounting and disclosure standards and to promote their worldwide acceptance.

Of the foregoing international organizations, the IASC is today recognized as the leading force. Both the United Nations and OECD have deferred any standards-setting activities and today cooperate with IASC to ensure that the latter is responsive to the concerns of the former. In 1989, the EU became a member of the IASC consultative group and an observer at IASC meetings. In 1995, the EU confirmed that it would not create a new tier of European accounting standards and would examine the possibility for European multinational corporations to use international accounting standards (IASs) in their consolidated accounts. Thus cooperation between the two bodies is at an all-time high.

Until the late 1980s, IASC standards were viewed as less than definitive. Its standards, in addition to lacking the force of law, were general in nature and permitted alternative treatments. Consequently, IASC standards did not attract much attention nor affect practice. To rejuvenate its mission, the IASC undertook a major initiative to eliminate as many alternatives as possible from its pronouncements. Known as the comparability project (subsequently renamed the improvements project), the IASC sought to narrow areas of difference permitted by its pronouncement and to expand its disclosure requirements so as to provide readers with sufficient information to make informed investment decisions.

In the early 1990s, IOSCO, interested in some form of harmonized reporting requirements for foreign registrants around the globe, started a dialogue with the IASC. In effect, IOSCO would embrace IASs as the basis for reporting in world financial markets if IASC (1) significantly reduced the number of acceptable alternatives among its standards, (2) added explanatory material to its revised standards to make them more helpful in practical situations, (3) enhanced the quality and completeness of its standards, and (4) promulgated additional disclosure standards to provide more complete information to investors. In mid-1995, both organizations agreed on a work program that would result, by mid-1998, in a set of core standards that, if approved, would result in IOSCO's endorsement of IASs for purposes of raising cross-border capital and listing in global markets (Wyatt 1997).

At the national level, the disclosure requirements of the U.S. Securities and Exchange Commission have proved influential. Although most countries recognize a foreign registrant's home documents, the United States stands alone in requiring the same disclosure from foreign registrants as it does from domestic ones. Foreign firms are subject to SEC disclosure requirements when (1) the firm issues securities for original sale to the U.S. investing public, (2) the firm wishes to trade its outstanding securities on an orga-

nized U.S. exchange, and (3) the firm's stock is traded over the counter if it has assets in excess of \$1 million and more than 500 shareholders worldwide, of whom 300 or more reside in the United States.

U.S. financial disclosure standards are the most stringent in the world. At the same time, numerous studies have documented the liquidity, efficiency, and depth of U.S. markets, including a well-developed accounting profession and securities legislation aimed at protecting investors (Cochrane 1992). Not surprisingly, U.S. financial markets have long enjoyed the distinction of being the market of first choice for foreign companies desiring to raise new capital or seeking to list their shares abroad. Several international developments, however, threaten to undermine the competitiveness of U.S. financial markets.

Many European markets, such as those of France, Spain, and the United Kingdom, have been restructured or deregulated to improve efficiency (Smith and Walter 1992). Market integration is promoting the development of supranational markets featuring attractions that dwarf those of individual markets. The European Community, for example, has proposed or adopted a number of directives aimed at harmonizing the regulation of securities markets among member states. An issuer listing on a stock exchange in a member country is now able to use the same disclosure document when listing its securities on other member exchanges. Such gains in efficiency make European markets increasingly attractive (Scott-Quinn 1994).

A major bone of contention among foreign registrants is the SEC's insistence on disclosure levels that exceed those imposed in the issuer's home country, including financial statements that have been reconciled to U.S. GAAPs. Issuers offering securities simultaneously in the United States and abroad have often found it burdensome to comply with U.S. disclosure regulations when structuring an international offering and preparing offering documents. As a consequence, many potential foreign registrants avoid the double expenditure of having to comply with requirements in both their home country and in the United States by bypassing U.S. markets in favor of London, Frankfurt, Amsterdam, or other markets where disclosure requirements are more accommodating to foreign registrants.

### ***The SEC's Response to Globalization***

The SEC has responded to the forces of globalization by adjusting its registration procedures to accommodate better the needs and practices of foreign registrants and adapt U.S. securities regulations better to the needs of the global market, as evidenced by initiatives such as rule 144A.

Recognizing that excessive regulation could pose an unnecessary barrier to cross-border capital formation, in November 1988 the SEC published a policy statement regarding the regulation of international securities markets (U.S. SEC 1988). The commission stated, among other things, that an effective regulatory structure for an international securities market system should include as a minimum sound disclosure systems, including accounting principles, registration and prospectus provisions, and listing standards. These safeguards, in turn, should be based on *mutually agreeable* standards that attempt to protect investors while balancing the costs and benefits for market participants. The object of efforts aimed at resolving international disclosure and registration problems should be to minimize regulatory impediments without compromising investor protection.

In April 1994, the commission announced several measures designed to reduce some of the barriers to entry for foreign issuers into the U.S. public capital markets. These initiatives reduced, on a limited basis, U.S. GAAP reconciliation requirements for new issuers to two years of primary financial statements (versus the currently required five most recent fiscal years), accepted cash flow statements based on guidelines promulgated by the International Accounting Standards Committee without reconciliation to U.S. GAAPs, and omitted several detailed financial statement schedules (Securities Act Release No. 7029, Exchange Act Release No. 33, 139, 58, *Federal Register* 60, 307-01, November 15, 1993).

In December 1994, the SEC permitted foreign issuers to account for their operations in hyperinflationary economies as per IAS 21 instead of U.S. GAAPs and to account for business mergers in accordance with IAS 22.

Together, these accommodations signal that the SEC is interested in assisting foreign registrants in accessing U.S. capital markets. In the interest of competitiveness, the SEC is considering several options as promising solutions to the problem of foreign access to U.S. capital markets.<sup>14</sup>

*International accounting standards.* One option would be to require foreign registrants to prepare their accounts according to standards promulgated by the IASC as a condition for listing on U.S. exchanges. Major concerns raised by issuers are the additional administrative and competitive costs as well as the loss of flexibility in supplying information that best reflects the underlying circumstances affecting their operations (Choi and Mueller 1993). Concerns expressed by institutional investors relate to the dangers of treating unlike things in the same manner. In their words,

*Investor 1:* To harmonize all the accounting systems around the world, you have to harmonize the incentives for every company and every country for it to make sense. Unless tax systems are harmonized, true harmonization will never happen.

*Investor 2:* Harmonization may be so broad in the alternatives permitted as not to make any difference to sophisticated investors. What does matter is the availability of sound audited financial statements. We have been investing in overseas equities for over thirty years and are doing quite well without international standards, thank you, and we are prepared to adjust the financial statements ourselves. Harmonization is likely to be more needed in emerging capital markets. However, there, inflation and currency considerations are more important. (Choi and Levich 1990)

Despite such misgivings, voluntary implementation has achieved a modicum of success. Singapore and South Africa, for example, use IASC standards as the basis for some or all of their national requirements. The International Stock Exchange in London requires reconciliation to IASC standards when reports of foreign listers are not in compliance with U.K. GAAPs, and German companies are slowly moving to IASC norms in an

<sup>14</sup> These generic policy alternatives do not preclude hybrid options based on combinations of the three basic themes. For example, firms could supplement financial statements prepared for home-country readers (primary statements) with statements prepared according to international accounting standards (secondary statements). Another alternative would be to use international standards that specify a preferred treatment, where permitted alternatives are reconciled to the preferred treatment.

attempt to diversify their funding sources outside of Germany. (Peter Gumbel and Greg Steinmetz, "German Firms Shift to More Open Accounting." *Wall Street Journal*, March 15, 1995.)

*Mutual recognition.* Another option being considered by the SEC to assist foreign registrants in accessing U.S. capital markets is the practice of mutual recognition. Mutual recognition implies that participating national jurisdictions would recognize prospectuses from one another's jurisdiction. Decisions to allow an underwriting or a listing would be made on the merits of each case. At the present time, a bilateral pact exists between the United States and Canada to establish the Multijurisdictional Disclosure System, which has been in effect since 1991. The mutual recognition approach is also featured in a number of directives for securities markets in the European Community.

Mutual recognition offers a number of advantages. First, there would be no need for companies to change their current accounting procedures. Companies would incur no costs of change and no competitive costs from additional disclosures. Second, the accumulated experience of analysts in interpreting national accounting statements would retain its value. There would be no need to retrain analysts to understand yet another accounting system; that is, international standards. Third, a system of reciprocity acknowledges national sovereignty and differences in national economic taxes.

The costs of mutual recognition, however, fall primarily on those countries whose regulatory and accounting conventions are most at variance with those of other nations. The United States perhaps is the best example. Foreign accounting practices and disclosure policies often fall short of current U.S. regulatory requirements. In this sense, U.S. registrants may be held to a higher standard than foreign registrants. This, in turn, could place U.S. companies at a competitive disadvantage relative to registrants who are less forthcoming.

*Compromise on U.S. standards.* Where lies the answer? Another reporting option is to compromise on the basis of U.S. standards. Foreign registrants recognize that access to U.S. capital markets requires communicating with readers, many of whom are accustomed to providing capital on the basis of U.S. GAAPs. Given the diversity that exists in accounting standards around the globe, the European chief financial officers interviewed suggested that conformity with some internationally recognized benchmark would be helpful. U.S. standards are viewed by many at this point in time as the most meaningful. First, they are investor-oriented, which is a perspective that is increasingly being embraced by firms interested in diversifying their funding sources internationally (Steil 1994).

Second, U.S. accounting standards are internationally recognized and by far the most carefully researched. Thus, even if the SEC were to embrace IASC standards or extend the notion of reciprocity to all countries, foreign registrants might still find it beneficial to address U.S. investors on the basis of U.S. GAAPs. However, international chief financial officers uniformly viewed SEC disclosure requirements as excessively detailed and burdensome. In this regard, market forces may offer a useful benchmark for establishing a minimum disclosure threshold for international financial reporting based on U.S. standards. Hence, further accommodations of foreign issuers, whether through formal rules adopted by the SEC or informal waivers or no-action letters, whereby SEC staff members agree not to recommend enforcement action without expressing a legal conclusion, appear to be both warranted and feasible.

## Conclusions

Concessions notwithstanding, if emerging-market countries wish to avail themselves of the benefits of financial market access, they must do more to promote the laws, securities regulations, accounting and disclosure requirements, training, and administration necessary to support an active securities market. The extent to which these countries (including some not in the emerging category) regain access to the global pool of capital will depend on how well they are able to accomplish this. After all, financial markets compete with one another.

In discussions of corporate transparency, the allocation of accounting information among various user groups becomes a major policy issue. Because the provision of accounting information is not costless, managerial judgments as to appropriate disclosures require the consideration of varied interests and competing demands. In short, managers must attempt to balance the costs and benefits of any expanded disclosure policy.

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## THE MOVE TOWARD INTERNATIONAL ACCOUNTING STANDARDS: AN ANALYSIS OF THE MEXICAN EXPERIENCE

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*Information is the engine of production ... Globalization is not a round, perfectly shaped Dutch cheese, but rather a Swiss cheese full of holes. [Carlos Fuentes, prize-winning Mexican novelist]*

Mexico's economy up until the mid-1970s, continuing the trend of the preceding decades, was experiencing a period of stabilizing growth with moderate inflation. Gross domestic product (GDP) growth hovered around 8 percent, and inflation held below 4 percent. The picture changed in the second half of the 1970s, which saw growth with inflation and unemployment. GDP remained in the 6 percent range, while inflation soared to an average of almost 19 percent. The structural weaknesses of a resolutely inward-looking economy that had raised barriers to international trade and looked to import substitution were clearly revealed in these years. For a while, the discovery of huge oil deposits and the dramatic rise in oil prices held off economic adjustments that, even then, were known to be needed. This same decade (the year 1973, precisely) saw the first-ever share offering by a Mexican company, Tamsa, on the New York Stock Exchange. The bulk of the financial surplus yielded by the oil boom was deposited in western banks, unleashing a wave of quick lending without due diligence on the banks' part. From 1970 to 1982 the economy closed so tightly that the percentage of imports requiring licenses doubled, from 51 to 100 percent.

The 1980s, a period of decline against a backdrop of inflation and unemployment, were marked by the drop in oil prices, removing the anchor that had been staving off economic adjustments. Mexico's adhesion to the General Agreement on Tariffs and Trade (GATT) in 1986 was a watershed, bringing to an end a long chapter in the country's economic history and signaling a shift to an outward-looking strategy. Meanwhile, in the United States, Mexico's largest creditor, signs of stagflation became apparent, pushing up interest rates and making credit harder to obtain.

The percentage of imports requiring licenses dropped from 31 percent in 1986 to less than 11 percent in 1992. The import tariff ceiling was lowered from 100 percent in 1985 to 25 percent in 1993, and the average tariff fell from 27 percent in 1982 to 13 percent in 1993.

There is no doubt that what chiefly propelled Mexico's strategy to "go global" were expectations surrounding a free trade agreement with the United States and Canada and the eventual signature of that treaty. Foreign direct investment more than doubled be-

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tween 1985 and 1990, from \$1.7 billion to \$3.7 billion, and by 1994 it had soared to \$8.0 billion. In a word, with the North American Free Trade Agreement (NAFTA), Mexico became a full partner in the global economy.

Despite the severe crisis that buffeted Mexico toward the end of 1994, it is unlikely that the economy will change course. It seems safe to predict that by virtue of NAFTA and other regional trading blocs, Mexico will gain an even stronger profile in the international arena, to the extent that the immediate effects of a crisis of those dimensions can be absorbed. Internationally, the bolstering of confidence in the quality and content of financial information disclosure will go a long way toward pushing investment flows back up to the figures posted by Mexico in 1993.

### **Why Embark on an Accounting Standardization Project?**

As a natural outgrowth of these economic developments, Mexico has gained a place for itself in international financial markets. This is all the more evident when one considers that the cost of money locally ranges (in real terms) around 15 percent and up.

As of 1990, Mexican companies started over-the-counter equity and paper offerings on the New York and European markets. With the single exception of the Tamsa offering in the early 1970s, Mexico had no precedents for such operations. When they proved successful, others rushed to complete Securities and Exchange Commission (SEC) registrations and launch public offerings on the New York, American, or NASDAQ (National Association of Securities Dealers Automatic) stock exchanges.

This activity triggered the need for international-caliber financial reporting and disclosure. How can a set of financial statements, for instance, report a healthy profit, yet, when the information is converted using U.S. generally agreed accounting principles (GAAPs), net earnings not only shrink but in the more dramatic cases disappear altogether, leaving the company with a loss? How can any weight be given to a credit or surplus associated with an appraisal performed to be reflected in the company's financial statements? When do inflation gains on liabilities become cash flow? These and various other concerns are bound to be present in the mind of the user of financial information in such an environment.

The scant comparability or confidence in Mexican financial information at that time resulted in higher interest rates in money operations or lower earnings in price-earnings ratio computations. This is something that ought to be spelled out in capital letters, because it represents, in our view, prospective added value for a developing country that wants to improve its accounting standards so its financial information will be credible and comparable at international disclosure levels. This can be framed as a theorem: the better the financial information and the broader the disclosure, the lower the cost of funding. This can apply at the country level as well.

This theorem lends itself well to the situation of public companies or governments as far as their borrowings from multinational organizations are concerned. But, what about other kinds of enterprises that do not fall into those categories? One frequent comment on this issue from small or mid-size Mexican companies or accounting firms that typically serve those business segments is "Yes, I understand that this or that accounting change will help with international standardization, but how will it affect or benefit my company?"

The response may not be easy to "sell," but it can be tackled from two angles. One is to point out that even though the firm may not currently be listed on any exchange, the

time may well come when it might be able and want to do so. Likewise, it could at some point want to approach an international financial institution to secure funding for a particular project or operation. The other angle has to do with the country's financial culture. Obviously, the higher the quality of a country's financial information, on a par with the industrialized countries, the more its business sector stands to benefit directly or indirectly. This is perhaps the only kind of incentive that might persuade nonpublicly traded companies to back efforts to bring the country's accounting standards into line with international norms.

Once the need for quality financial information on a par with international standards has been acknowledged and the requisite consensus has been shaped, a country has to assess options and select its own particular strategy for achieving that objective. Guatemala, for instance, uses the Financial Accounting Standards Board (FASB) in toto; some Asian nations refer to the International Accounting Standards Committee (IASC). Venezuela has adopted a hybrid approach, and Mexico is following yet another course for accounting standardization.

### **Opportunities for Improving Mexican Accounting Standards through International Harmonization**

The following diagnostic overview is the most productive analytical starting point for any Latin American country that wishes to embark on a process of accounting standardization. Without such an analysis, the country runs the risk of focusing on effects or questions of form rather than on substance or root causes of situations that are the outgrowth of the standards it has been using. Any such analysis should look at the following issues: the country's track record in standard-setting, makeup and profile of the bodies involved, degree of independence, and economic considerations in the standard-setting body.

Mexico's first accounting principles were framed in the 1950s, bound up closely with creation of the Mexican Institute of Public Accountants (IMCP). For the most part, the Mexican accounting profession is organized into chapters, each having full legal capacity, that may take in professional accountants in a city or a region. IMCP is the umbrella federation for all the chapters.

The mission of the individual chapters is to represent their membership in dealings with government, business and other organizations, and the public at large. To further their members' professional development, the chapters design and run seminars and courses. Unlike the chapters, IMCP has no operating functions; it represents the accounting profession nationally and develops and issues standards. The standards it releases are binding on its membership, and it has long-standing moral authority vis-à-vis the business community.

IMCP is responsible for issuing accounting and auditing standards and directives on professional ethics, bylaws, and continuing professional education. Accounting principles in Mexico (Mex GAAPs) are researched, formulated, processed, and released by the Mexican Accounting Standards Committee (MASC). MASC develops and issues a draft statement on an accounting issue, which requires approval by the IMCP executive committee. Feedback is then sought from the IMCP membership, and input is elicited from constituencies with a vested interest in financial reporting, such as information preparers, banks, analysts, the National Banking and Securities Commission (CNBV), and business organizations. Since deciding, as a strategic priority, to harmonize its standards with international GAAPs, MASC has been consulting with other regulatory bodies such as the

FASB and the SEC (United States), the Accounting Standards Board (Canada), and the Chilean Commission.

MASC also issues guides and position papers (called *circulares*), comparable to releases of the American Institute of Certified Public Accountants' emerging issues task force in the United States. Such pronouncements are not binding, but they carry considerable professional weight, in line with Mex GAAPs. These circulars also have to be endorsed by the IMCP executive committee; their advantage is that they can be released quickly because they do not have to go through the consultation process required by Mex GAAPs.

One crucial element in any accounting standardization process is an assessment of the process followed to put together the standard-setting committee. In Mexico, the configuration of the committee is prescribed in IMCP's own bylaws, which stipulate that at least 50 percent of the members must be representatives of the "big six" audit firms (the goal being quality and independence) and that the other members may be representatives of companies, researchers, mid-size audit firms, and other constituencies, the aim being to bring different ideas to bear and to enrich the discussion.

Members are appointed by the committee chairman. Their appointments must be ratified by the IMCP executive committee. The committee members serve strictly *ad honorem* and defray their own expenses. Before it launched Mexico's international standardization process, MASC had twenty-five members, among them representatives of banks, CNBV, and the Financial Executives Institute.

Four approaches were studied for strengthening the harmonization process. The first was to reduce the size of the committee to streamline the decisionmaking process, as FASB in the United States, Accounting Standards Board (AcSB) in Canada, and IASC had done. At the same time, this approach would foster the creation of a direct consultation group through which to elicit views from the broadest possible institutional spectrum, but without giving group members a vote in MASC. Members of the group would include the Mexican Institute of Financial Executives, the Banking Association, CNBV, securities analysts, other government agencies that issue accounting rules, and intermediate business organizations. It was decided that the first order of business was to accelerate work on studies and research in order to lend support to the MASC membership.

The second approach was to bolster the flow of information with other standard-setting bodies: on the one hand, to monitor carefully the development of draft standards and the final product and, on the other, to seek feedback on drafts and standards as they are released in Mexico. A third approach was to refine the strategy for communicating with parties having an interest in financial information, assessing the merits of standardizing the channels of communication as in FASB, AcSB, and IASC. The final approach was to find ways of dislodging the bottleneck in the workings of MASC, acknowledging the constraints faced by its members, who hold full-time, salaried positions elsewhere and work for the committee *ad honorem*, in the little time they have available.

What happens if a company's financial information does not conform to accounting standards or Mex GAAPs? If the company is listed, CNBV can impose a number of sanctions, up to and including a suspension of trading. For nonlisted companies, the watchdog (though with no punitive powers) is the figure known as the *comisario*, an inspector appointed by the stockholders or partners, which every company is legally required to have. The *comisario's* task is to produce a report certifying that the information provided to shareholders for approval during annual meetings was prepared in conformity with Mex GAAPs.

The enforcement instrument that is proving to be most effective in the United States and Canada needs to be built into Mexico's financial and stock exchange culture. This refers to the steady stream of complaints lodged against companies and public accounting firms in the United States and Canada contending that financial information does not conform to the applicable GAAP. This practice is unknown in Mexico, but it could soon become a fixture in the country, as the Mexican economy gets back on the global finance track.

There are institutional avenues whereby an affected party can seek sanctions against a public accountant who has examined a set of financial statements and whose opinion is subsequently refuted. IMCP has an honor committee to look into such complaints. The ultimate decision it can hand down is to suspend the accountant in question permanently from IMCP membership.

### **Selecting an Approach**

A country can take one of two basic approaches to bringing its accounting standards into line with those of industrialized nations. It can adopt IASC standards or those of an advanced country or it can start with its own body of standards, add to it, and rewrite it as needed to align it with IASC standards. The first approach is obviously less complicated, if only because the body of standards is already at hand. We might go so far as to predict that the world may at some future juncture have a single body of standards. This is unlikely to happen in the near future, however, because it is unlikely that the United States, Canada, or the United Kingdom, for instance, will halt work on its own accounting standards and adopt IASC standards, nor would a country like Japan or Spain, with less tradition in this area, be likely to do so.

The second approach is the more realistic one for countries that have some tradition in setting accounting standards. The reasoning for Mexico could be as follows: the accounting standards in force in IASC do not eliminate the most significant differences in reconciling financial information prepared by reference to Mex GAAPs with that prepared by reference to U.S. GAAPs. The fact is that neither deferred income tax nor goodwill would change. For one thing, IASC is currently revising the standard on deferred income tax; as for goodwill, IASC offers (understandably) a menu of choices, one of which is the practice followed in Mexico. Accounting for inflation is another matter. Out of necessity, Mexico has examined this question in great depth and has fashioned standards for it accordingly; MASC has brought a proposal before the IASC board to revise its standards on price-level accounting to harmonize with the Mexican standard. The idea is that either IASC changes or MASC changes, but the two should be the same.

With due regard for all of these considerations, Mexico opted for the second approach, and since 1992 it has considerably stepped up its work on harmonization. Its points of reference have been the United States and Canada, touching base with IASC. The rationale for this choice was the caliber of those countries' accounting standards and prospects for a boost in international trade under NAFTA. However, a country that elects this course has to factor in the costs involved (in time as well as money) including the cost of reconciling and, to some extent, keeping two sets of accounts—reconciling local GAAPs to FASB, in the case of companies registered on a U.S. stock exchange.

There are several reasons why a country should ever embark on this second approach if the first option is so much simpler. Taking the first approach—that is, adopting ready-made standards—may mean ignoring certain circumstances that are specific to a

country or region. In Mexico, for instance, inflation and recurring macro devaluations create a somewhat unique economic environment. Another reason for advocating the second approach has to do with the speed at which changes are brought in. Mexico has learned from its experience in the move to harmonization that, although the technical content that needs to be reworked into an accounting standard may be very clear, the changes need to be implemented gradually, especially when they will have an appreciable impact on the financial structure of listed companies.

One self-evident step in a harmonization process is to ascertain the differences between local GAAPs and international yardsticks. Each Latin American or Caribbean country should determine its own particular situation as regards the selection of benchmarks or comparators.

The following might be the most indicated: the standards set by IASC, FASB (United States), AcSB (Canada), and Latin American countries with a recognized track record, such as Chile, Argentina, or Mexico. Venezuela is currently supplementing its own standards. For matters not addressed in its own body of standards, it looks first to IASC; if IASC has no standard, it applies Mex GAAPs, and, as a final recourse, it refers to the FASB.

At first glance, there may appear to be far more similarities than differences with the benchmark countries. Before the recent push for standardization, it was common practice in the profession to reference U.S. GAAPs and, occasionally, IASC. As a result, many persons who deal with financial reporting and information on a day-to-day basis felt that Mex GAAPs and U.S. GAAPs were very similar. But securities offerings on the U.S. and international markets have shown that this was not at all the case. Although the number of standards may not have been vastly different, the differences in the figures they produced could be considerable.

Almost all SEC registrants presented reconciliations between the two sets of GAAPs that tested the limits of credibility. The common denominator was book earnings that shrank or disappeared altogether when U.S. GAAPs were applied. The differences to be bridged using IASC, FASB, AcSB, and Chilean standards in a paper on financial reporting in North America and Chile that was published in early 1997 by the standard-setting bodies of the countries involved (FASB, CICA, IMCP and CCC, 1997). A thorough examination of these differences in treatment is beyond the scope of this chapter, but a brief mention of the most representative, in terms of the amounts at issue, is in order. They include treatment of income tax, treatment of purchased goodwill, and accounting for inflation.

In the matter of income tax, the current Mexican treatment is known as partial allocation, which recognizes as a liability only the tax stemming from permanent differences between book and taxable income, eliminating considerations of differences in timing, which presumably will be replaced by other comparable ones. This method was one of two accepted by IASC up until 1997, and presumably it will be harmonized to FASB (meaning that it will no longer be an option) when the exposure draft is approved. IASC now recognizes as a liability all timing differences, regardless of degree of reversal or replacement in the future, including those stemming from fixed-asset valuation. Incidentally, the United Kingdom voted against this new standard, asserting that the partial allocation method used by Mexico is the correct approach. This is unquestionably the major difference and the one that comes up most often in earnings reconciliations using Mex GAAPs and U.S. GAAPs.

In the case of goodwill, the biggest difference arises when the share acquisition price is lower than the figure on the books of the acquired company, for example, in situations of negative goodwill. Mex GAAPs treat such goodwill as a deferred credit that must be amortized through the profit and loss account (considering it as income) over five years at most. The FASB position, in contrast, is to treat it as a loss in value of nonmonetary assets, which thus is charged off over the useful life of the assets via depreciation. In essence, the difference here is in the interval over which this item is recognized in income statement accounts: up to five years in Mexico and between ten and forty years in the United States, depending on the asset's service life. As in the case of deferred income tax, one might say that there is no "difference" between Mexican and IASC standards, because IASC allows the two approaches. Here, too, IASC decided in early 1997 to revise its standard, which will probably erase the option that is still in Mexico's standards.

On the subject of accounting for inflation, we could begin with the issue that users of financial information most frequently call into question. For one thing, income statements contain an item (usually under income) called monetary gain, or inflation gain, that in nominal terms does not represent a flow of funds. For another, including a figure arrived at by appraisers as an asset, with the huge margin of subjectivity or leeway this entails, raises the question of the credibility of information and its comparability with information from countries like the United States, Canada, and even Chile. One merit of the Mexican methodology is that it is in line with the approach accepted, although not preferred, by IASC. Given the importance of this issue in Latin American and Caribbean countries, we would refer those interested to a best-seller first published in 1993 and updated in 1996, Harry Dent's *The Great Boom Ahead*, which discusses the theoretical possibility of predicting the behavior of securities markets based on demographic strata. Dent refers to the catastrophic setbacks suffered by the Japanese economy in recent years and affirms that the free market economies are better equipped to prevent the overvaluation of stocks and real estate that occurred in Japan. How much of Japanese profits are real, he asks, and how much can be traced to the Japanese accounting system? In Japan, the value of assets is calculated annually at current market value, as opposed to the U.S. practice of valuing them at cost adjusted for depreciation. With that form of window dressing, the effects of inflation are countered; and on the strength of paper profits, companies can secure financing to invest in such assets, to subsequently push up prices and profits.

The foregoing three foci of accounting standardization have been at the top of the MASC agenda for the past four years. A final harmonized version was produced in 1997.

### **Financial Reporting by Financial Institutions**

Mexico's financial sector is made up of banks and other credit institutions, brokerages, and insurance and surety companies. On the legal and accounting side, these institutions are regulated and overseen by the National Banking and Securities Commission and the National Insurance and Surety Commission, both under the Ministry of Finance. In Mexico, as in a number of other countries, banks were in business before any accounting association was created and, hence, before any accounting principles or standards were handed down. But bank regulation in Mexico differs from that in countries such as the United States in that the federal government is by law accountable for, and insures, 100 percent of bank deposits and commitments with the general public. The banking industry

has historically been an oligopoly, and by virtue of its enormous influence and economic clout, it has not been held to full transparency standards in its financial reporting.

After Mexico's banks were nationalized in 1981, economic and efficiency thrusts gave way to motives of a more political bent, and oversight criteria were relaxed. When in the late 1980s and early 1990s, the banks were restored to private hands, a number of points of stasis and other circumstances were left, to which we will refer further on.

When IMCP began to release accounting standards back in the 1960s, the banks were already being regulated by the National Banking Commission, which itself issued accounting rules binding on banks. As a result, the banking industry was not addressed, creating a vicious circle that kept the banks out of IMCP's standard-setting process. One positive feature of financial reporting in the era of nationalized banks was a federal government directive that all bank financial statements be audited by independent auditors. The downside of that move, as might have been expected, was that audits were not referenced to Mex GAAPs but rather were prepared in accordance with the National Banking Commission (now CNBV) accounting rules.

### ***National Banking Commission Accounting Standards***

Until the mid-1980s, National Banking Commission accounting rules differed widely from Mex GAAPs. For instance:

- They did not use the accrual principle.
- Standards were based on charts of accounts, rather than the essence of transactions.
- Depreciation was not charged off.
- Future flows were not used to conceptualize assets and liabilities.
- No notes were appended to financial statements.
- Some circulars contained accounting requirements or dealt with issues specific to one bank.

One consideration here is that the banking industry has always been solidly united via the Association of Mexican Banks, which as a group has heavily influenced CNBV accounting requirements.

When the banks were sold back to the private sector—basically to investors who were already operating in the brokerage business—the government fostered the formation of financial groups that, in quite a few instances, included a bank, brokerage firm, insurance company, and currency exchange. This meant consolidating the financial information of these groups, a move that posed the following difficulties:

- Banks and other credit institutions were regulated by the National Banking Commission, brokerages by the National Securities Commission, and insurance companies by the National Insurance and Surety Commission.
- There was no coordination of accounting standards among the three regulators, nor were the standards aligned on Mex GAAPs.
- Each of the three regulators operated independently of the others.
- At the time, the three regulatory bodies showed very little interest in Mex GAAPs, perhaps because each preferred to maintain the status quo.

### ***Mexican Banks and Mex GAAPs: A Recent Breakthrough***

The picture began to change in 1994, with a reshuffling in the executive ranks of the National Banking Commission, which was soon revamped, becoming the CNBV and taking on as well the former National Securities Commission functions of oversight and regulation of the securities market. The new team responded to a demand that was already more than evident in the international capital markets: apply Mex GAAPs to bank financial information and put an end to the practice of individually crafted standards from a regulatory watchdog.

In 1995, after a short interval of intense work, CNBV issued a first draft of the new accounting standards and sent it to MASC for review. Later that year, MASC sent back a set of comments to the regulator, drawing attention in particular to points of difference with Mex GAAPs and referencing U.S. GAAPs. After much analysis and back-and-forth exchange of comments between the two institutions, CNBV released a compendium of accounting standards that reflect the new guideline of approximation toward the general principles.

This first corpus of binding standards took effect in 1997, with the option of applying the standards from year-end 1996. Despite the major headway they represented in harmonization efforts, there are still some differences between the two sets of requirements:

- Unrealized gains or losses on financial instruments available for sale are handled through the capital accounts, unlike the Mex GAAP requirement.
- Standards for the treatment of convertible bond premiums are also different.
- Deferred tax is computed on a basis comparable to past FASB rules (the deferral method) rather than on total provision—the approach on which feedback is being sought in Mexico—which is indicated by FASB and IASC.
- Not all subsidiary companies are consolidated, as is required by Mex GAAPs.
- Carryover rules for loan losses differ from U.S. usage and could be considered at odds with Mex GAAPs.

When asked why the regulator did not adopt Mex GAAPs or U.S. GAAPs in toto, CNBV officials noted that changes needed to be implemented gradually. This is particularly the case with adjustments such as U.S. GAAP standards for loan-loss provisions, which required a more thorough study in light of Mexican particularities such as the Bank of Mexico's role in insuring customer deposits.

The foregoing notwithstanding, the headway made in alignment to Mex GAAPs was impressive, and we would be remiss not to underscore some of the gains:

- The conceptual framework followed is identical to that of Mex GAAPs, which is virtually identical to that of FASB.
- The inflation accounting approach indicated in Mex GAAPs was adopted in toto. This meant, for one thing, erasing the appraisal valuation alternative for restating financial information, mandating instead the use of historical cost indexed at constant pesos, which has been a fixture of Mex GAAPs since 1997.
- The Mex GAAP supplementarity approach is being followed such that, in the absence of a standard, Mex GAAPs are followed first, in its absence IASC standards are followed, and, ultimately, FASB standards are referenced.

- Mex GAAPs are taken as the standard for currency translation of financial statement information of foreign subsidiaries (a new MASC standard that took effect in 1997).

The first giant step toward international harmonization of accounting standards for financial institutions was taken in 1997. Because of the clout of the international financial market and the political will of the regulator as manifested in MASC, the trend appears to be to move CNBV standards toward Mex GAAPs. This inclination, coupled with the moves described elsewhere in this chapter, suggests that the financial sector is on the right track: harmonize with international standards.

A recent development warrants mention here. In order to speed up the standardization process, MASC and CNBV signed an agreement to create a MASC subcommittee made up of CNBV executives, bank officials, and public accountants appointed by MASC, with the sole mandate of producing draft accounting standards for banks. The final screening body would be the standards committee itself. This marks the realization of a long-standing aspiration of those of us in professional, independent standard-setting bodies: that the IMCP committee hand down accounting standards for financial institutions. The benefits for the users of financial information are obvious: information that is more credible and lends itself better to comparisons, with better and broader disclosure.

Among nonbank institutions, we could mention the situation of insurance and surety companies. Echoing the process that has unfolded in the banking industry, the National Insurance and Surety Commission is preparing to submit to MASC proposals of new accounting standards aligned for the most part on Mex GAAPs.

### **Mexico's Strategic Moves toward Harmonization**

#### *The American Free Trade Association Working Group*

One of the moves that unquestionably has paid off most handsomely for Mexico was the creation of the American Free Trade Association, an informal association founded in 1992 and composed of the three countries that were at the time initiating talks to create NAFTA. Canada, the United States, and Mexico took up the challenge of harmonizing their accounting standards. Chile joined the group in 1995 and is engaged in talks for formal accession to the treaty.

As a first item on its agenda, the group decided to produce a study pointing out the differences in each country's standards. Apart from examining those differences per se, the analysis looked at substantive elements such as the membership and operation of standard-setting bodies. It also identified the standard that in each case is embodied in IASC international standards. This was no easy task, and it took some time to complete, but by 1995 the study had been released in English and Spanish.

It was important that this product, a true milestone in the group's work, be kept current, and indeed a second English edition came out in January 1997 (FASB, CICA, IMCP, CCC, 1997). That text includes a comparison with Chile, which was absent in the first edition. Mexico is now producing the Spanish translation of the revised edition.

To know the differences in accounting standards among countries is to bring them into alignment. What this means is that the different sets of rules often seem far apart because of a lack of knowledge and contact, but when there is knowledge and contact, the two immediately, almost imperceptibly, begin to draw together. Hence the

vital importance of pinpointing the differences between standards of the countries involved.

Another commendable approach was the group's commitment to sharing information among the participating countries. This meant essentially two things: work agendas (to identify priorities and planned standards work) and draft standards on which each country would seek feedback. This information-sharing approach was an invaluable source of feedback on the draft standards that Mexico has been putting out in recent years. Indeed, in more than one case, the comments received alerted the group to points that needed adjustment, whereupon the drafts were refined or the proposed standard was aligned even more closely.

Another group initiative was the development of joint drafts. For instance, the U.S. FASB and Canada's AcSB decided to tackle a joint revision of the segment reporting draft; Mexico was invited to take part on a permanent basis in order to share its views on this principle, for which there is no standard. Feedback on this joint initiative (which began in 1995) is being elicited in the two countries, with virtually identical requirements. The standards used by the two countries were endorsed by Mexico's MASC, and Mexico awaits the final text from Canada and the United States before releasing its pronouncement.

The group also reviewed specific issues that are treated differently in the four countries' standards, with a view to making the relevant changes and ultimately having uniform provisions. In 1996, for example, the group began to look at the question of pooling interests. Although work on this issue is not yet finished, there appear to be good prospects for common ground, to judge from the tenor of the meetings held thus far.

Lastly, the system of holding periodic meetings of the member countries (at least once a year) has proved to be sound. The information gained during these gatherings is extremely helpful, and the meetings themselves are a means of monitoring advances in the process, where the participants can discuss issues, agendas, and progress made.

### *International Accounting Standards Committee*

The core mission of the IASC is to formulate internationally accepted accounting principles. The statements it releases are not binding directives but rather points of reference or, perhaps, of influence for accounting rulemakers the world over. Nevertheless, as momentum builds for global accounting standardization, IASC's influence is mounting.

As a body to which countries can look directly for accounting standards, IASC has received two major boosts. The first was in 1994 when the SEC, in an unprecedented move, announced that on the matter of SEC registration of foreign issuers, it would not require cash flow statements prepared pursuant to IASC standards to be reconciled to U.S. GAAPs. This coincided almost exactly with an agreement between the SEC and the International Organization of Securities Commissions (IOSCO), a counterpart to IASC for securities regulators, to the effect that if the required changes (or new standards) identified by a technical advisory committee were implemented, financial information submitted in conformity with IASC's GAAPs would not have to be reconciled to U.S. GAAPs. That accord has been formally ratified and is expected to take effect as of 1999. By virtue of its commitment to IOSCO, IASC has adopted fast-track procedures for completing its work plan, and the time frame for coming up with core standards has been shortened.

The strategic actions selected by Mexico to advance harmonization with respect to IASC were twofold. The first was to secure a seat on the IASC board. Mexico had been an

IASC board member at several points in the past, but in 1994 it became clear that membership was a necessity. The appropriate representations were accordingly made, and in due course a seat was assigned to Mexico. This means that in addition to its interface with this important body, as yet another avenue for monitoring the accounting standards it issues, Mexico has a part in analyzing and formulating the standards. Other Latin American and Caribbean countries might wish to consider this benefit, although they would need to weigh the minuses as well (such as the time and cost of a representative who must travel around the world to attend meetings and the research effort that full board membership entails for the in-depth study of technical issues taken up in the board's day-to-day work).

The second strategic action was supplementarity. In 1993, in recognition of the importance of international harmonization and of IASC itself, Mexico issued a principle on supplementarity that addressed two needs: it stepped up the harmonization process and provided a fast-track procedure for dealing with issues on which the Mexican standards are silent. The use of IASC standards when the subject matter in question is not addressed in Mexican standards became mandatory from that point onward. And, if IASC has no standard for the accounting issue in question, recourse must be made to other sets of standards, notably U.S. GAAPs.

### ***International Federation of Accountants***

The International Federation of Accountants (IFAC) is an organization of international representatives that devises rules on other issues in the purview of IMCP, except for accounting principles. Its primary role is as the international institution charged with setting audit standards. The harmonization process has been far simpler in the audit field than in other fields discussed in this chapter because of the manifest leadership of international public accounting firms, notably the so-called "big six," whose standards are uniform worldwide.

### ***U.S. Securities and Exchange Commission***

In 1992, Mexico moved into a new chapter in its dealings with the U.S. SEC, which placed Mexico in continual contact, both at an institutional level and by way of various companies trading public paper on the New York markets. Day-to-day meetings with that agency and with representatives of the international area of the American Institute of Certified Public Accountants have been particularly useful. Mexico has benefited greatly from SEC comments on drafts of new Mexican standards, and the U.S. agency's input has been unfailingly professional and extremely helpful as Mexico sets out to harmonize Mex GAAPs with U.S. GAAPs.

### ***Other International Bodies***

Three other agencies that deserve mention are the International Organization of Securities Commissions, the Council of Securities Regulators of the Americas (COSRA), and the Inter-American Accounting Association. For Mexico and very possibly for other Latin American and Caribbean countries, these are valuable sources of feedback concerning the international standardization of accounting principles. Ultimately, each country will have to weigh what it could draw from one or more of these organizations.

### ***Mexico's Banking and Securities Commission***

Mexico's Banking and Securities Commission plays two key roles in standard-setting. First, it is the rulemaker for the banking sector. Second, it is empowered to set standards for financial reporting by entities trading on the Mexican securities exchange.

CNBV practice on the matter of financial reporting by Mexican publicly traded entities has been to endorse MASC standards, handing down its own pronouncements only as guidelines for choosing between alternative practices where Mex GAAPs accept more than one. The strategy of aligning Mexico's standards with international norms has been backed through COSRA and IOSCO (CNBV is a member of both of these bodies). CNBV's permanent role in MASC allows it to learn the views of this important prospective framer of accounting standards first-hand as draft standards are reviewed and assessed.

### ***The Road Ahead***

The cornerstone of Mexico's accounting standards strategy will continue to be harmonization with the American Free Trade Association group and with IASC, keeping to the course charted some five years ago but, according to the current agenda, stepping up the pace. This will require structural changes in MASC and a research push, with the additional funding burden this entails—an issue Mexico has yet to resolve. In other words, Mexico needs to move its structures toward the configuration and modus operandi of FASB, AcSB, and IASC, whose committee members work full-time and are backed by strong, committed staff. Mexico should consider a setup along the lines of Canada's AcSB, whose board members donate their time but (this being the big difference) have full-time support staff, with the concomitant payroll cost.

Echoing countries that have adopted advanced or international standards, Mexico must move more quickly to set up a consultative body that can assemble the different constituencies with an interest in financial information, but with the advantage that they will not have a vote or sit on the standards committee proper. FASB and IASC are excellent benchmarks because they have a wealth of experience in this respect.

Future work will proceed using a fast-track approach built around the principle of supplementarity, that is, not issuing a Mexican standard on a given accounting issue if IASC or FASB has one to fit the Mexican situation. This will leave Mexico free to move forward on harmonizing other issues that warrant more urgent attention.

Another area in which IFAC has gained considerable experience (whereas Mexico is just starting out) is setting standards for government accounting. To tackle this territory, the idea is to set up a subcommittee like the body referred to for bank GAAPs. The aim would be to have MASC promulgate accounting standards for this huge sector of the economy that has thus far been left untouched by the IMCP standards committee.

### ***Impediments to Change in Mexico***

One of the main stumbling blocks in Mexico's move toward international accounting standards has been the difficulty of building a consensus with companies that disclose financial information to the public. This refers to the corporate sector in MASC. Although one may challenge these companies' stance, their skepticism or resistance to change is understandable if they perceive that modifying accounting standards could impair the market price of their shares. But there are other obstacles as well. For one thing, corporations

opposing the change often claim that altering some accounting principle or other could affect "the covenants" and leave them vulnerable.

One good illustration of this concern is a case from 1994, when a major change in inflation accounting rules was adopted, to take effect in 1996. Beginning in that year, companies would no longer be permitted to restate nonmonetary assets (inventories and fixed assets) on the strength of valuations by independent appraisers. This turned out to be one of the most hotly debated changes in MASC's history. In the end, the standard, whose aim was to elicit more reliable financial information, was issued more in line with international accounting principles based on historical cost.

Two factors that helped to move this major alignment forward were the 7 percent inflation rate forecast for the year and the fact that the modification had the endorsement of the other members of the American Free Trade Association. Unfortunately, the problems that befell Mexico in December of that year and their aftermath, including a 50 percent devaluation of the peso, complicated matters greatly, and MASC delayed the change until 1997. In 1996, as it sought to confirm the entry into force of the change, MASC ran head-on into the protests of public companies, which feared yet another macro devaluation of the peso (an unlikely scenario, but always a political possibility) that would leave them with too little net worth to satisfy leverage covenants comfortably. They argued that if general price-level accounting was mandatory, and there was another macro devaluation, dollar liabilities would climb more quickly than assets.

Another proposed change in standards that is currently out for comment concerns accounting for deferred taxes, to align with the FASB and AcSB approaches and the standard recently approved by the IASC board. Companies are also concerned about the huge impact that such a change could have on their bottom line, since Mexican financial reporting currently does not recognize the portion of "liabilities and equity" that does not belong to the shareholders but instead goes for taxes; that is, tax liability is not recognized. Here, the input received from business circles falls into two categories—technical and practical. From a technical standpoint, echoing arguments by the United Kingdom last year when this important issue was on the table, this liability should not be recognized because a company normally will not know when the tax will be paid to the government. And on the pragmatic side, companies complain that their bottom lines are still being buffeted by the 1994 crisis and that this new accounting rule will eat away at the equity on their balance sheets.

Another unanticipated problem with which Mexico has had to grapple is the need to speed up its reaction to international developments in this area. Nowadays, every standard-setting body that aspires to a top-quality work product is closely monitoring the formulation and promulgation of draft and final international accounting standards. This means professional researchers, and that takes money. The situations of Canada and the United States are illustrative. The governing body of Canada's AcSB is a board of about ten members, all of them unpaid, although the board defrays all costs incurred while doing their work. The board is assisted by a research and development staff headed by a director for accounting standards. The staff is paid by the board. In the case of FASB, all members of the board as well as some seventy research staffers are remunerated by the board itself.

MASC members serve *ad honorem* and also defray, out of their own pockets, the expenses associated with performing their committee duties. Because it has no support staff for research, MASC resorts to informal working groups; but since members of these groups also serve without remuneration, they tend to work through their agendas much

more slowly than desirable. The new push to align Mexico's standards has left this problem very much in evidence; obviously, we would like our work to proceed at the same pace as in the more advanced countries.

Another obstacle warranting mention is the inevitable overlap of domains of the regulatory bodies that are charged, by law, with accounting rulemaking and those that develop and promulgate standards by dint of purely professional and moral authority. In fact, this obstacle has been virtually eliminated in the case of listed companies, although there will always be the occasional problem when political considerations run up against accounting profession ones.

There has been no instance in recent years of CNBV handing down an accounting rule for securities issuers that is at odds with any accounting principle. For a long time, Mex GAAPs were largely ignored by the banking industry. The year 1997 proved to be a landmark for reconciliation in this area. Nevertheless, there is an element of inertia that could slow any comprehensive alignment. If MASC does not rise quickly, and with a high-quality product, to the opportunity CNBV is offering it to become the professional standard-setter, leaving the legal end of things as it is for publicly traded companies, it runs the risk of losing ground and regressing to approaches that are simply obsolete.

### **What Can Be Learned from the Mexican Experience?**

The first lessons that the Mexican case yields relate to four goals that are not being achieved as planned and the possible reasons and remedies. First, do not expect the process to be simple or to see a consensus built readily about the changes that harmonization entails. Such changes undeniably affect the financial information prepared by companies that trade on securities exchanges. In Mexico's experience, the orthodoxy of the standards cannot be considered in isolation from certain practical realities, and countries may be well advised to think in stages (rather than launch into a single move), leaving the eminently technical elements to the end.

Second, and along these same lines, the Mexican case shows that regulators that oversee public companies or banks will only endorse technical pronouncements in pursuit of international harmonization when this does not create situations with political overtones that would place the agencies in a very awkward position.

Third, even when a country acknowledges that it must devote far more time and effort to research and development of international standards, that is only half the battle. Mexico, for instance, is now rethinking its strategic plan, and one element is the practical matter of finding the resources to pay for a body of researchers to underpin the process. Fourth is the speed of response. Unless MASC can come up with formulas to work more efficiently, it runs the risk of missing opportunities. And this raises yet another concern: if we fail to move quickly and with the world-caliber product required, the regulator could take back its legal rulemaking role and undermine IMCP's moral authority to set standards.

We turn now to some of the gains that Mexico has achieved in the harmonization process, which might serve as guideposts for other nations. The decision to embark on a harmonization process, and to fast-track the work since 1992, has been one of the best decisions ever made by MASC and IMCP. As we move forward, the benefits that the country, and the business community in particular, stand to gain are increasingly evident. The goal is clear: harmonize to the maximum and bring down the cost of funding.

Rather than simply adopting the GAAPs of IASC or some other body, Mexico elected to begin with its own body of standards and move them, wherever relevant, toward inter-

national standards. To do otherwise—to ignore our particular economic and political circumstances—seemed most imprudent. Although that other avenue may be the choice of another Latin American or Caribbean country, our own experience suggests that it would be wise to weigh other options before making a final decision.

In the course of harmonization, strengthening communications and relations with official rulemakers, to persuade them to look as much as possible to MASC, has yielded enormous dividends. Keeping in close touch with intermediate business organizations also appears to have been a sensible move.

On the technical side—how best to go about harmonization—the role of Mexico in the American Free Trade Association group has worked greatly to its advantage. Obviously, this strategy cannot be replicated in all cases, but the idea is there for other countries in the hemisphere: work in blocs as the Southern Cone is doing, touching base with FASB and IASC and perhaps with other Latin American countries such as Argentina, Chile, or Mexico, but not forgetting the Inter-American Accounting Association and COSRA.

Finally, as we turn more attention to specialized segments such as banks, insurance companies, and government, which were largely left out in the past, harmonization of standards is becoming, as it must, a truly all-encompassing process.

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## ACCOUNTING PRINCIPLES IN VENEZUELA: HOW INTERNATIONAL WILL THEY BE?

ALBERTO KRYGIER\*

In recent decades, the international business world has changed and expanded greatly. It now includes enterprises that are truly multinational and some that approach global scale, operating in most countries of the world. This development is accompanied by a growing movement of capital, which, in the view of many analysts, is the engine that impels it. Together with far-reaching technological changes, this is giving organic coherence to a new business system.

Shareholders, investors, company managers, financiers, participants in transnational movements of capital, multinational enterprises, and governments and their regulatory agencies all need a common language in which the financial positions, operations, and transactions of enterprises can be understood and communicated. Just as individuals of different countries and cultures need to share a common language in which to communicate, those who invest capital and manage business enterprises need to share a common financial reporting system in which to communicate the financial, economic, and operational aspects of the business enterprise.

Every enterprise operating beyond the borders of its own country needs common, uniform accounting standards that apply everywhere it operates. This uniformity is needed to ensure that the results of each segment of its operations are reported on a basis comparable with that applying in other segments. Comparable reporting is necessary for both internal and external purposes, that is, for both the manager and the investor. It is needed internally so that operations may be properly controlled, resources may be correctly allocated, and managers may be appropriately evaluated and remunerated. This is very important for internal and external benchmarking. Comparable reporting by all segments of a company also facilitates consistent reporting of consolidated results to shareholders, creditors, and the public. Actual and potential investors and other users of financial statements require an intelligible financial language (which could be that of global accounting and information standards) to analyze the financial statements of companies regardless of where they are located and to evaluate them in relation to investment objectives.

The development of accounting has paralleled and been necessary for the development of capital markets. In the past, capital markets were national in scope, and accounting practices differed from country to country. Today, national capital markets are becoming a global feature of the marketplace. The level of foreign investment in Venezuela, as well as Venezuelan investment in foreign markets, has grown significantly in proportion to the size of the country's capital market and the level of economic activity. Such a closely interrelated capital market needs an international financial language with worldwide accounting standards (and in some cases regional standards) and a clear concordance between them.

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### Who Defines Accounting Principles in Venezuela?

In practice, public accountants use the phrase “generally accepted accounting principles” in professional pronouncements, but the phrase is subject to some limitations. For example, there is a recognized order of precedence led by domestic statements and followed by international ones in Venezuela.

There is the impression that some recently adopted domestic accounting principles are not generally accepted because of the economic complexities inherent in adjusting for inflation and currency devaluation. Some financial pronouncements for use abroad are based on principles of the United States and the International Accounting Standards Commission (IASC) instead of or in addition to domestic standards. Banks and insurance companies, savings banks, mutual funds, and other entities have to apply standards framed by local regulatory institutions (superintendencies), which are not recognized as generally accepted principles, although in some cases they may be more prudent. The disclosure standards of the Comisión Nacional de Valores (National Securities Commission, CNV) enjoy the status of quasi-generally accepted accounting principles. The phrase “generally accepted accounting principles” occurs in laws and official documents but is not defined in them.

Venezuela functions mainly within the economic sphere of influence of the United States and of Anglo-Saxon culture and tends to look to the North, although its legal roots and traditional culture lie mainly in Europe. Mexico is regarded as one would an older brother, and there has recently been a rapprochement with the Mercosur countries.

Like the financial market, accounting follows capital flows. The strong influence exerted by the United States stems from its weight in this sector. The first public accounting firm in Venezuela was established in the mid-1940s to serve the international oil companies, which had long been operating in the country. This firm modeled its auditing services and its advice in matters of financial statements on those prevailing in the United States at that time.

The manufacturing and extractive industries that flourished in the 1950s were owned by domestic investors, the government, and foreign enterprises. The bulk of financing came from international banks, most of them from the United States. The accounting principles and auditing standards defined by the American Institute of Certified Public Accountants (AICPA) were already accepted. In those days the accounting profession consisted of little more than an association of the best bookkeepers and income tax specialists, who were referred to as accounting technicians. Accounting rose to the status of a university-taught subject some years later. As a consequence, even as recently as the early 1970s, generally accepted accounting standards lacked any specification of where the acceptance came from. It was tacitly understood that the principles employed in Venezuela were the same as those used in the United States.

In 1973 four bodies came into existence that would make key contributions to the preparation of financial statements in Venezuela:

- *The Federation of Associations of Public Accountants (FCCPV)*. The FCCPV established a ranking of the principles that would be applied. The first level of priority would thus rest with the FCCPV's own declarations. The principles of the Mexican Institute of Public Accountants (IMCP) would apply to cases in which FCCPV has not taken a position, and AICPA standards would hold in cases where neither the FCCPV nor the IMCP has established a precedent.

- *The National Securities Commission.* The CNV issued standards for the presentation of financial statements by enterprises subject to its supervision.
- *The Financial Accounting Standards Board (FASB).* The replacement of the Accounting Principles Board by the FASB, a U.S. body of much greater resources and superior approach, was perceived in Venezuela as providing a positive contribution to the professional literature then available.
- *The International Accounting Standards Committee.* Because accounting principles were only beginning to be developed in Venezuela when the IASC was established more than twenty years ago, and given the strong influence of the United States, the impact of this body has been limited.

### **The Legal Framework**

Several laws (including the commercial code, the central bank law, the income tax legislation code, the law on the practice of public accounting, and the law on capital markets) have provisions on commercial and accounting practice that, in many situations, give rise to doubts and confusion regarding the recording of financial transactions and statements. Yet none of these laws establishes accounting principles. This legislation should be harmonized and brought into line with modern practice.

The Superintendency of Banks and Credit Institutions and the Superintendency of Insurance only permit the publication of financial statements that conform to their standards of measurement and, at the very least, to their standards of disclosure. These rules of disclosure are often broadened in practice. As a result, contrary to the case in other countries (including the United States), Venezuelan standards of measurement differ from the accounting principles applied outside banks and insurance companies. Recently introduced rules require that primary financial statements that are not consolidated and compiled in accordance with bank rules be accompanied by statements constructed on the basis of principles in general use. Thus, it is customary for a public accountant's opinion on a bank or credit institution to refer to bank rules (and those issued by the Superintendency of Insurance for its own industry) as something different from generally accepted accounting principles. We find, however, that the accounting principles of those establishments can be more prudent than so-called generally accepted principles.

In their present form, the standards of the Superintendency of Banks are of recent issue and come closer than before to the principles applied outside the industry. This distinction between "standards" and "principles" and the major differences between them are expected to disappear as accounting principles are harmonized.

### **Federation of Associations of Public Accountants**

It is important to understand the order in which sources of reference are ranked by the FCCPV. Starting in 1997, the FCCPV began to group the accepted principles in the five bodies of pronouncements, ranked in the following order:

- (i) The declarations and publications of the FCCPV
- (ii) The international accounting standards (IASs)
- (iii) The pronouncements of the IMCP

- (iv) The pronouncements of the FASB
- (v) The pronouncements of other Latin American countries in economic situations similar to Venezuela's.

This ranking differs from the one that prevailed for two decades, which was Venezuela, then Mexico, and then the United States.

Most current declarations are based on studies and research on the declarations of the Accounting Principles Board, FASB, IASC, and IMCP and their adaptations to the local environment, with some sections comprising responses to purely local situations. Until recently, the most significant difference between U.S. and Venezuelan principles (as issued by the FCCPV) was the Venezuelan standard allowing amortization of preoperational costs over several years. In the United States, these costs are shown directly on the income statement, an example of how the legal context influences the development of accounting principles.

Changes in the value of the currency and in the cost of living have given rise to truly local pronouncements. Recent declarations include many paragraphs and sentences found in the IAS or Mexico's B-10 but do not necessarily agree with every section of those standards. Situations arise in which it is difficult to determine the extent to which these domestic declarations may be interpreted in light of the foreign pronouncements or whether foreign pronouncements may be used as reference.

### ***National Securities Commission***

Almost all of the standards of the National Securities Commission relate to disclosure and are, in effect, a summary version of U.S. Securities and Exchange Commission rule S-X. On disclosure, they do not conflict with the declarations of the FCCPV or international principles.

### ***Firms and Their Customers***

There can be no question that the leading public accounting firms are vehicles for the transmission of concepts and the detection of emerging issues. On many occasions, publications of public accounting firms support the FCCPV and the regulatory agencies. The latter are prone to solicit suggestions and to inquire through the firms about practices in other countries.

However, the largest accounting firms are not among the lead actors in the FCCPV. The country's lead industries are in a similar situation. The oil industry, for example, has applied financial accounting standard (FAS) 19 in its accounting for oil exploration and extraction, interpreting it in light of local conditions where necessary. Other extractive industries also look to the outside world for their accounting guidelines, and this enriches local doctrine.

### ***Foreign Actors***

As noted, the FCCPV's order of precedence among its sources of principles (in the absence of pronouncements of its own) is IAS/Mexico/United States/Latin America, and until recently it was Mexico/United States. However, a distinction must be drawn between this ranking and the traditional influence of these sources of principles. Indisputably, the

United States has exerted the greatest influence, followed by Mexico; it remains to be seen the extent to which this will change as the IASC becomes more prominent.

One question concerning the precedence and interpretation of the principles to be applied is the meaning of the phrases “*pronunciamientos expresos*” (explicit pronouncements on the part of the FCCPV and “*principios ... expresamente mencionados por el IMCP*” (principles ... explicitly mentioned by the IMCP). To cite just one example, Venezuela has one declaration on the consolidation of financial statements, and Mexico has another. The two are similar, but Mexico’s includes elements not found in the Venezuelan one. Needless to say, the United States has its own, which is considerably more extensive. The approach is essentially similar, but if the U.S. declaration is taken as the basis for comparison, one must conclude that the two Latin American documents fail to cover some issues that arise from time to time. Now, does the U.S. document have to be followed in its entirety? Or can it be assumed that Venezuela has defined its own principles in this area and that what is not found in the declaration of accounting principles is not integral to the body of our doctrine?

This question will become increasingly important in the new hierarchy of principles, in which the IASs (which are markedly generic compared with the FASs) are resorted to first in the absence of domestic pronouncements. As can be seen, it is important to establish a body of single principles consonant with the domestic economic situation.

#### ***Instituto Mexicano de Contadores Públicos***

It is natural that the Mexican principles should have influence in Venezuela. The IMCP’s bulletins on accounting principles are published in Spanish. They come from a Latin American country with an economy and culture similar to that of Venezuela. They are well reasoned, and they do not differ enough from U.S. principles to give rise to confusion. And, although of a more limited content than those of the United States, they are much more simple and understandable. However, today fewer details are covered in the IMCP’s bulletins that are not dealt with in the FCCPV’s declarations. There is a pronounced trend in the profession to bypass the *boletines* and go straight to the U.S. pronouncements.

#### ***International Accounting Standards Commission***

In recent years, there has been a strong inclination to apply international accounting standards. Despite the influence that the United States has had on the development of its accounting framework, that country’s reluctance to accept the IASC’s pronouncements has apparently impeded their worldwide acceptance as a common language. Owing to the strong influence of the United States in Venezuela, these discrepancies with the international standards have made themselves felt over the past two decades. Some observers advocate the general application of the U.S. generally accepted accounting principles (GAAPs) because they are the broadest and most stringent in regard to disclosure in financial statements. Today, this view is losing ground in Venezuela. As we will see, a few enterprises have already issued financial pronouncements based on IASC standards without making any reference whatever to Venezuelan principles.

#### ***Interamerican Accounting Association***

The Interamerican Accounting Association (IAA) has no significant role in Venezuela, although the country sends a large delegation to each IAA conference, and the conference

reports circulate in the country. The reason lies in the fact that in economic matters Venezuela looks to the North. Perhaps more attention will be paid to the conferences as the country opens itself further to world trade in nonpetroleum markets. The new, higher ranking on the scale of sources of consultation recommended by the FCCPV for “pronouncements of other Latin American countries in economic situations similar to Venezuela’s” may also have the same result. Perhaps we should look more closely at this path when we start thinking about harmonization.

### **How Good Are Venezuelan Accounting Principles?**

The accounting principles applied in Venezuela during decades of official boom and even as recently as 1982 gave no major cause for concern. The U.S. and Mexican principles filled the gaps in the meager domestic literature. Moreover, the economy was—or was supposed to be—in good shape, and there were relatively few accounting challenges. The general price index jumped 20 percent in 1979 and as much again in 1980. But it was not until 1988 that Venezuela experienced a cumulative increase in inflation of 100 percent or more in three years, which the FASB had defined as a sign of hyperinflation.

The immediate consequences for the public accountant were, among others, (1) an accentuation of the old problem of technical erosion of the nation’s wealth, according to the commercial code, (2) uncertainty about the exchange rate applicable to liabilities in foreign currencies, (3) doubts about the rate applicable to the conversion of financial statements into dollars and other foreign currencies, and (4) the problem of the treatment of exchange losses. The first two of these consequences, in particular, tested the skills of independent auditors to their fullest, but this is not of great interest here. I will refer to the first and last points in the context of accounting principles.

The commercial code requires that certain steps be taken when the deficit of a stock company exceeds its capital stock by a certain percentage. If every kind of preoperational cost or expense for research and development had to be accounted directly, a fall in net worth would raise problems for many enterprises that are developing or are in the preoperational stage of new projects. With inflation and the exchange crisis, these amounts rise, especially when much of the machinery is imported or financed in foreign currency. To avert this balance sheet loss, costs of this kind are deferred and amortized. This practice diverges considerably from that of FASs 2 and 7. Therefore, in 1983 the FCCPV formalized the practice in a declaration. This was the first formal divergence from U.S. GAAPs. But it was not the main one. Some enterprises started to value their fixed assets at their estimated replacement cost (revaluation) because of inflation and the rising costs of finance in foreign currency. There was no local pronouncement—much less any from the United States—to authorize this method. Nor was it authorized by the National Securities Commission, which also did not, however, disallow it when authorizing increases in capital stock brought about by the surpluses generated.

As a result, the opinions issued by independent auditors were full of caveats and reservations and remained so for several years. Yet this remained a common practice. The National Securities Commission, realizing that some accounting response had to be made to inflation, gave its tacit consent. It was a classic case of a generally accepted practice that public accountants did not call a generally accepted principle! Another deficiency was the lack of principles for the important liability of labor remunerations.

Let us now move to the fourth consequence on the list: how to record exchange losses. In 1986 the FCCPV issued a declaration that allowed the amortization or inclusion

of exchange losses in the cost of the fixed asset or merchandise that gave rise to the debt. Justification for this action was found in an IAS and in the professional literature of some foreign countries, but not in that of the United States (it was later modified by DPC-10). The gap was widening: U.S. principles appeared to be unsuited to an inflationary economy in a non-Anglo-Saxon legal setting. In 1991 the FCCPV issued a declaration on allowance for the effects of inflation (DPC-10).

For three years, the new financial results adjusted for inflation could be presented solely as complementary information. The change was completed, for purposes of the profession's principles, in 1996. The FCCPV holds that the generally accepted accounting principles are complied with only by financial statements that have been adjusted for inflation, which means that the historical cost is dropped.

The three-year adjustment period was not long enough for industry, government, and the profession to interest themselves in the complexities and consequences of this decision and to study them properly. Banks and insurance companies—two industries whose net worth was being eroded by the inflationary spiral—apparently had no need to apply the declaration and did not do so.

This declaration—with its many amendments—resembles its Mexican counterpart and is conceptually very close to IAS 29, FAS 89, APB (Accounting Principles Board) statement 33, and the models used in the Mercosur countries. However, it has met with strong opposition because it is very complex and confusing. The reason for this is a lack of early training, weaknesses and gaps in the language of the standard, and other causes, but most of all, doubts about the usefulness and objectivity of the resulting financial statements and information. In particular, there is the option of restating using the general price index or, if preferred, using current values for fixed assets and inventories. Hence, the effect of adjustments differs greatly among enterprises whose financial statements would otherwise be similar. Also, rates of inflation vary by region and industry. The gain or loss produced by the currency variations is at once reflected in the results for the year despite the fact that part of it may not be realized and the effect on dividends may not be felt during the same financial period. The relationship between inflationary gains and exchange losses can become significantly skewed when there is no reasonable correspondence between the rise in the price index and currency devaluation.

Needless to say, Venezuelan enterprises were heavily indebted in the past. Now that the exchange system has been repealed, this indebtedness has become more moderate but is again denominated by foreign currency debt. As a result, some enterprises in a weak financial position have relied on the net profits shown in adjusted financial statements (a consequence of the accounting benefit that accrues from converting the net liabilities) for purposes of dividend distributions when they should not have done so. And, perhaps more harmless, others have included in their capital stock the surplus from revaluing fixed assets that will probably never be replaced at the values assessed. The professional technical publications and the National Securities Commission provide few guidelines for the declaration of dividends.

There is no doubt that, in times of high inflation, ideal financial reporting becomes a highly complicated—if not actually impossible—exercise. The most important point for application of the standard has been to present the information in a constant currency. However, given the ups and downs of economies like Venezuela's, it has been considered appropriate to state fixed assets and merchandise inventories at their replacement value (FAS 121 is the U.S. counterpart). This procedure has been given the inelegant name of "mixed method." It departs from homogeneity in combining current and past values. But

these amounts must not exceed the use value, which simply restricts that value to discounted future income. This is another departure from the homogeneous-currency principle. That is, complications ensue when financial statements are presented in a current currency and at a value not above the market value. The irony is that, despite these complications on the balance sheet and income statement, in high-inflation countries it is cash flow that receives special attention from financing entities and investors.

The purpose of this chapter is not to consider whether these effects are the consequence of a deficient accounting system or a misinterpretation of the information supplied in financial statements. The fact is that adjustments for inflation do not receive the understanding and support that accounting principles should enjoy. Most enterprises apply the declaration in their primary financial statements and try to understand it. Others do not apply it and accept the resulting reservations in their auditors' opinions, focusing on financial statements denominated in foreign currency unadjusted for the effects of inflation. In its annual reports, the national oil company does not issue as its principal statement financial statements in domestic currency adjusted for inflation. Instead, it publishes financial statements denominated in dollars, applies the international accounting standards, publishes financial statements in bolivars at nominal value as complementary information, and applies all the principles generally accepted in the country except the adjustment for inflation. It remains to be seen the extent to which any of these practices will become more widespread.

Other extractive and manufacturing enterprises are in similar situations. None of the largest companies has decided to discontinue issuing financial statements in bolivars adjusted for inflation, and most of them could not do so because they are subject to the standards of the National Securities Commission.

One response envisaged could be to comply with the national principles but at the same time to circulate, within and outside the country, financial statements in foreign currency based either on the IASs or the FASs. A few enterprises are doing this. It might be the most reasonable and intelligent thing to do until we put our house in order.

In conclusion, inflation, devaluation, and their variations are complicating the principles of accounting and the preparation of financial information to the point that these statements are losing credibility and acceptance (see box 4.1).

### **How Can Accounting Principles Be Harmonized?**

We have implied that the work of the FCCPV in framing principles is gaining momentum, but there is need for more participation in and contributions to the unification of standards by domestic entities, such as the profession, shareholders, bankers, government superintendencies, and users of financial information. It has also been recognized that inflation and devaluation are eroding the effectiveness of the domestic principles and the use of the national currency in financial statements.

#### ***Discrepancies with Other Systems***

Deficiencies of disclosure (or of preparation) are minimal. Many accounting firms use programs based on the requirements of the IASC and the U.S. Securities and Exchange Commission, in addition to those of the National Securities Commission and the domestic statements. Discrepancies between principles stem from measurement of value.

**Box 4.1. The Current State of Accounting Principles in Venezuela**

- The definition of Venezuelan principles such as those enunciated by the FCCPV plus, where they are lacking, a series of foreign statements ranked by the weight given to them in Venezuela
- Evidence that U.S. principles are not entirely applicable or appropriate
- Recognition of the usefulness of the Mexican principles and the standards of the IASC
- Little law, but a good body of National Securities Commission disclosure rules
- Differentiation between the so-called generally accepted principles and the standards of government superintendencies
- The inclusion of adjustments for inflation based mostly on foreign statements, which are not, however, satisfactorily understood or accepted in Venezuela
- The beginning of a shift toward the IASs as the model for domestic statements
- Evidence that the IASs and/or FASs may be incorporated into or adapted to domestic principles.

Regarding discrepancies between the principles of the FCCPV and those of IASC, it is obvious that at issue are the rules Venezuela is following that contradict those of the IASC, with regard to what is either required or permissible. For example, Venezuela defers preoperational costs on a more liberal basis than IAS 9, and Venezuela requires the inclusion of “negative appreciation” (known as commercial debit in some countries) as part of the consolidated net worth of one group, whereas IAS 22 sees it as a deferred credit.

One reason for the minimal number of discrepancies is that several standards allow for alternative options. For example, as long as the IASC continues to accept the deferral method for income tax purposes, Venezuela can continue to use the old APB 11 (the deferral method is “permissible” in the IAS but is apparently about to be dropped). Discrepancies tend to increase as alternatives are eliminated from the IAS standards, which will compel its definition.

A different picture emerges with regard to discrepancies with the U.S. principles. The Mexican *boletines* and, at least in theory, the IAS standards have a higher preference ranking. In practice, it cannot yet be known the extent to which enterprises and the accounting profession will put into practice the recent change in ranking that gives IASs preference over FASs. Old habits die hard, and, besides, there are those for whom the flexibility of the IASs, which is disappearing, is not enough. To simplify at the outset, the Securities and Exchange Commission does not regard the controversial adjustments for inflation as a discrepancy with U.S. GAAPs.

I will not attempt a detailed inventory of differences along the path FCCPV/IASC/IMCP/FASB, but some come to mind:

- Mexico allows direct costing in the valuation of inventories, and, in theory, the method is permissible in Venezuela.
- The IASs advocate adjusting the financial statements of a foreign branch for inflation followed by its reconversion at the current exchange rate for consolidation purposes. This method is disapproved in the United States, especially when there is no asymmetry between the levels of inflation and devaluation.

- Several differences—not necessarily of great impact—are seen in consolidation techniques and application of the method of participation in net worth.
- If a Venezuelan enterprise were to apply the Mexican accounting standards on leases (which is traditionally not done, although the country has no standards of its own), it would discover differences with the United States.
- In consolidation, net appreciation is amortized over twenty years at most in Venezuela, compared with a maximum of forty years in the United States, at least in theory.

### Options

Each country should have a set of core principles consonant with its own cultural, economic, and legal setting. Beyond this, two difficulties arise:

- (i) The country may become dependent on standards that are alien to local conditions. For example, U.S. GAAPs were developed in an industrialized country and culture and are not necessarily appropriate for countries with different cultures and at other stages of development. Moreover, they are based on negotiations among different actors and on interests that respond to particular situations.
- (ii) Local standards are issued in subjects in which extensive experience has already been acquired throughout the world.

It is taken for granted that the FCCPV will substantially extend its series of statements under the title of generally accepted accounting principles. It is also taken for granted that there will be some harmonization between these principles and the standards of the superintendencies, although not necessarily in the immediate future. However, the following doubts have arisen:

- Will domestic pronouncements diverge from foreign ones?
- Will the predominant influence on domestic principles be that of the IASC or of the FASB?
- Will enterprises that resort to foreign financing use the IASs or the FASs in lieu of domestic principles?

Globally, the question is the extent to which U.S. and international accounting principles will come together or, if they do not, the extent to which the U.S. Securities and Exchange Commission, in particular, and other agencies will regard IASs as acceptable in the United States.

It should be clear by now that Venezuela's standards are, in theory, not far removed from those of the IASC, but there is not yet adequate harmony with them. On the one hand, Venezuelan standards are taken as models in recent pronouncements, and IASC standards are recognized as a second reference source. On the other hand, the FCCPV has issued about the same number of pronouncements and amendments in the past six years as it did in the previous twenty years and may be expected to go on writing standards of its own. U.S. principles are deeply rooted, and the general preference is to opt for some detail in the FASs instead of relying on broader matrixes in the IASC standards; and the FASs cover subjects that the IASs do not yet deal with (the extractive industry is an example of particular importance to Venezuela.)

The road to take could consist of three steps. The first step would be to include by reference all IASs as accounting principles generally accepted in Venezuela, and the second would be to include, also by reference, certain FAS pronouncements to complement, but not contradict, the first step. This second step would permit the inclusion, under the heading of "accounting principles generally accepted in Venezuela," of the standards of the Superintendency of Banks and the FASs on specific industries that are essential to the national economy, for example, oil and gas. The third step would be to issue domestic pronouncements or to include domestic exceptions where necessary. This step is very important and would allow the coverage of matters peculiar to the country and also eliminate IAS alternatives perceived to be inappropriate for Venezuela.

Harmonization of Venezuelan and U.S. principles is a horse of a different color for the following reasons. Venezuela is closer to the United States but, at the same time, farther apart because the IASC and IMCP alternatives stand in the way. The U.S. doctrine is inconclusive on accounting in an inflationary setting, and the pronouncement on deferred taxes is acquiring few converts outside the United States. Moreover, there is the argument that the many branches of U.S. parent firms will always have to adhere to the U.S. GAAPs, and, if the FASs are going to be so used in the country, why not apply them almost universally? This argument is intrinsically weak, and, briefly put, it is not "politically correct." The solution is not to Americanize the world but to internationalize or globalize the United States. Suppose a migration to the IASs similar or not to what I have recommended and keep in mind that the migration could be to the FASs instead. What would be some of the obstacles, logistical issues, and possible consequences in this scenario? Answers to this question cannot be categorical because situations differ.

The only distortions meriting special attention are those that arise from what is known by the misnomer of inflationary accounting. They would not be eliminated by the IASs alone. The FASs could not cope with them. Both systems would permit restatement by a general price index, the consequent uncertainty about realization of the results reflected by the currency position, and the consequences of any imbalance between inflation and devaluation. The IASs would view with benevolence the concept of current value for nonmonetary assets, but the FASs would accept it only in a context that showed the effects of inflation.

Distortions would be reduced instead by pressure to use the dollar, or some other strong currency, in financial statements sent abroad. This point is important here because one reason for doing this would be to avoid the application of inflationary accounting. But the point is not entirely valid. Doesn't using the dollar as a reporting currency engender its own distortions when the business is operated in local currency?

### **The Impact of Harmonization**

Today many accountants are carrying out every kind of reconciliation, analysis, and explanation so that the reader will interpret financial statements in the "language" of the FASs or the IASs. This is accomplished, but sometimes not in an orthodox way. The point has considerable force, however. It would be highly desirable for those who rule the destinies of the accounting profession to speak with one voice to the entrepreneurial community, the banks, and the stock exchange community inside and outside the country and to those who will follow us in the profession. The more discrepancies in methodology and difficulties of interpretation and the less clarity there are, the less confidence there will be—and has been—in the product.

One way or another, every user estimates his results, net worth, and so forth in his own way. A harmonization (I prefer to call it fusion) of principles would obviate or facilitate this work for many and help others to understand it better. That net profit is going to change is not in doubt. Several enterprises have hastened to apply adjustments for inflation because they have expected a better result, and just as many want to discard the method because they do not like what they see. Inflation aside, however, the financial statements being generated in Venezuela nowadays are not radically different from what they would be under the IASs or FASs alone.

In theory, instruction in accounting principles generally accepted in Venezuela will have to change in any case. Hitherto instruction has been based on the FASs, with IASs mentioned as an afterthought. In the ranking formalized by the FCCPV in 1997, this order of precedence should be reversed. However that may be, the instruction should also include the standards of the National Securities Commission and the rules of other superintendencies. Harmonization would simplify the system and improve professional training by focusing more precisely on important doctrine. Training and communication must be broadened and extended to all users of financial information, for the gap in this area is very wide.

The sources of reference used by the superintendencies are those of Latin America and the United States. But government regulatory bodies do not easily give up their regulatory power. Regulatory bodies in Venezuela would be much affected by harmonizing FCCPV with either IASs or U.S. principles.

Financial information must take cognizance of economic and commercial events beyond their mere legal reality. However, commercial laws must provide for the recording and reporting of commercial and financial transactions. If they do not, there would be a legal vacuum in which information would be of no importance for the legal decisions that enterprises must make, as in the case of capital increases and payments of dividends. This is what happens in Venezuela: the laws do not provide for currency exchanges or for novel accounting principles such as the restatement and conversion of financial statements or the effects of the ones on the others.

The business community would welcome any harmonization of Venezuelan principles with those accepted in financial markets abroad, whichever they were. Much of the entrepreneurial sector (both at home and abroad) has no confidence in adjustments for inflation or in the profession's reversals of position in recent years. Nor does it enjoy having to construct a second set of financial statements to satisfy readers outside the country.

It is interesting that in 1996, after using U.S. principles for its complementary information for three years, the country's main oil company opted to use the IASs for its primary financial statements. We must not conclude that every entrepreneur will necessarily choose the IASs, because the FASs have a better tradition and are mandatory for the financial statements that must be submitted to U.S. parent companies.

However, the entrepreneurial sector wants a guidepost and would generally accept whatever the financial market accepts. The more international the operations and funding sources of an enterprise, the less interested it will be in local pronouncements. Etiquette is not its foremost consideration; what it wants is a single set of reports, or two sets, that it can understand and trust and that satisfies the sources of its financing and its investors, complies with the applicable laws and regulations, and is useful in the management of its business.

We have already seen some signs of political reaction to the formalization of principles that are not purely of domestic origin:

- Regulations and contracts with government enterprises customarily refer to “the accounting principles generally accepted in Venezuela.”
- The references to which the government superintendencies turn tend to be those of U.S. and Latin American origin.
- The government superintendencies have been cautious, not to say slow, in including inflation accounting into their own rules.
- The generalized application of U.S. principles would not be acceptable.

The interpretation of these signs—some of them mutually contradictory—is that there would be no strong objection to a body of statements of international origin (especially if they were the IASs instead of the FASs) so long as they were designated by the domestic accounting profession as generally accepted in Venezuela.

### **The Role of Financial Markets**

Four primary entities influence Venezuela’s financial markets: national banks, international banks, national stock exchanges, and foreign stock exchanges. The fourth category includes the major institutional investors that take up securities under rule 144A. Two additional entities—domestic shareholders and parent companies abroad—have already been discussed. None of these entities differs greatly in the financial information it expects to receive.

Although the Venezuelan banking system is very small relative to market demand, the leading domestic banks want reliable and understandable financial statements just as much as do their international competitors operating within and outside the country. It is true that they tend to think in terms of the national currency and, up to a point, in terms of the individual entities in a consolidated group. Like Venezuelan stock market analysts, there are bankers who regard inflationary adjustments as nothing very serious. Family groups that used to be the envy of the business world in past decades, like enterprises that were greatly sought after on the securities market in the 1980s, have long been teetering on the edge of forced liquidation or have been acquired by foreign creditors despite the apparently satisfactory results they presented for years. The most common story is that companies incur indebtedness in foreign exchange that shows up on the books as an exchange profit that does not materialize—and is never realized because the exchange rate is adjusted to realistic parity! The moral of the story may be that the financial markets do not know how to read, but in their view, it is the accountants who do not know how to write.

Today only three Venezuelan enterprises have their American depository receipts quoted on the New York Stock Exchange. A few have issued securities to large investors under rule 144A. Many intermediate-size enterprises owned entirely by domestic investors even send their financial statements abroad. In a recent declaration, the FCCPV included a separate provision on how these enterprises were to convert their financial statements for use abroad.

Sooner or later the rules of the U.S. Securities and Exchange Commission set the standard. They are not the last word for those who have not fallen within their sphere of oversight, but they are the yardstick for the quality of financial statements even for companies that obtain financing outside the United States and its stock markets. As we all know, these rules are less demanding than they used to be for securities-issuing enterprises established outside the United States. The U.S. view is that its Securities and

Exchange Commission has done much to facilitate access to the country's capital markets. The view abroad is that, although this is true, the SEC could do more. Fortunately, there is some agreement that this "more" includes a rapprochement between U.S. GAAPs and the accounting standards of other jurisdictions.

For countries that cannot work almost day-to-day with the FASB as Canada does, the IASs offer a vehicle for rapprochement. Venezuelan enterprises deal with international banks; some of these banks customarily ask for financial information in compliance with U.S. principles, while others ask for it in compliance with principles of the IASC. When the SEC finally accepts the IASs as a proper medium for the presentation of financial information—and we hope it will do so soon—those banks will probably ask for financial statements in compliance with the IASs or the GAAPs.

### **The Role of the Independent Auditor**

The audits performed by public accountants in the independent practice of their profession are part and parcel of the financial market in Venezuela, apart from the demand for these services by parent companies abroad. External auditing is still an expanding industry.

The domestic banks, the Central Bank of Venezuela, several ministries, the National Securities Commission, the Superintendency of Banks, and the larger and intermediate enterprises that enter into agreements among themselves all include in their rules and contracts a reference to financial statements certified by public accountants, possibly adding the phrase "in compliance with generally accepted accounting standards." Since the 1950s every major international firm of public accountants has had a branch in the country, which is required by law to use a business style consisting exclusively of the names of the senior partners. The largest firms have connections with some foreign firms, but they are purely domestic firms of established prestige. There is no review program under which one firm evaluates the procedures of another.

The accounting profession consists of the associations of public accountants, whose members, in turn, are university-trained public accountants, who elect officers with duties that include the issuance of accounting principles. The professionals representing international firms take little part in the work of the committees and the board of directors of the FCCPV. These committees are appointed by the board of directors, which is elected by delegates of the associations in the different states of Venezuela.

Some of the partners and managers of these large and intermediate-size firms work as teachers of accounting and administration in Venezuela's leading universities. These professionals also conduct many of the technical gatherings of the profession, and the seminars are open to the public. This accounts for the wide disclosure of both domestic and international accounting principles and auditing standards.

There is no mechanism to give a voice or vote to the various audiences (the business sector, the stock market, investors and banks, government agencies, workers, and so forth) in the framing of principles and other activities of the FCCPV and its constituent associations.

Today the public accounting profession is a chair with several legs: large firms, intermediate and small firms, the FCCPV, and universities. Their measures differ among themselves, and their alliances are unstable. It would be well to seek closer rapprochement among them.

There are no generic definitions in Venezuela for the term "generally accepted auditing standards," even though the phrase is used in all auditors' opinions and other

documents. Unlike accounting principles, no one has defined an order of precedence for recourse to the pronouncements of foreign entities on subjects on which domestic standards are lacking. It would be difficult to defend the thesis that the phrase means less in Venezuela than in the United States. Perhaps this is why the code of ethics of the FCCPV, in referring to the performance of “an audit in compliance with the generally accepted auditing standards promulgated by the Federation,” adds “or those generally applied or accepted in the profession and the community.”

The FCCPV has issued eleven bulletins defining standards on specific subjects such as confidence in internal control and in the work of internal auditors. They are all based on the statements on auditing standards of the AICPA. The Mexican translations of this U.S. series also circulate widely in the country, as do the bulletins issued by the IMCP. The standards of the International Federation of Accountants are probably less known in Venezuela.

The FCCPV has also promulgated a standard on the opinion of the independent public accountant. This declaration, including its model opinions, follows the guidelines of SAS (Statements on Auditing Standards) 58 of the American Institute of Certified Public Accountants but places disproportionate emphasis on how taking into account or disregarding the adjustment for inflation influences the opinion at the expense of other aspects. There are firms that do not apply this declaration in all its details—without diminishing the confidence of the reader of the financial report—precisely because, as in the context of accounting principles, including the phrase “generally accepted” in a pronouncement does not make it so if the standard proves to be unsatisfactory in practice.

The commercial code requires the appointment of a *comisario* in each public company, which is the rough equivalent of a fiscal inspector or auditor in other countries. This officer has unlimited right of inspection and oversight over the firm’s operations. The auditor must hold one of three university degrees: business administration, economics, or public accountancy. It is common for the intermediate-size and large enterprise to appoint both the *comisario* (an individual) and the external auditors (usually a firm) and for the *comisario* to base his approval on the opinion of the latter. When the *comisario* is a public accountant—especially one who is practicing the profession independently—his certification of financial statements is normally no more than a modified form of the conventional opinion in compliance with auditing standards, and he usually confines himself to the issuance of this report. The National Securities Commission does not allow an enterprise’s *comisario* to be at the same time a member of the firm of independent public accountants that audits the enterprise. It takes the view that this duality of function constitutes a conflict of interest.

The National Securities Commission, the Superintendency of Banks, and some other entities have examined the working papers of several firms in recent years, as have court-appointed experts who investigated the banks that failed in the first years of this decade. However, there is no public knowledge of any suit ever being brought against a firm of public accountants, for example, or of significant sanctions being imposed by a government superintendency.

At the beginning of the recent acute bank crisis, some independent public bank accountants figured on a long list of persons accused by the investigating judge of complicity in the crime of falsifying financial statements as if they were executives or directors of the financial institution and subject to civil and criminal liabilities. The charges against them were dropped by another court.

During the long judicial investigation of banks, credit institutions, and bankers accused of fraudulent acts, which led to the closing of a dozen establishments, the profession wondered greatly whether judges understood the nature of an independent audit and an opinion on financial statements. Recently the Superintendency of Banks was placed under the direction of persons with extensive experience and established competence. The image of this regulatory agency was greatly strengthened, although its governing legislation needs to be expanded and adapted to current circumstances based on the experience of Venezuela and other countries.

The profession's prestige has been enhanced, at least in the eyes of serious observers in the private sector, by the disclosure of exceptions, objections, and refusals of opinions that some firms had been including in their reports.

### **What Lessons Can Be Learned?**

The Venezuelan experience yields the following lessons:

- *The "generally accepted" designation.* As a rule, accounting principles are not accepted just because they are designated as "generally accepted." The processes by which these principles are issued have to be revised to give the accounting profession, stockholders, entrepreneurs, managers, investors, regulatory agencies, public accountants practicing the profession independently, and users in general an active role in framing them. Moreover, the most appropriate paths must be tried so that, if necessary, the laws and regulations may follow the routes taken by these principles, and legal vacuums and contradictions can be avoided. Consideration must also be given to the aspects of communication, training, and review and evaluation based on experience.
- *Measurement of the effects of inflation.* The economy has a fundamental impact on financial information and its effectiveness in satisfying the needs of those who use it. Unfortunately, the negative effects of inflation on that information are difficult to neutralize, the more so if commercial laws do not provide for these situations and their effects. This becomes more important when an enterprise is heavily indebted in foreign currency and operates in an economy in which inflation and devaluation follow different paths: the results obtained could be hard to interpret and the effects highly negative.
- *Diversity of arrangements.* Those who write and those who read financial statements look for the conceptual framework that best enables them to communicate the information. The entities that regulate the securities market are primarily interested in protecting the investor. Those that regulate banks are interested chiefly in protecting the depositor. Organizations that provide financing are interested in homogeneous information on cost structures but also on cash flows in order to evaluate the paying capacity and continuity of the business. The shareholder must be interested in the performance of management—its maintenance of the capital—in addition to the profitability of the business. Everyone wants information that is reliable, clear, important, comparable, and timely, so that he can analyze it in light of his own objectives and interests.
- *Incorporation of established standards.* The professionals in a country that does not yet have a well-documented doctrine or enough experience would be better served by the adoption, by reference or adaptation, of pronouncements in international use and their amendment in response to local needs after extensive analysis. Moreover, when a

local pronouncement is essentially a summary of an international one, or when extensive sections of another statement are inserted without discussion or explanation of their application, confusion is generated about the extent to which one document replaces another. Also, when local circumstances differ from international ones, special local treatment is needed.

- *Harmonization between the principles of the United States and international accounting standards.* The IASs are highly useful for analysis of the Venezuelan situation. In situations requiring pronouncements that the IASs do not cover or in which they do not meet the specific needs of Venezuela, the GAAPs of the United States can be of additional help. However, the aim must not be to include some principles automatically and as a kind of appendix, but to have a single body of integrated, coherent standards that meet the needs of their users. There would be more harmonization between the Venezuelan principles and those of the rest of the world if there were greater harmonization between the principles of the United States and those of the IASC.

In conclusion, the FCCPV faces a great responsibility to help bring the profession and the business world of Venezuela into the international economy. It will only succeed if it intelligently opens its doors and seeks the ideas and collaboration of all interested parties, as has been done by other countries and accounting professions from cultures similar to ours. In this chapter, I have suggested some paths. Leaders in the profession have others, and I am sure that they will find a satisfactory solution. I also trust that international organizations will be able to help us in this work.

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## **A TRANSITION PLAN TO GLOBALLY ACCEPTED ACCOUNTING PRINCIPLES AND UNIFORM APPLICATION OF INTERNATIONALLY ACCEPTED AUDITING STANDARDS**

ALVIN CARLEY

Differences in accounting principles worldwide are a serious issue and should be resolved. This chapter discusses various conditions required to move from the accounting and auditing standards currently used in Latin America and the Caribbean to globally accepted accounting standards and to uniform application of internationally accepted auditing standards. The Inter-American Development Bank has a keen interest in the adoption of either U.S. generally accepted accounting principles (GAAPs) or the generally accepted accounting standards (GAASs) of the International Accounting Standards Committee. Such a transition is necessary for a higher level of disclosure and comparability of financial information as perceived by lenders, investors, regulators, and other users of financial statements. This change would greatly reduce the differences among accounting principles, which spawn lack of comparability, and would improve our understanding of the need for disclosure and its consistent application.

Since its creation in 1973, the International Accounting Standards Committee (IASC) has been working diligently to raise the quality of accounting principles to a high, international level. Although it has not yet achieved that goal, it has made significant progress by issuing thirty-three standards. It has proved to be a competent, technically sound organization, willing to devote the effort to accomplish its goals and resolve difficult issues. Furthermore, it has earned the respect and support of important professional organizations such as the U.S. Financial Accounting Standards Board and comparable standard-setting bodies in other countries, governmental regulatory bodies, and many multinational corporations. It is in the process of developing a set of core standards for review and approval of the International Organization of Securities Commissions (IOSCO) with a target completion date of March 1998.<sup>1</sup>

Auditing standards and practices aligned closely with the GAAS of the American Institute of Certified Public Accountants and those recommended by the International Federation of Accountants (IFAC), reinforced by a rigorous peer review process, would add significantly to the credibility of the audit opinion and the value of audited financial statements.

The conference at which the chapters in this book were first presented served as a forum for discussion of the transition to IASC or U.S. GAAPs and alignment of auditing standards and practices to IFAC GAASs, including consideration of various issues pertaining to implementation plans. These two changes are referred to in the remainder of this chapter as "the transition."

<sup>1</sup> The March 1998 deadline was not met. Currently the IASC is targeting completion of the core principles for the end of 1998.

### **Options for Adopting IASC or U.S. GAAPs**

Five options are available to the countries of Latin America and the Caribbean for effecting the transition to IASC or U.S. GAAPs:

- (i) *Effect the transition completely, at one time, for all business enterprises.* The principal benefit of this approach is efficiency: it will get the job done in one operation. This should result in lower costs and get all enterprises into the new GAAP at the same time, which will benefit users of the financial statements. It will also send a strong signal that the country is ready to participate in international capital markets. Excellent financial reporting, especially regarding full disclosure (which instills a sense of trust) contributes to lowering the cost of capital and enhances the reputation and goodwill of a firm, lending it greater receptivity in the marketplace.
- (ii) *Effect the transition completely, at one time, for all business enterprises, adopting IASC or U.S. GAAPs, but with exceptions permissible as necessary to comply with local economic and legal conditions or requirements.* There may be special conditions that allow for the economic reality to be better expressed by a particular local treatment that is not valid under IASC or U.S. GAAPs. Furthermore, the government might require a particular treatment of certain events or transactions (for example, the accounting treatment of the foreign exchange losses of many companies in Thailand resulting from the recent devaluation of the baht). In the interests of full disclosure, modifications should be revealed in the notes to the financial statements, with explanations of the reasons for and nature of these modifications.
- (iii) *Effect the transition by using local GAAPs for all business enterprises but modify them when necessary to comply with IASC or U.S. GAAPs.* This approach should result in lower out-of-pocket costs. It is no doubt less expensive to treat the exceptions than to make a complete change. However, it would be more difficult to implement this approach because users of financial statements would have to rely on all preparers and all auditors to be sufficiently knowledgeable of IASC or U.S. GAAPs to identify all conditions requiring adjustment. The risk that financial statements would not comply fully with IASC or U.S. GAAPs would, therefore, be greater. Therein lies an additional cost: a lower level of confidence by users of the financial statements.
- (iv) *Effect the transition by using IASC or U.S. GAAPs first for banks and all other publicly held companies (either domestically or through foreign stock exchanges), with all other enterprises phasing into the transition over some period of time.* The principal advantage of this approach would be allowing more time to include all enterprises in the transition process while, at the same time, getting the more highly sensitive enterprises changed to IASC or U.S. GAAPs quickly. The disadvantage would be slowness in getting all enterprises into the transition process.
- (v) *Effect the transition by using IASC or U.S. GAAPs first for banks and all companies, which could, in the future, use the planned IASC "core" standards for cross-registration purposes.* This option has the advantage of getting all banks into the transition quickly plus having those companies that will use the core standards ready for cross-registration when the core standards are approved. This option would also provide more

time to get all enterprises into the transition. This, however, can also be perceived as a disadvantage because of the delay in the process.

Which of these options is preferable? Although one could make a case for selecting the option that seems to be most advantageous, the first option is the right choice for five reasons. First, getting the job done all at once, rather than incurring the inefficiencies of repeating the process, could yield significant cost savings. Second, the decisiveness of implementing the process for all enterprises at once should motivate all of those enterprises. Third, having all enterprises on one set of standards would benefit users of the financial statements, including shareholders, lenders, regulators, and others. Fourth, all enterprises would be able to cross-register securities (and perhaps obtain easier financing for other kinds of securities) when the core standards are approved for that purpose. Fifth, external users of the financial statements would realize that all enterprises within the country have been prepared on the basis of GAAPs (with which they are, probably, familiar), raising the level of confidence.

### **The Transition Process**

Such an important change must be mandated by appropriate entities—the organizations responsible for setting accounting and auditing standards. Only through such a process will the resulting principles be truly “generally accepted accounting principles.” In most countries, the mandating entity will be professional group(s) of certified public accountants; in countries that use the legislative process to set the standards, it will be the designated legal bodies.

The Inter-American Development Bank has a role to play in this endeavor:

- (i) Provide the standard-setting bodies, whether private sector or government, with information and general assistance for gaining a full understanding of IASC and U.S. GAAPs
- (ii) Promulgate the IASC standards to the general public, especially to the preparers of financial statements and those who will audit them
- (iii) Help develop educational programs to teach IASC standards
- (iv) Help develop educational programs to teach internationally acceptable auditing standards and practices
- (v) Develop a bibliography of relevant books and articles regarding IASC and U.S. GAAPs and internationally acceptable auditing practices
- (vi) Consider the impact of the transition on matters such as (a) covenants in loan agreements, (b) regulatory reporting requirements, (c) disclosure of changes in accounting principles, and (d) increased disclosure requirements, especially regarding financial instruments
- (vii) Assist in the development of a peer review program to be conducted through the principal accounting professional organization(s), subject to approval of, and monitoring by, each country’s securities and exchange commission
- (viii) Help develop other appropriate monitoring programs.

### **Stakeholders**

The viewpoints and support of certain particularly important organizations and individuals will be essential to ensure the success of the transition. Some of those organizations and individuals include

- (i) The accounting standard-setters: private sector organizations such as the professional associations and governmental entities (probably legislative) assigned this responsibility
- (ii) Government entities that have oversight responsibility or monitor the standard-setting process such as the securities and exchange commissions and bank superintendencies of Latin America and the Caribbean; representatives of legislative bodies assigned this responsibility; and tax authorities who will have to consider the new accounting standards for tax purposes
- (iii) Partners in the accounting firms who will be responsible for auditing financial statements
- (iv) Educators who will have to incorporate the IASC and/or U.S. standards into their curricula
- (v) Representatives of the business community whose financial statements will be prepared under the IASC standards or U.S. GAAPs (general enterprise corporations, financial institutions, and so forth).

### **The Role of Government**

Government support will be of great importance in implementation of the transition and subsequent follow-up and monitoring. The extent of government involvement will depend on whether accounting and auditing standard-setting is a function of the private or public sector.

In Latin American and Caribbean countries where the private sector sets the standards, consideration should be given to the role of a number of government entities, including the securities and exchange commissions, the bank superintendencies, and the tax authorities. It is highly likely that the securities and exchange commissions will be deeply involved in the standard-setting process regarding both accounting and auditing. Accordingly, their acceptance of IASC or U.S. GAAPs, and of internationally accepted auditing standards and practices, is essential. The expectation is that all countries that are members of the International Organization of Securities Commissions will, at some time in the near future, accept IASC standards for cross-registration purposes. Acceptance and support by bank superintendents are crucial. Proper financial reporting is of great significance to superintendents in the fulfillment of their responsibilities. In some countries, tax law and GAAPs are closely related. The information prepared for financial reports is used also for tax purposes, so tax authorities have a keen interest in accounting standards (as would legislative bodies in those countries). In other countries, the many differences that exist between accounting for tax purposes and accounting for financial reporting are harmonized by income tax allocation. In such countries, tax authorities are

less concerned about accounting standards for financial reporting purposes, although they might well need to understand financial accounting standards in the case of complicated transactions.

In countries where standard-setting is government-driven, particular attention should be given to ensuring the support of legislative bodies as well as that of the securities and exchange commissions, bank superintendents, and tax authorities. If the standards are set by the government, it is likely that the standards used for accounting purposes will be very similar to accounting principles used to prepare tax returns.

Whether accounting standards are set by the private sector or are promulgated by the government, a professional relationship will be necessary between the preparers and users of financial statements and various elements of the government. This is as it should be because both groups have great responsibilities regarding financial reporting and much to be gained by having the highest possible accounting and auditing standards. The development of close professional relationships among the various parties will lead to high-quality standard-setting and reliable financial reporting.

### **Detailed Guidelines for Effecting the Transition**

The transition will be a major effort involving many people. Careful planning and reasonably detailed guidelines should be prepared to achieve the objectives on a suitable timetable. The detailed guidelines should cover matters such as the following:

- (i) Distribution of the international accounting standards (IASC GAAPs), and perhaps U.S. GAAPs, to the countries of Latin America and the Caribbean in English, French, Portuguese, or Spanish, as appropriate
- (ii) Preparation and distribution of educational material to the countries of Latin America and the Caribbean
- (iii) Coordination with organizations such as the IASC, Financial Accounting Standards Board, American Institute of Certified Public Accountants, and international accounting firms that may be able to provide assistance regarding educational material, translation, and other necessary projects
- (iv) Development of information pertaining to communications among the various parties involved in implementing the transition, including the roles and responsibilities of the various people, addresses, preferred methods of communication, and other information that will facilitate easy communications
- (v) Timing of the transition including timing objectives for getting started, various phases of the transition plan, and its completion.

Various educational programs will need to be developed to train the different groups involved in implementing the transition. The programs should cover both international accounting standards and auditing practices as well as procedures that are acceptable worldwide. These programs will require identifying appropriate textbooks; planning the courses, including preparing the syllabi and determining the timing and staffing requirements; making arrangements for giving the courses, identifying appropriate participants;

establishing times and locations; and determining monitoring and control practices such as course evaluations and procedures for assuring quality.

Although IASC GAAPs and IFAC GAASs will be the primary thrust of the training, it is possible that U.S. GAAPs and GAASs will need to be included in the training effort to some extent. Many Latin American and Caribbean people, both preparers and users, are already familiar with U.S. financial reporting and auditing practices, so the training approach would be considerably different.

A program that will provide for independent peer review of the auditing practices of the various firms will be of great importance. Credibility of the audit opinions will be substantially enhanced through a program demonstrating that internationally accepted auditing standards and practices are being followed throughout Latin America and the Caribbean.

Subsequent to acceptance of the peer review program, responsibility for its development (including seeking advice and assistance from countries with well-established programs) should be assigned to move the project forward. The parties responsible for the peer review program in each country should probably be the professional body of certified public accountants, with monitoring by the country's securities and exchange commission or comparable entity.

Much material will require translation into the appropriate languages of Latin America and the Caribbean. The material will include the international accounting standards (which, through IAS 32, have been translated into Spanish); a suitable textbook; for bank personnel, the American Institute of Certified Public Accountants' industry audit and accounting guide, "Banks and Savings Institutions"; and any course material written in English.

Each element of the implementation process should be scheduled with the objective of setting an effective date for the transition, expressed as follows: "The accounting principles adopted as a result of the transition will be effective for all fiscal years beginning after December 31, 1998" (or such other date as is appropriate). Each country will be responsible for setting the implementation timetable. Of course, the earlier this is done, the earlier the benefits will accrue. In the meantime, a timetable should be established to cover matters such as communications with organizations and individuals whose involvement in the process is desirable; development of the educational programs, including detailed guidelines about various matters; development of a peer review program; and development of a translation program. It is too early to establish detailed, specific timetables for moving forward on these matters, but that process will be addressed as advice is received about the overall transition process.

## **Conclusions**

Financial reporting, when practiced at the international level, yields particularly important benefits. First, it allows for *comparability of financial information*. If a high level of commonality of accounting principles does not exist, the financial information about similar companies in different countries will simply not be useful for comparing the values of those companies. Comparability is tremendously important to investors, lenders, analysts, and others.

Second, financial reporting leads to the *use of internationally acceptable accounting principles and auditing standards*. The executives of international lending organizations, whether in the private or public sector, as well as executives of many other kinds of

entities, will have a much higher level of confidence in financial statements that have been prepared in accordance with internationally acceptable accounting principles, accompanied by an audit opinion based on internationally acceptable auditing standards, and supported by a strong peer review process.

Third, financial reporting raises *the quality of the accounting standards*. The GAAPs used must be of high quality. IASC is dedicated to that goal. Furthermore, the core standards must be approved by IOSCO before they will be accepted for cross-registration purposes, adding another level of assurance that the core standards will be of high quality; U.S. accounting standards have been so recognized for many years. Credibility of financial reporting is absolutely essential, especially in the area of disclosure.

Finally, financial reporting adds *economic value*. A high level of confidence in the financial statements can lower the cost of capital. That confidence should also ease the process of registering securities. Once the transition to IASC or U.S. GAAPs has been made, the process of keeping accounting principles, as well as auditing standards, up to date should be easier and less costly.

Having had the pleasure of working with professional accountants and business people in Latin America and the Caribbean for many years, and having been involved in the international accounting and financial reporting arena for at least a decade, I am enthusiastic about the benefits of the transition for the Latin American and Caribbean countries. Adoption of IASC or U.S. GAAPs and of IFAC or U.S. GAASs will strengthen the benefits elaborated here. I hope my enthusiasm is contagious and finds its way into your thinking.

## FINANCIAL MARKET DEVELOPMENT

Financial markets depend on information to operate effectively. Without reliable and timely information, investors cannot evaluate risks associated with investment opportunities, the cost of capital for investments increases, and many otherwise acceptable investments are prevented from taking place. One of the most effective ways to improve disclosure is to adopt high-quality, globally acceptable accounting principles and auditing standards.

The five papers collected in this volume make a strong case for improved disclosure and international standards, present case studies on the transition taking place in Mexico and Venezuela, and include guidelines for ensuring an effective transition. These presentations were made at a conference entitled "Financial Disclosure and Development of Financial Markets in Latin America and the Caribbean," co-sponsored by the Inter-American Development Bank, the International Accounting Standards Committee, and the Interamerican Accounting Association.



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