

INTERNATIONAL ACCOUNTING STANDARDS

**Transparency, Disclosure and Valuation
for Latin America and the Caribbean**

José Antonio Laínez
Pietro Masci
Juan José Durante

Editors

INTER-AMERICAN DEVELOPMENT BANK

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Foreword

Financial markets are critical to economic growth. They allow the allocation of resources at lowest cost, and promote progress and innovation. Globalization, which increases the speed and extent of financial transactions in foreign markets, has made their role even more important. In spite of the efforts the countries of Latin America and the Caribbean have made to foster the development of financial markets, financing and credit is still unavailable to large segments of the population and the cost of capital is too high to boost competitiveness.

Macroeconomic instability, political and policy uncertainties, fragile rule of law and weak enforcement have had a negative impact on market development. This is apparent in the capital markets in Latin America and the Caribbean, which have shown a steady contraction. The realities of the region (low economic growth rates, high poverty, declining foreign direct investments and banking flows as well as portfolio investments) call for continuous efforts by all stakeholders and in particular by the Inter-American Development Bank (IDB) in promoting the development of financial markets and facilitating private sector involvement.

The IDB collaborates with governments and the private sector to enhance financial market efficiency and effectiveness. To that end, over the last 12 years, the Bank has dedicated more than US\$18 billion in loans and technical assistance programs for financial sector reform and initiated many activities to promote best practices, place specific issues on the region's development agenda, and provide advice to policymakers.

This publication is part of the overall commitment of the Bank to financial reform. It intends to highlight the fundamental importance of accounting for institutional development in free-market oriented society and the merit of the adoption and implementation of international accounting standards in the region to fulfill the function of accounting, i.e., disclosure and transparency as significant elements for improving financial markets.

Over the last few years, IDB work on these issues has led to the development of Multilateral Investment Fund programs, which offer technical assistance to countries willing to move towards international accounting and auditing standards.

The Bank will continue supporting the implementation of the standards at the national and regional level, and interact with international and regional organizations such as the International Standards Accounting Board, the Inter-American Accounting Association, and International Federation of Accountants among others to promote the development and implementation of international accounting and auditing standards.

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The authors represent a wide range of expertise in accounting and financial market development, economics and public policy. Their varied perspectives and experiences will not only provide insight on the subject but also guidance in the formulation of strategies for the implementation of accounting and auditing reform. They are: Kenroy Dowers, former financial specialist of the Inter-American Development Bank and now at the International Finance Corporation; Vania Lorenzo, consultant; Pietro Masci of the Inter-American Development Bank; Ivan Sotomayor of the American Institute of Certified Public Accountants; William Casey and Richard Findlater of Ernst & Young; Enrique Ortega Carballo of the Instituto de Contabilidad y Auditoría de Cuentas, Spain; Donna L. Street of the University of Dayton; Salvador Ruiz de Chavez of the National University of Mexico; Javier Cocina of the Mexican Institute of Public Accountants; José Antonio Láinez, Susana Callao, and José Ignacio Jarne of the University of Zaragoza. The authors also benefited from valuable contributions and comments from numerous individual reviewers who provided feedback on various chapters of the book and guidance.

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Introduction

The experiences of the last decades in Latin American and Caribbean countries brought about important reforms in financial markets, encompassing changes in legal and regulatory framework, ownership patterns and in operating terms. Regulatory frameworks also evolved toward scenarios where private sector participation prevails, with supervision, regulation and competition playing complementary roles. However, despite these reform processes, financial and capital markets in the region are falling behind and do not facilitate access to financing to spur economic growth and enhance competitiveness in the economies of the region.

The Inter-American Development Bank (IDB) has actively promoted financial sector reforms in Latin America and the Caribbean, while also financing private sector projects.

The adoption of internationally recognized standards, or codes of good practices, helps improve economic policy and strengthen the international financial system. Although they are not new, in the last years work on international standards and their development has accelerated in order to provide policymakers with benchmarks of good practice in key areas. Focus has been increasingly directed at improving transparency and consequently at formulating internationally accepted standards for accounting and auditing.

Following the policy work and prompted by the corporate crisis that capital markets witnessed at the end of 2001 and early 2002, the Multilateral Investment Fund (MIF) of the Bank, launched the Cluster Action Plan, a program that is part of a broader strategy to support competitiveness in Latin American and Caribbean countries. This program, approved in 2002, seeks to provide support to the adoption of internationally accepted standards, particularly in the accounting and auditing area. As of today, five technical cooperation programs were approved for Chile, Jamaica, Mexico, Trinidad and Tobago and Uruguay and five programs are in the pipeline for Costa Rica, the Dominican Republic, Ecuador, Honduras and Panama. Given the cases of corporate mismanagement, the initiative is timely and of critical importance at a moment when economies in the region are striving to improve their access to capital and financial markets.

The Role and Relevance of Accounting Standards

Accounting standards have always been seen as a mechanism to ensure consistency in interpretation of financial information as a basis for evaluating performance and making investment and lending decisions. In more recent times, international best practice for accounting standards has been divided between U.S. Generally Accepted Accounting Principles (U.S. GAAP) and International Financial Reporting Standards (IFRS), previously called International Accounting Standards (IAS). While these two approaches show some differences, they are generally consistent in their scope. U.S. GAAP has moved into a “principle-based approach” and plans to achieve harmonization with IFRS by 2005.

Over the last several years, experts have come to recognize that financial crises may result from improper accounting practices. In the last three years, crises in the accounting world — made evident by debacles in corporate America and Europe — have raised the importance of accounting standards to unprecedented levels. On both sides of the Atlantic, staggering losses were caused by improper accounting practices. A subject once considered dull and tiresome has gained interest as a result of scandals involving important companies such as Enron, WorldCom, the Dutch retailer Ahold and Parmalat.

While the passing of the 2002 Sarbanes-Oxley Act, the collapse of Arthur Anderson, and the legal battles faced by various firms are the events that dominated the media, there are two important consequences that have demonstrated the importance of accounting standards to prevent such financial debacles. The first is the clear impact of appropriate accounting standards on firm value, which can only be assured by the introduction of standards and the effective regulatory enforcement on compliance. Experience confirms that an increase in the level of enforcement fosters institutional development and increases the level of compliance.

The second consequence is not as direct. As reliable information is important to facilitate financial sector development, and financial sector development is an important contextual factor for economic development, there is an implicit relationship between reliable accounting information and economic development. It is well established that a sound financial sector is important to maintain and encourage a strong, healthy economy because of its pivotal role in allocating capital efficiently, facilitating risk management and improving corporate control. An effective financial sector enables savings to flow

to investments with the highest marginal return. As explained in more detail in subsequent sections, the economy grows thanks to various factors including improved capital accumulation, resource allocation and the resulting technological innovation. Good information is vital to attain this beneficial and reinforcing cycle, as it guarantees better investment decisions, and hence maximizes investment returns. In fact, accounting, or its primitive form of “double entry bookkeeping” originated in middle-age Italian city-states, is considered the source of the idea of the firm as a going concern separate from its owners. Therefore, accounting information is fundamental to understand the financial status of the firm and the most effective approach to distinguish good versus bad companies. Optimal investment decisions are further ensured by reducing information asymmetry, which occurs when investors and insiders possess different levels of information.

While accounting crises have been limited to firms in developed countries, there is important policy relevance for emerging countries. Many emerging markets have developed their financial and capital markets as an important policy objective, yet have not been able to make appropriate advances in accounting standards and practices. In many developing countries, there are still significant gaps between local GAAP and the IFRS, thus the potential for crises is even greater. For emerging markets, accounting and auditing standards are crucial to achieve disclosure as well as transparency and, hence, influence economic and financial growth. Furthermore, good information is a key component of effective financial markets as it also serves as direct input for risk management. Lack of proper information to establish the level of risk associated with a financial decision, diminishes the possibilities to determine the true value impact of decisions and thus lead to excessive risk taking. It is, moreover, essential as a means of effective corporate control in order to monitor and strengthen management performance, to ensure that decisions are taken by managers in accord with shareholders, and to detect potential bribery and corruption. Against this background, one has to be cautious to use the international accounting standards as a blueprint for Latin America and the Caribbean. The introduction of the rules has to deal with specific local environments to prompt a process of disclosure and transparency. Therefore, by supporting enhanced disclosure, accounting and auditing standards function as safeguards against financial crises and their related costs and social strains, which above all affect the poorest segments of the population.

Why this Book?

Globalized markets make the need for disclosure even more compelling since information needs to be understood by market participants around the world. The need for a common language, as well as its exceptional role in preventing financial distress and enhancing the financial sector, account for the origin of international accounting standards. Numerous organizations have been engaged in their implementation and promotion. The most influential among them remains the International Accounting Standards Board (IASB), responsible for setting the International Financial Reporting Standards (IFRS) and promoting their convergence worldwide. Likewise, the International Federation of Accountants (IFAC), as well as the International Forum on Accountancy Development (IFAD) have been important forces in the course of developing and sponsoring an integrated set of international standards. IFAC is responsible for issuing the International Standards on Auditing (ISA) and International Auditing Practice Statements. Inspired by their work and in collaboration with numerous accounting associations, the Inter-American Development Bank established several initiatives related to the dissemination, adoption, and implementation of IFRS and ISA. This book is, in fact, motivated by the fertile cooperation among these organizations and by the IDB's existing work on this subject.

Specifically, the initiative and background effort for the book originated during a Roundtable on International Accounting and Auditing Standards at the Bank's headquarters in 2001, which presented best practices and policy analysis on which the activities of the Bank have been based. The rationale for the book became even more evident, as shortly thereafter the corporate crises caused by improper accounting practices were brought to prominence.

By its own nature, international accounting standards constitute a typical instrument of harmonization and eventually integration of the Latin American and Caribbean financial markets that would boost their efficiency.

The various chapters of the book focus mostly on accounting standards for large companies in some cases traded in stock exchanges. Another important universe—particularly relevant in Latin America and the Caribbean—has to do with small and medium size companies generally family-owned. Transparency, disclosure and accounting for this group is part of another project being undertaken.

Main Contributions

The different sections in this book offer an overview of the overall framework of accounting reforms in the context of capital and financial market development. Furthermore, the various articles intend to show the role that transparency plays in the valuation of assets and other financial instruments, as well as, once again, in improving capital markets. The need for accounting reforms is addressed from different perspectives and point of views, both in terms of specific elements that require improvement as well as geographical examples and case studies that clarify this. This publication seeks to identify the context in which the accounting and auditing reform takes place and how countries apply those standards, as well as experiences outside the Latin American and Caribbean region.

One of the fundamental aspects of accounting reform in particular, and of the implementation of different international standards in general, is the role played by the countries that undertake the reforms. In this respect, international standards cannot be simply transplanted. Instead there is a need for a process of adaptation and harmonization of international standards that takes the social, political, and cultural reality of the country in consideration and ultimately establishes accepted institutions. Specifically, the book looks into the Latin American and Caribbean context, as this represents the scope of work of the IDB, and presents the status of accounting standards in some Latin American countries. The adoption and acceptance of international accounting standards in the region have been diverse. Some countries have implemented them fully, whereas others only in part or not at all. The introduction of IFRS would be extremely beneficial as it could foster the integration of Latin American and Caribbean countries not only within the region but also with the rest of the world, which would, moreover, ease the lowering of the cost of capital and enhance the global competitiveness of the region's economies.

Intended Audience

The book is directed to policymakers, regulators, practitioners and experts in developing countries, with a special emphasis on countries in Latin America and the Caribbean, who are responsible for designing policy directives to stimulate financial market development. The book's primary purpose is to raise awareness among experts and

support their efforts towards increased transparency. The concrete examples provided can help demonstrate practical approaches and issues in various country settings. The many challenges posed by reforms seeking to improve disclosure and information are addressed in the book. Various sections center on specific topics, but the overreaching scope needed for reform, however, should not be overlooked. Reforms cannot be successful without an overall view of the different sectors whose improvement is complementary to that of the area of transparency. Policymakers and regulators interested in this book, therefore, should encourage the development of transparency and the application of accurate accounting standards, without disregarding important factors such as the role of education—as Chapter 5 points out—as well as other aspects of financial sector development. Their role, therefore, is essential in providing vision, spending political capital for change, and assuring leadership and commitment to move ahead with reforms.

Structure of the Book

The book has five sections. Section I offers a conceptual framework. Section II further expands on the role of accounting standards in capital market development and illustrates concrete accounting rules for valuation of companies and mergers and acquisitions. Section III illustrates different types of accounting standards implementation through the examples of various Latin American countries, Spain and the European Union. Section IV identifies gaps between national practices and international standards, whereas Section V offers conclusions, putting forth a general outlook of the international harmonization of accounting standards.

The chapter in Section I examines the effect and importance that proper disclosure has on the development of financial markets. Initially, it reviews the essential connection between a stable financial sector and economic growth and then turns to the importance of international accounting and auditing standards to accomplish financial disclosure and, thus, its influence on capital markets. Further, it stresses the relevance of liquid and vibrant financial markets in fostering economic growth in emerging economies, particularly in Latin America and the Caribbean. The chapter also analyzes the progress of international accounting standards application and identifies their implementation in Latin America and the Caribbean.

Section II contains Chapters 2 and 3. Chapter 2 analyzes the uses of accounting rules in further detail and expands on their key role in capital markets reform. Chapter 3 examines accounting rules for valuation of companies and mergers and acquisitions in Latin America and the Caribbean. Chapter 3 also makes a detailed analysis of U.S. GAAP as well as IFRS and highlights the main differences between them. Finally, it also describes the impact and the use of the different set of accounting standards — U.S. GAAP and IFRS — in Latin America and the Caribbean and the importance of the implementation of standards in the context of national realities. The discussion in this chapter is important in view of the consequences globalization has had on capital markets. It reveals the main effects on business valuation and possible investments of local GAAP compared with U.S. GAAP and IFRS.

Section III illustrates and compares how accounting reforms have and are being undertaken in Spain in connection with the European Union, and in various Latin American countries. Thus, Chapter 4 offers an overview of the accounting situation in Spain and in the European Union (EU), and the concrete steps it is taking to achieve harmonization within the region and specific goals it has set. Numerous EU directives have determined, during the last 20 years, the aim of achieving comparable information released by companies throughout the Union. The EU, however, is aware of the fact that a sound accounting framework needs to be established to accomplish real harmonization. In fact, the framework will have the IFRS as a regulatory base and specific measures are being taken to implement them.

Chapter 5 provides a discussion and analysis of a survey prepared by the six largest accounting firms aimed at encouraging convergence of national accounting standards with the IFRS. In particular, it discusses the results for various Latin American countries such as Argentina, Brazil, Mexico, Peru and Venezuela.

Section IV consists of Chapter 6, which stresses the need for progress and development of transparency in international reporting. It proposes a plan to accomplish this at the country level, rather than embarking on a more global effort. Chapter 6 maps out a detailed action plan that includes establishing a country management team that completes fact finding missions, develops a specific plan and compares international with local standards (benchmarking) as first steps toward improving accounting standards and meeting international requirements.

The concluding section provides a final overview of present harmonization efforts, those designed for the future, as well as their chances and prospects. Different endeavors related to the implementation and application of IFRS in diverse geographic regions, such as Latin America and the Caribbean or the European Union, are examined in detail, evaluating their scope and effects. Chapter 7 reflects on the crucial value of the harmonization accounting standards and its influence on functioning and globalized financial markets. It ends by demonstrating some of the problems and obstacles that IFRS still face and probably will confront in the future.

I

The Impact of Disclosure on Financial Market Development

Kenroy A. Dowers and Vania A. Lorenzo*

Financial markets perform the important function of efficiently allocating an economy's scarce resources. The existence of reliable information is a key ingredient in guaranteeing that this objective is realized. This information serves three important functions: (1) as an input for investment analysis, (2) as a direct input for risk management, and (3) as a means for effective corporate control and the required level of governmental regulatory enforcement.

This chapter intends to, first, review the importance of financial disclosure as a significant element in improving financial market activity. Second, it explores the relevance of creating international accounting and auditing standards for financial disclosure as a factor in promoting financial market activity. In this context, the chapter illustrates that in the case of emerging economies, it is even more critical and a very desirable objective to cultivate vibrant financial and capital markets. Third, it reviews the development of international accounting and auditing standards from a practical standpoint and also to benchmark the application of these standards within Latin America and the Caribbean.

Existing literature has demonstrated the integral relationship between economic development and a robust and liquid financial sector. Demirgüç-Kunt and Levine (1996) suggest that the Industrial Revolution, and the resulting economic prosperity, would

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not have been possible without financial markets. Economic development is fostered by the activities of financial intermediaries through the mobilization of domestic savings, risk management, support for corporate control, and increased efficiency in resource allocation. Savings are channeled into productive industries, facilitating the availability of capital for productive sectors. Finally, resource allocation, as well as capital accumulation, promote technological innovation and spur economic growth.

In terms of the information presented in this chapter, the second section reviews the role of financial information, while the third section examines the factors that make financial disclosure relevant for financial market development and specifically, in this context, the relevance played by the International Financial Reporting Standards (IFRS), which are covered in the fourth section. The fifth section reviews the development of the ongoing global effort to achieve enhanced disclosure through IFRS, and the sixth section contains an analysis of the extent to which IFRS are applicable for accounting regimes in selected countries in Latin America and the Caribbean.

The Key Role of Financial Disclosure

The relevance of financial information and disclosure is best understood in the context of the existence of information asymmetry, which refers to the differential levels of information held by investors in comparison with insiders.¹ This is, fundamentally, a derivative of the problem of the principal-agent relationship. Under conditions of uncertainty, information asymmetry presupposes that insiders understand the value of the securities being offered and have better knowledge than investors of the potential return and risks associated with the firm's future activities.

Furthermore, the problem of asymmetric information is made more compelling by the fact that firms sometimes have incentives to misrepresent the information they possess. Information disclosure helps to reduce the uncertainty regarding investment opportunities and forms implicit contracts between the two parties. In this chapter, we contend that information has three fundamental economic properties. First, it helps to maximize the efficient allocation of scarce resources. Second, it helps to reduce the cost associated with financial distress. And third, it acts as an appropriate external mechanism of corporate governance to reduce agency cost.

1. Akerlof (1970) attributes the so-called *lemons* problem to information differences that could cause a failure in the functioning of markets.

Financial markets have already been mentioned as being crucial for the efficient allocation of capital within an economy by enabling savings to flow to the investments with the highest marginal return. This claim presupposes a link between those that hold the relevant information (insiders) and those that own the capital (investors). This link in capital allocation and financial information is realized through security prices.

Although demand and supply conditions determine market price equilibrium, securities prices are essentially a function of investors' expectation of returns and its associated risk. This could be presented theoretically as:

$$P = f\{\hat{E}(R)\}$$

where P is the price of the security and $\hat{E}(R)$ are expectations for future returns. Investor expectations of returns thus depend on information regarding financial and economic prospects:

$$\hat{E}(R) = f\{\Pi\}$$

Here $\{\Pi\}$ is the information set that determines the actual future returns, which can be expressed as:

$$\Pi = V\{I_1, I_2, I_3, \dots, I_n\}$$

This information set is varied and includes the investor's perception, I , for a range of firm and nonfirm specific factors.²

Theory suggests that financial markets and institutions emerged to overcome market friction. Different types of friction, such as transaction costs and information search costs, have encouraged the growth of diverse financial instruments over time.

From the perspective of the investor, information costs originate when each investor consumes resources to analyze, research, and evaluate different firms and their economic condition. Because households and individual investors have a limited capacity and ability for acquiring information, their investment decisions can be enhanced by financial intermediaries with the evaluation skills, technology, and economies of scale necessary to acquire relevant information. These intermediaries recognize the most productive technological possibilities and channel funds toward profitable ideas, which im-

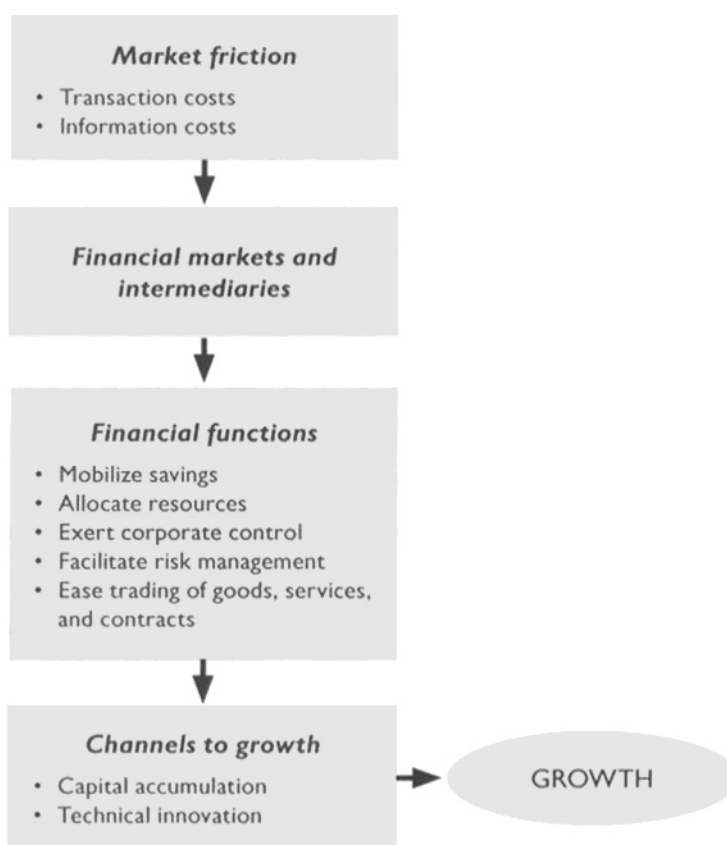
2. A firm's value, potential, and future economic performance can often be grasped by analyzing its stock prices, which in turn should reflect available information. In fact, markets are regarded as being efficient when all prices fully reflect all information. For a detailed description of the theory of efficient capital markets, see Copeland and Weston (1988).

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proves resource allocation and thus encourages productivity. Through the specialization of these agents, individual investors can indirectly access reliable information.

As shown in Figure 1.1, good information is relevant not only when making investment decisions but also for monitoring management performance. The skills necessary to acquire investment information are closely related to those needed to monitor management decisions. Consequently, financial intermediaries and markets reduce the costs of acquiring and screening information and of exerting corporate control. Once a significant investment has been made, there is an additionality in monitoring management and in ensuring that it manages the firm in the best interests of the owners. Alternatively, management's interests can be more closely aligned with those of investors by linking managers' compensation to stock performance (Levine and Zervos, 1996).

Figure 1.1. Finance and Growth



Source: Levine (1997).

To summarize the theoretical framework outlined above, and as illustrated by Levine (1997) in Figure 1.1, financial instruments and systems perform the functions of allocating resources, mobilizing savings, monitoring managers, facilitating risk management, and promoting the exchange of goods and services to overcome market friction. Furthermore, they facilitate capital accumulation as well as technological change, which in turn spur economic growth.

This theoretical framework has also been established on a practical basis. Levine (1997), Levine and Zervos (1996), Demirgüç-Kunt and Levine (1996), and Levine et al. (2000) demonstrate a clear link between economic growth and financial development. Particularly in Levine and Zervos (1996), cross-country regressions suggest that the pre-determined component of stock market development is positively associated with long-term economic growth. Using instrumental variables for stock market development (e.g., depth, size, and liquidity) they demonstrate the connection between stock market development and long-term growth. Levine et al. (2000) also confirm this argument, even when taking into consideration other benchmark determinants of growth.

Financial Disclosure and Financial Market Development

Proper financial disclosure becomes even more critical in a globalized environment with increasing cross-border activity.³ Information needs to be made available and understood by investors, shareholders, firms, and analysts operating in a global context. This increases the need for consistent financial market conventions and principles, particularly in light of the inconsistencies in national financial statement practices due to the complex legal, political, and economic fabric that is the foundation for corporate financial disclosure. A solution to this problem is to provide for greater harmonization and/or integration of corporate financial disclosure.

This section reviews the influence of financial disclosure on financial market development. In particular, we claim that financial disclosure has an impact on financial market development due to its direct effects on key elements of the financial system, such as capital allocation, corporate governance, and the prevention of financial crises. Financial market development is realized on the basis of a reduction in the cost of capital

3. Cross-border activity is just one indication of the current internationalization phenomenon that involves greater integration of financial markets, the free flow of financial resources among countries, privatization processes, excess of capital savings worldwide, etc.

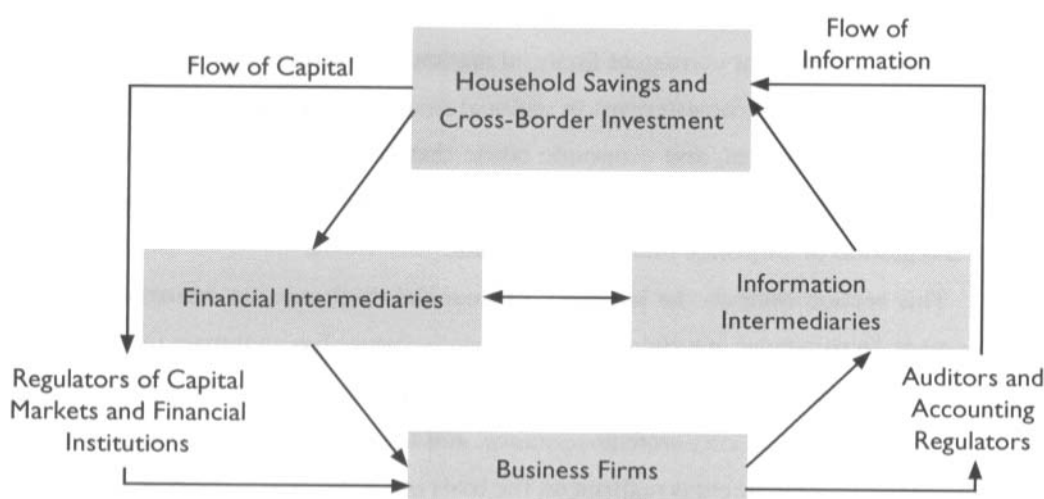
and more efficient investment decisions resulting from increased access to reliable information and to improved financial market performance influenced by advanced corporate governance. All this, in turn, enables the market to attract more investors, stimulate market confidence and liquidity, and spur market innovation given wider security offering. Below, we look more closely at the specific ways in which these three functions affect financial systems.

As shown in Figure 1.2, these three key features influence the financial sector in at least two ways. First, they have an impact on investors through improved investment decisions and the maximization of returns on investment, thus helping to mobilize savings. Second, they are directly relevant for financial intermediaries and users, who are subjected to higher disclosure standards.

Efficient Asset Allocation

As noted above, in the basic principal-agent relationship that exists between a firm's investors or shareholders and its manager, it is assumed that differential levels of information are held by each party to the contract. In the case of investors, the lack of certainty regarding the firm's prospects and management tendencies creates an addi-

Figure 1.2. Financial and Information Flows



Source: Healy and Palepu (2000).

tional premium on the return on investment. For the issuer, this represents an increase in the cost of capital.

The idea of value relevance of financial information is based on the assumption that the quality of financial information is viewed in the context of the correlation between financial statement variables and firms' stock prices. This is true, although we recognize, as in Ball (2001), that even if the concept of value relevance is essential in the context of increasing financial disclosure, we should remember that there are various types of readers interested in financial statements.⁴ Thus, the issue of firm valuation is just one of the aspects to bear in mind when referring to disclosure, and analysis should not be merely limited to it.

Accordingly, one can deduce that reduced information asymmetry will ensure optimal investment decisions and, therefore, that more firms will be willing to participate in the market. A firm will further maximize its value if it enhances its disclosure regime by publishing additional information on a timely basis, independently from what is required by law. The willingness of a firm to provide complete information is often interpreted as a sign of the good quality of the information (Staking and Schulz, 1999). While we look at the size of the providers of information, i.e., firms, one does not have to lose sight of the investors' side, e.g., institutional investors, that should not be unduly in the choice of the optional investments.

Bushman and Smith (2000) analyze channels through which financial accounting can affect firms' productivity, value added, and investor commitments, and they emphasize that accounting information is the most efficient way for managers and investors to identify good versus bad projects (i.e., project identification). Accounting information in particular plays also a very relevant role by facilitating the comparison between actual and expected results (Choi, 1999). This relationship has several implications. First, by ensuring better alignment between real asset prices and investors' expectations, financial information leads to improved allocation and efficiency of capital within the economy.

Also, because investors apply different values to information variables, these inconsistencies are manifested in market pricing. Increasing consistency among the variables would reduce surprises and exert a positive bias on market volatility. Therefore,

4. Ball (2001) refers to the heterogenous demand for financial statement information, which should not be exclusively limited to the use of the information in share markets but also acknowledges its use for the efficient contracting with the corporation, in management evaluation, and in labor markets, and that it is also used internationally in levying corporate income taxes.

by enabling security prices to reflect the performance and future achievements of a firm with more certainty, financial information guarantees that more capital will be available to those businesses and companies that will use it in the most efficient fashion (Choi, 1999). In summary, by reducing uncertainty, financial disclosure lessens pressure on the cost of capital. This reduction in the cost of capital increases firms' access to financial markets. This is a fundamental link of particular relevance for small and medium-sized enterprises and for emerging economies.

Financial Distress

Financial reporting is also important for financial market development, given its role in averting financial crises.⁵ Our central point in this subsection is that the absence of an appropriate mechanism to determine the level of risk associated with a financial entity reduces the capability to determine the costs of possible volatility. Mishkin (2001) supports this claim and suggests that asymmetric information causes a fundamental adverse selection problem when potentially bad credit risks are those most actively seeking out a loan.

Good corporate disclosure enables markets and supervisors to monitor financial institutions and retards the propensity for excessive risk taking. It is a commonly held view that the weaknesses in the accounting, disclosure, and legal framework of many emerging-market economies contributed to the financial crises of the 1990s.⁶ Due to recent financial liberalization in these emerging economies, lending expanded intensely, with excessive risk taking without a commensurate improvement in financial regulation and supervision. Private investors or banking supervisors were then unable to detect weak banks without accurate and comprehensive financial information regarding their creditworthiness and the creditworthiness of their customers (Goldstein and Turner, 1996).

Financial disclosure also creates a timely demand for the incorporation of economic losses, especially in the context of debt markets and corporate governance. As a firm's debt capacity falls, there is a concomitant increased demand to monitor manage-

5. At this point, it is useful to quote Mishkin (2001) "The asymmetric information problems ... provide a definition of what a financial crisis is: A financial crisis is a disruption to financial markets in which adverse selection and moral hazard problem become much worse, so that financial markets are unable to efficiently channel funds to those who have the most productive investment opportunities."

6. See Goldstein and Turner (1996), who indicate weaknesses in accounting, disclosure, and legal framework as a factor behind banking crises. See also Padoa-Schioppa (1996).

ment performance. This scenario in fact leads to an increased demand for disclosure, which is driven by the need to have early warnings of anticipated losses.

The financial crises of the 1990s have often been seen as caused by volatile capital flows. However, capital flows per se were not the main problem. As has been shown, many of the target emerging-market countries for capital flows had not developed a sound underlying legal and regulatory framework for their financial systems. The receiving countries need to learn to develop a strategy to manage capital flows and to ensure that these flows have productive uses, because the effect of these flows will depend to a large extent on domestic policies and on the degree to which the composition of flows is changing.

A fundamental lesson learned from these financial crises is that emerging markets can decrease the volatility of capital flows through improved financial disclosure and transparency. Reversals in capital flows are heightened when problems or uncertainty increase. Thus, timely and complete financial disclosure could significantly reduce the possibility of sudden reversals in flows.

Corporate Governance

Financial information is also vital to achieving effective corporate control, because financial disclosure provides a mechanism for disciplining managers and improving performance monitoring. Managers are often likely to make decisions that may be in their own interest but not in that of the shareholders—and not consistent with the risk bondholders accept when purchasing their stake in the company. To increase investors' confidence in markets, and particularly in industry performance, management is required to disclose corporate information and decisions. Financial disclosure certified by independent audits more closely aligns the interests of managers and other claim holders.

Particularly, financial accounting provides a direct input to corporate control mechanisms, as well as providing an indirect input to these mechanisms by contributing to the information contained in stock prices (Bushman and Smith, 2000). Hence, good accounting and auditing practices can enhance corporate governance by increasing the objectivity and accuracy of management disclosure. Through these confidence-building measures, financial markets acquire depth and further acceptance.

Good corporate governance is also important as a mechanism for reducing corruption and agency costs. Developing countries frequently have a higher incidence of corruption and fraud, and hence they have a compelling need for sound financial disclosure and accounting practices. Ball (2001) mentions China, a country in transition toward a market economy, as an example of one in which accounting could be enhanced to detect bribery and corruption.⁷ Well-established accounting and auditing practices have an impact on reducing corruption, particularly bribery and asset expropriation. However, the development of these practices needs to be backed by a strong ethical code and by discipline, which must be enforced by a professional body and a robust legal system.

There is another aspect to the agency problem, which focuses on how to reduce the divergence between the objectives of the two parties to ensure greater alignment of their interests. Appropriate disclosure ensures that investors have adequate information on the performance of management, which helps monitor performance and thus ensures greater alignment between incentives to issuers and investors.

Good financial information also helps to cement contractual relationships. The contracting principle recognizes that all parties contracting with a firm will likely have a demand for financial statement information, and stakeholders require assurances that the firm will be able to meet its contractual demands. Financial statements developed in conformance with established principles provide an efficient form of contract verification between the firm and its factor suppliers. Accurate, standardized statements are in the interest of regulators, the public, and shareholders, as well as those that have contracts pending with the firm. Further, they act as a mechanism to reduce the potential for agency costs. Full disclosure reduces the risk that a party to a contract will provide misleading information about its assets or credit capacity.

Healy and Palepu (2000) identify several possible ways to reduce contracting problems and suggest that optimal contracts between entrepreneurs and investors should encourage full disclosure of information on a direct basis. Also, regulations should oblige firms to reveal private information in its entirety, or effective information intermediaries, such as financial analysts, should be held to this standard. Many countries have been able to deal with the problem of information asymmetry through a combination of measures and rules linked to the above-mentioned solutions. Many other nations have not reached

7. See also Ball et al. (2001).

that disclosure level, but they are taking relevant steps—for instance, by implementing internationally accepted accounting standards.

The Role of International Accounting and Auditing Standards

In the previous section, we demonstrated the relevance of financial disclosure on financial market development. In this section, we discuss the relevance of IFRS and also present a case for global accounting and auditing standards as a way to improve and harmonize information practices and thereby foster financial market development.

The Relevance of IFRS

Increased globalization and the integration of financial markets make the need to create an effective standard for disclosing financial information a pressing reality. Investors currently pursue global strategies, and many companies barely rely on their home markets.⁸ Common accounting practices facilitate proper communication between investors and companies that operate in a global environment. Accurate and consistent information also helps to stimulate cross-border capital flows and foreign direct investment for companies that demonstrate a commitment to increasing the standards. Investors can easily make informed financial decisions thanks to their ability to compare information globally, hence reducing their risk, as well as the cost of capital. IFRS would provide the basis for such comparable national and cross-border financial reporting.

Furthermore, regardless of their domicile, companies will be able to report under the same accounting rules, which would save time and money. Thus, global accounting rules improve access to capital markets and economies in general by facilitating greater investment opportunities through comparability, establishing benchmarks, and facilitating decision making. In the GAAP 2001 report, Andersen et al. (2001) suggest that the present lack of common accounting requirements around the world is a significant impediment to the globalization of capital markets.

The *Report to G7 Finance Ministers and Central Bank Governors on International Accounting Standards* by the Basel Committee on Banking Supervision also discussed the relevance of high-quality internal accounting standards for banking supervisors and strongly supports the harmonization of accounting practice internationally.

8. Gebhardt (2000) gives the example of Nokia in Finland.

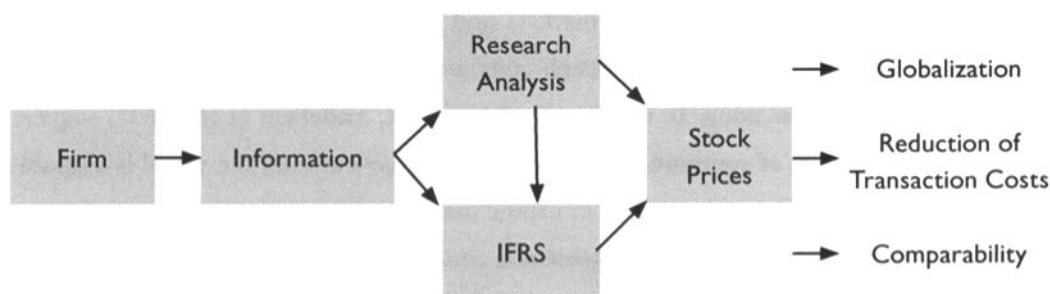
High-quality accounting standards offer a basis for trustworthy measures of assets, liabilities, equity and income, and capital adequacy, and they enhance discipline through transparent reporting. The G-7 Report further states that the growing interdependence of international financial and banking markets requires accurate and transparent published financial statements that are consistent and comparable.

IFRS are increasingly gaining importance, as many countries use them as a benchmark for their own accounting rules. This is evidence of a trend toward high quality and will, it is hoped, in the end lead to an increasing implementation of IFRS. The convergence of local standards with IFRS is still an important task for many countries, and it involves a joint effort by governments, financial statement preparers, statement users, stock market regulators, standard setters, and the accounting profession. Accountants and auditors must be trained, enforcement mechanisms established, and users informed (Andersen et al. 2001). Figure 1.3 shows how the use of IFRS by the firm and financial analysts would have an effect on the stock price in a global environment, enabling comparability and reducing transaction costs.

Issues in Implementing Accounting Standards

Accounting standards reflect diverse economic and social patterns, as well as the level of a country's economic development. However, they are also a consequence of the uses established for the standards. A key aspect of this is the underlying legal founda-

Figure 1.3. Relevance of IFRS for International Firms



Source: Inter-American Development Bank.

tion that governs financial activity and this is evident in comparing accounting practices and institutions for code-law countries versus countries with a common-law tradition.

Code-law countries using the continental approach, such as France, Germany, and Spain, give priority to creditors. Accounting information is intended primarily for creditors and for tax purposes. For example, the main objective of the German accounting framework is not to supply information to the providers of risk capital but to determine distributable profits (Gebhardt, 2000). For these countries, financial reporting is designed with the primary use for entities that require corporate payouts. This group of countries displays a high level of ownership concentration, illiquid capital markets, and a high degree of cross-holdings, and it is frequently known as an *insider system* (Berndt, 2000).

The *outsider system*, conversely, is characterized by dispersed ownership, liquid stock markets, a low level of intercorporate cross-holdings, and an active market for corporate control (Berndt, 2000). For instance, in the American system, the main role of financial statements is to inform participants in capital markets, as well as the general public. Thus, in code-law countries, accounting plays a larger role at the government level, because of its relevance in determining taxes and, at times, even macroeconomic policy, as is the case in France. Furthermore, codification takes place through government action. Hence, political influence in the process of establishing accounting practices is more relevant than in the market approach visible in common-law countries. In this context, it is of interest to keep in mind Ball's (2001) idea of separating the systems of public financial reporting and corporate income taxation, so that tax objectives do not distort financial information.⁹

In common-law countries, accounting regulation is the responsibility of a government agency, such as the Securities and Exchange Commission in the United States, and of private standard-setting bodies, such as the Financial Accounting Standards Board. This is a clear demonstration of the role accounting plays, because the information provided is addressed to the general public and especially to financial market participants. Financial information is conceived from a market point of view; it is information intended for capital providers to make investment decisions. According to Ball (2001), evidence suggests that code-law accounting satisfies the criteria of an efficient disclosure system to a lesser degree than does common-law accounting, in part because of a comparative

9. The example of Germany, which imposes excess taxes on undistributed profits, is relevant.

lack of auditor independence. This permits considerable managerial discretion over reported income. Furthermore, a near absence of stockholder and lender litigation reduces incentives to confront economic losses.

When considering financial information in the context of financial market development, the United States has acquired a dominant position, because its markets have the depth that attracts most investors. Investors have an interest in intervening in American financial markets, and companies want to have their shares traded on these markets. The reason for this success can be traced to the United States's economic well-being and to the reliable structure of market institutions that has also been achieved thanks to U.S. Generally Accepted Accounting Principles (U.S. GAAP).

Furthermore, the American enforcement mechanism to ensure the proper application of these accounting principles is quite reliable and efficient. U.S. financial disclosure requirements are extremely rigorous and strict. But even though they appear to be effective accounting principles in terms of financial market structure, when thinking about globally accepted standards, the continental system also should be taken into consideration. The continental system is in force in a significant part of the globe, and hence some thought needs to be given to its influence.

A natural consideration from this structure would be to understand the reluctance to uphold U.S. GAAP as international standards. One possible explanation lies in national pride, because this alternative would have required appropriate subjugation of the national interest based on the notion of lost sovereignty. It is also important to recall a point made above regarding the importance of standards as reflective of specific economic and social conditions. Furthermore, U.S. GAAP, despite their success, are not perfect. This has become especially apparent through the Enron scandal, which has led to questioning the adequacy of U.S. accounting rules (see Box 1.1). In the process of developing global standards, it is necessary to consider different and broader issues to ensure that implementation in different countries is feasible.

The current business environment does point to a situation that will facilitate a general consensus in the business community, and among standard setters and legislators, on the need for one global set of high-quality accounting standards. Global standards should be oriented, in a common-law tradition, toward the needs of providers of finance in capital markets. However, according to Frankel and Lee (1998), there are

Box 1.1. Recent Accounting Scandals

Enron, the Houston-based energy-trading firm, filed for Chapter 11 bankruptcy on December 2, 2001. The fall of this once extremely successful firm has been described as the largest bankruptcy in U.S. history until WorldCom, the second largest long-distance company in the country, filed for bankruptcy protection on July 22, 2002. Both business failures had tremendous consequences all around the world. Even though Enron's top executives attributed its failure to a loss of confidence in financial and energy markets, public documents revealed that the source of the disaster could be traced to the network of affiliates or special purpose entities (SPEs) created by Enron. The SPEs were created to hold assets (especially debts and losses) moved from the balance sheet of the mother firm. Because several assets were performing badly, reallocating them helped to maintain Enron's high-quality image.

Enron's aggressive accounting schemes indicated to its investors that the company was more profitable than it really was, which kept Enron's share prices up.

WorldCom, which had grown largely by acquiring other telecommunications companies (particularly MCI), had also misinformed its investors. The company admitted in June 2002 that it had overstated its cash flow by US\$ 3.8 billion, which made it appear profitable when it was not. In August an additional US\$ 3.3 billion in irregular accounting since 1999 was made public.

Attention was focused not only in Enron's and WorldCom's failures themselves but also on the failure of the companies' external auditors, Arthur Andersen, which, particularly in Enron's case, did not alert the public, and on the accuracy and adequacy of the U.S. Generally Accepted Accounting Principles (U.S. GAAP). The issue that seemed to be at the core of the problem for the auditor was the fact that accounting firms frequently sell consulting services to their audit clients, which creates a clear conflict of interest.

As a result of Enron, WorldCom and other scandals, doubts have been raised about U.S. accounting standards, which had been regarded as the most rigorous in the world. The United States will no longer look down with disdain on standards issued by other countries or international bodies. In fact, the international accounting rules on SPEs established by the International Accounting Standards Board are tougher than those of U.S. GAAP and would have forced Enron to include the SPEs in its accounting. The Financial Times declared that even though the U.S. GAAP deal with more issues and applications than any other set of accounting rules, these prescriptive rules encourage companies to concentrate on compliance with the letter of the law rather than the spirit (Peel and London, 2002). In fact, this sounds quite encouraging for the further development of international accounting standards.

However, in spite of the Sarbanes-Oxley Act (refer to Box 1.2.) and lessons learned from Enron, accounting scandals continue to sweep through the corporate sector in the United States. In June 2003, Freddie Mac, which buys mortgage loans from lenders and packages them as securities for investors (Zea, 2003), announced that it will need to adjust earnings upwards by US\$ 4.5 billion for the past three years to correct accounting problems that led to numerous errors in applying GAAP. Apparently, executives misrepresented the company's financial results and failed to properly account for derivatives transactions. Most of the accounting errors surfaced when the company recognized gains and losses in its massive securities portfolio and in how it treated certain derivatives. The overall effect was to smooth out earnings and make it appear as if profits were growing steadily (Day and Hilzenrath, 2003). These problems also shed a negative light on Freddie Mac's regulator, the Office of Federal Housing Enterprise Oversight and on the treatment the company receives from the government. Freddie Mac, like Fannie Mae, is a government-sponsored enterprise created to boost homeownership. Both Fannie Mae and Freddie Mac have long received special benefits from the federal government without being held to the same level of accountability as private companies in the mortgage market (NCPA, 2003).

Box 1.2. The Sarbanes-Oxley Act of 2002: Enhancing Financial Disclosure, Corporate Governance and Public Accounting Practice.

As a response to accounting and corporate scandals such as those of Enron, WorldCom and Tyco, the U.S. Congress passed the Sarbanes-Oxley Act in July 2002 with the intention of restoring confidence in U.S. audited accounts. The law impacts the fiduciary role of CEOs of American companies as it pertains to disclosure, results in changes in the corporate governance landscape for companies in the U.S., and also introduces regulations regarding the practice of public accounting in the country. In terms of the role of the CEO, the law introduces a certification requirement regarding the accuracy of the company's financial statements. Chief executive and financial officers will now be obliged to sign quarterly statements that their results are 'fairly presented' in all material respects 'to the best of the officer's knowledge' (Winter, 2002). Certifying false accounts can lead to imprisonment of up to 20 years and also a fine up to US\$ 5 million.

The Sarbanes-Oxley Act will also have direct impact on corporate governance. First, the law will lead to a significant expansion of the role and responsibility of the audit committees, particularly in relation to their management of the outside auditor relationship: including appointment, compensation, and oversight of a company's outside auditor (Atkins, 2003). The law will require members of the audit committee to be independent from the company management and at least one of the members is required to be a financial expert. Second, the law has a direct impact on the role and structure of the board of directors. In order for the directors to act as representatives of the shareholders and fulfill their oversight function, more independence from the company's management is required as well as a clear separation between the duties and responsibilities of the chief executive officer and the president of the board of directors (Hymowitz and Lublin, 2003).

Finally, the law establishes a new body, the Public Company Accounting Oversight Board, with wide-ranging powers to regulate accountants. While the law was challenged by industry groups on the ground of increased cost to companies and engendered significant debate on the specific role of management, it has been largely welcomed within the investment community and is viewed by many as a landmark legislation for the finance industry since the securities laws of the early 1930s.

reasonable concerns regarding whether international standards can actually be totally harmonized, because a country's accounting regulation reflects its cultural, economic, and political institutions.¹⁰ We will, nevertheless, illustrate in the next section the current efforts being made by the international community to establish high-quality global accounting standards.

The Process of Developing International Accounting Standards

This section reviews the process of creating a unified set of international standards in the form of the international accounting standards. Several organizations and associations have been involved in this process (see Box 1.3). The International Account-

10. See also Ball (1995) and Zarzeski (1996).

ing Standards Board (IASB), an independent accounting standard setter based in London, was created in 1973, and its goal has been to promulgate and encourage the implementation of IFRS and to attain a greater consistency in accounting standards worldwide. After IASB discusses and comments on proposed drafts, final standards are produced.¹¹

Box 1.3. The Process of Developing International Financial Reporting Standards (IFRS)

- The primary objective of the International Accounting Standards Board (IASB) is to achieve international harmony of accounting practices.
- IASB was preceded by the International Accounting Standards Committee (IASC, 1973-2001). IASC was established in June 1973 with representation from nine countries (Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the United Kingdom, and the United States).
- According to its Constitution, IASB is committed "to developing, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require transparent and comparable information in financial statements; b) to promote the use and rigorous application of those standards; and c) to bring about convergence of national accounting standards and International Accounting Standards and International Financial Reporting Standards to high quality solutions."
- In April 2001 the IASB adopted the body of International Accounting Standards (IAS) issued by its predecessor, IASC. The accounting standards approved and developed by the Board are known as International Financial Reporting Standards (IFRS). As a general term, IFRS includes standards and interpretations approved by the IASB as well as IAS and interpretations issued by IASC.
- In 1977, the International Federation of Accountants (IFAC) was formed. IASC continued to be autonomous but had a close relationship with IFAC.
- Collaboration between IASC and the International Organization of Securities Commissions (IOSCO) began in 1993 with the aim of producing a list of "core standards."
- In 1998, the core standards were completed.
- After several studies and reviews, in May 2000, IOSCO recommended that its members permit incoming multinational issuers to use IAS to prepare their financial statements for cross-border offerings and listings.
- In 2000, the U.S. Securities and Exchange Commission (SEC) issued a concept release which discussed the use of IAS in U.S. capital markets. The release solicited comments regarding the quality of IASC standards and raised questions regarding what supporting infrastructure would be necessary in an environment where issuers and auditors often are multinational organizations, providing financial information in many countries. The release sought to identify what important concerns would be raised by acceptance of IASB standards; and then asked for comments on whether the SEC should modify its current requirement for all financial statements to be reconciled to U.S. Generally Accepted Accounting Principles. In October 2002, the SEC welcomed the decisions by the Financial Accounting Standards Board (FASB) and IASB to work together toward greater convergence between U.S. Generally Accepted Accounting Principles and IFRS. In December 2003, the SEC welcomed the publication by FASB of proposals that would modify several aspects of U.S. accounting standards to be consistent with the guidance on those issues currently included in international accounting standards.

Sources: International Accounting Standards Board (www.iasb.org); International Federation of Accountants (www.ifac.gov); and U.S. Securities and Exchange Commission (www.sec.gov).

11. IASB is responsible for setting *accounting* standards. The International Federation of Accountants (IFAC), through its International Auditing and Assurance Standards Board (IAASB), is responsible for issuing International Standards on Auditing (ISA) and International Auditing Practice Statements (www.iasb.org and www.ifac.org).

Likewise, an IASB Standing Interpretations Committee considers problems related to existing standards. Although other international organizations, such as the Organization for Economic Cooperation and Development (OECD) and the European Union (EU), also have been involved in the elaboration of accounting standards, IASB is the main force in this process. At its inception, IASB had limited influence and importance, particularly because of its lack of enforcement possibilities. However, it has now gained strong global support.

The partnership of IASB with the International Organization of Securities Commissions (IOSCO), which consists of securities regulators around the world, gave IASB new strength. With IOSCO's collaboration, IFRS would become the basis for accounting requirements in financial markets worldwide. This fruitful dialogue between the two entities and IOSCO's endorsement of IAS was achieved by 1999, after a series of main standards had been approved. In April 2001, IASB was reconstituted from the former International Accounting Standards Committee, and is now composed of professional staff and collaborates actively with the United States. This is of extreme relevance, given the prestige ascribed to U.S. GAAP. Financial markets in the United States have held this prominent position to a large extent because companies that wish to list their shares on American stock markets are required to adapt to U.S. standards.¹²

The European Commission (EC) has also been closely cooperating with IASB. However, member countries of the European Union have not harmonized their accounting standards through the creation of a common set of European standards. Instead, the EC intends to harmonize EU directives with IAS. In this context, five EU member states have introduced dispensations allowing major companies to use IAS rather than comply with national standards for their consolidated accounts (Harding, 1998).

Another important organization in this field is the International Federation of Accountants (IFAC), which is composed of national professional accounting organizations that represent accountants employed in private practice, business and industry, the public sector, and education. As of March 2004, IFAC had 157 member organizations in 118 countries. Its main objective is to improve the profession and to harmonize its standards internationally so that accountants can offer consistent expert services around the world. Its responsibilities include, moreover, the development and formulation of

12. The U.S. Securities and Exchange Commission is considering recognition of stock exchange listings prepared according to IAS in the near future, which will represent a significant move toward the integration of the two major world accounting systems.

international accounting standards and a code of ethics. IFAC's role is to promote and encourage the development of accounting standards, but it is not involved in their promulgation.¹³

It is important to keep in mind that neither IFAC nor IASB expect countries to implement international standards without the needed analysis and consideration. More and more often, adaptations and minor changes need to be made so that standards are suitable for different jurisdictions, since there might be cultural, social, and legal reasons why principles cannot be applied fully unchanged. The mere implementation of standards is not enough. For this implementation process to be rewarding, changes need to occur in countries' infrastructure. Moreover, training the auditing and accounting profession would be the first relevant step to follow to ensure a system with high-quality and independent accountants (Ball, 2001).

Furthermore, a reliable enforcement mechanism is vital. This can be achieved through an efficient legal system that can perceive and deal severely with noncompliance. The example of China comes to mind, where the adoption of IFRS has been encouraged, but where the institutional environment diminishes their result. This environment is characterized by the political influence of the government, the lack of auditor independence, and the absence of any type of litigation risk. However, even if some effort needs to be made, given the central influence transparency has on financial market development and economic growth, IFRS should be more widely adopted around the world.

The Case of Latin America and the Caribbean: Observance of International Accounting Standards

The financial sector in Latin America and the Caribbean is changing rapidly, with evidence of increased diversity in the types of instruments traded, greater participation by institutional investors, expansion of the banking sector with greater presence of foreign banks, and more attention to improving the legal and regulatory framework. Many countries are taking steps to implement standards and principles that could help enhance the performance and stability of the financial sector.

13. See "About IFAC, Organization and Objectives" (www.ifac.org).

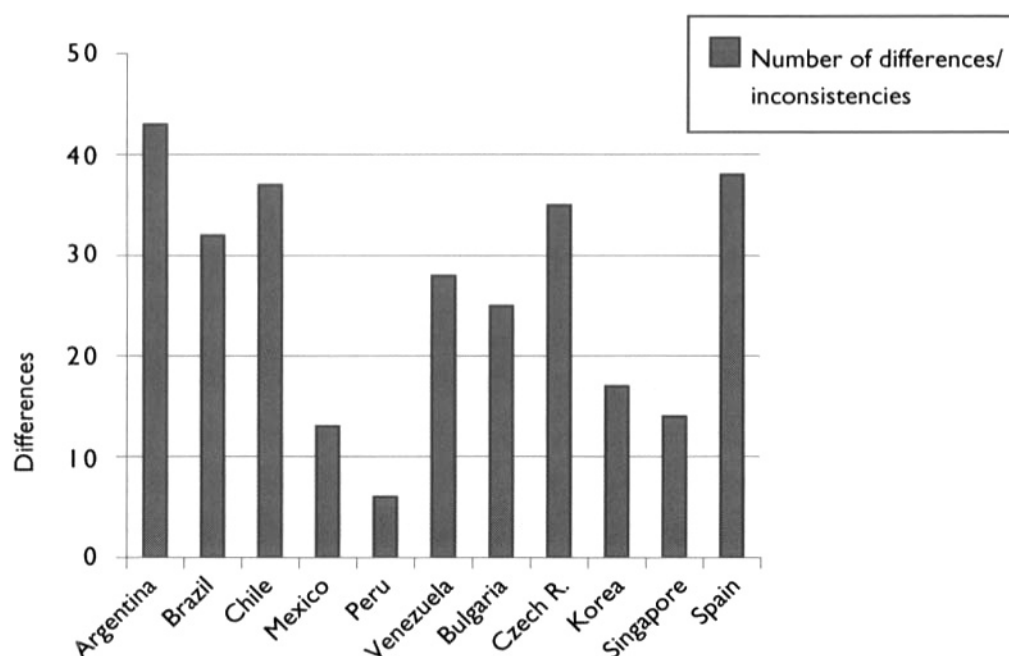
A key aspect of this challenge involves the improvement of transparency and disclosure. Particularly in the Latin American and Caribbean region, the attainability of transparency and proper disclosure mechanisms is of extreme importance, considering the financial instability it often encounters. In spite of encouraging developments, many financial-sector entities are still very susceptible to volatility and fragility within the marketplace, which underscores the need for perseverance. Indeed, harmonization of financial accounting has been a priority in the region. The efforts and accomplishments of several authorities can be observed in more detail in other chapters of this volume.

However, by and large, the countries of the region have or are in the process of reviewing and adopting IFRS as local standards. In fact, most local standards are either very much influenced by or establish the use of IFRS on a supplementary basis. Hence, the prospect is positive because the implementation of IFRS is progressing—even though it appears that, particularly in this region, the problem does not lie in implementing these norms but in the actual application, which is often lacking.

Figure 1.4 provides an idea of the number of differences between local standards in Latin American and Caribbean countries and IASB standards. The figure illustrates the findings of the *GAAP 2001* report for a few countries of the region (Andersen et al., 2001). *GAAP 2001* was developed by the then so-called Big Seven firms (Arthur Andersen, BDO, Deloitte Touche Tohmatsu, Ernst & Young, Grant Thornton, KPMG, and PricewaterhouseCoopers), and it summarizes, for 62 countries, the areas in which national standards require different accounting and reporting treatment from IFRS. The differences indicate the instances in which a country would not permit, because of inconsistent requirements, or would not require, because of missing or permissive requirements, the IFRS treatment (Andersen et al., 2001).

The questionnaire used to generate the information in the *GAAP 2001* report focuses on approximately 80 accounting measures (Andersen et al., 2001). In Argentina, therefore, more than half of the analyzed accounting measures did not coincide with IFRS, whereas in Peru only 6 major differences were found. The improvement in Peru accounting measures is explained by an amendment of the General Corporations Law, which established that all companies are required to prepare financial statements following IFRS that have been approved by the Peruvian Accounting Standards Board.

Figure 1.4. Differences between Local GAAP and IFRS



Source: GAAP 2001.

However, one must consider that though the survey attempts to reflect consistency across the analyzed countries, the report emphasizes that the depth of explanation differences for each country may not be comparable. The differences are not truly analogous and do not necessarily reflect the value or condition of the accounting structure. Further, figure 1.4 does not reflect the state of their financial sector or capital market. Even though, in terms of accounting standards, harmonization with IFRS has not been achieved, financially it has been, for many Latin American and Caribbean countries.

In the absence of concrete accounting guidance, Chilean Standards defer to IFRS. Alternatively, Argentina and Brazil are directly influenced by IFRS, and in fact are in the process of adopting IFRS as local standards. For instance, the Argentine Federation of Professional Councils, the body that approves standards, is concentrating its efforts on achieving harmonization toward IFRS.

Brazil is adapting its accounting standards in accordance with IFRS, and in fact it has translated them into Portuguese to make this task more accessible. Yet it has encountered several obstacles: the strong influence of tax accounting in the country, the continental approach to accounting, and the large number of standard setters.

In the Caribbean, countries such as Barbados, the Dominican Republic, Haiti, Jamaica, and Trinidad and Tobago have all adopted IFRS as their national accounting standards (Table 2.1 in Chapter 2, page 43, provides detailed information for various countries).

In February 2003, the report *GAAP Convergence 2002* was published. This report explores the extent to which 59 nations have developed country plans to converge their national accounting standards with IFRS and identifies the problems faced by these countries to converge with IFRS. Chapter 5, "Large Accounting Firms' Survey explores efforts in Latin American Countries to converge National Accounting Standards with IFRS", included in Section three of this publication, provides a discussion and analysis of this report.

Overall, financial transparency in the region is improving and evolving gradually toward harmonization. In the process of moving toward complete IFRS implementation, various countries have achieved different levels and goals. Yet on the whole, they have attained the most significant objective: the awareness that the implementation and application of IFRS is the appropriate approach to financial development and stability.

Conclusion

Growing attention is being paid to the relevance of a stable, sustainable financial sector in promoting and supporting economic prosperity. As it has been explained, a well-functioning financial sector encourages economic development by mobilizing savings, facilitating risk management, enhancing corporate control, and increasing the efficiency of resource allocation. In turn, better resource allocation and capital accumulation promote technological innovation and spur economic growth. A basic component of assuring that this objective is realized is to guarantee that good information is available to help make financial decisions.

In the wake of recent financial crises in emerging economies and incidents of corporate mismanagement, interest has been shifting toward the attainment of trans-

parency in financial markets to achieve a sustainable stable financial sector. To accomplish this goal, international developmental organizations (including the Inter-American Development Bank and the World Bank) and institutions such as IASB and IFAC have pursued such objectives as the dissemination, adoption, and implementation of international rules and standards for accounting and auditing. Among the many standards, the International Financial Reporting Standards represent the main step toward supporting financial disclosure and thus market stability. These standards lead directly to greater transparency and disclosure, which can contribute to market discipline and thus promote economic and financial growth.

Furthermore, by promoting increased disclosure, these accounting and auditing standards serve as a bulwark against financial crises and their associated costs and social stresses, which particularly afflict the poor segments of the population. The introduction of these standards can also ease the integration of Latin American and Caribbean countries not only within the region but also with the rest of the world, helping reduce the cost of capital and increasing the global competitiveness of the region's economies.

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Capital Market Development in Latin American and the Caribbean: the Role of Accounting and Auditing Standards and the Steps towards Reform

Pietro Masci and Ivan Sotomayor*

Information disclosure plays an essential role in capital market development and in the valuation of assets by market operators and agents—investors as well as research analysts and rating agencies—according to the risk-reward paradigm. This function is regarded as a form of market discipline.¹ That is, bondholders, depositors, and stockholders use information disclosure to evaluate changes in the firms' risk and the actions of their management, shareholders, or other players to undertake corrective measures to control the risk level. However, to achieve market discipline, financial markets need essential information that allows market operators and agents to understand the performance and risk-reward functions of going concerns, and decide a course of action. Confidence in capital markets begins with the quality of financial information, that is, its timeliness, accuracy, and availability to the various market players.

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1. Market discipline is a relatively new concept in the financial literature. It constitutes one of the three pillars of the new Basel Capital Accord (the so-called Basel 2).

Disclosure of information according to agreed parameters, which make it easily accessible and understandable, allows investors to make decisions and in turn serves the overall objective of allocating resources. Thus, generally accepted accounting and auditing standards permit widespread participation in capital market activity, build the confidence of participants, and create the conditions for growth and the appropriate allocation of capital. The effective implementation and enforcement of accounting standards in a given country is one of the factors that enhance transparent disclosure of information. Moreover, the convergence and ultimate harmonization of the standards will facilitate the integration of capital markets and the cross-border flows of capital and foreign direct investment.

In December 2001, Enron Corp, one of the largest companies in the United States, filed for Chapter 11 protection from creditors under the U.S. bankruptcy code. The filing followed large losses in the previous quarters, repeated restatements of earnings, and revelations of partnerships that kept debt off the balance sheet, and inquiries from the U.S. Securities Exchange Commission (SEC). The Enron case shows that failures in information disclosure systems can have a devastating impact even in a well-developed financial system. Therefore, it emphasizes the need for continuous oversight in a complex capital market system that requires the intervention of various players and stakeholders.

Even before the Enron debacle, economic and financial crisis broke out in emerging economies in the late 1990s. Crises began in 1998 in Asia, and spread to other regions of the world, showing the need for reliable and transparent accounting and financial reporting to support sound decision making by investors, lenders, and regulatory authorities. In 1998, the G7 finance ministers and central bank governors committed to endeavor to ensure that private sector institutions in their countries complied with internationally agreed principles, standards, and codes of best practices. The ministers and governors called on all countries that participate in global capital markets to equally commit to comply with the internationally agreed codes and standards. In the international context, the objective was to achieve financial stability as a global public good.

Financial Information, Accounting, and the Capital Market

Max Weber underlines the historical starting point of the role of accounting: "...originally there was no separation between the household and the business. Such sepa-

ration gradually became established on the basis of the mediaeval money accounting” (Weber, 1961).

Investors as well as lenders have a clear interest in the value of the businesses in which they invest. Assuming efficient markets, a firm’s value is defined as the present value of expected future net cash flows discounted at the appropriate risk-adjusted rate of return. Within this framework, the firm’s performance as reported in its financial statements is important, but does not constitute the only input for the so-called fundamental analysis that establishes the value of firm. The Financial Accounting Standards Board (FASB) confirms this conceptual framework when it declares that financial statements should help investors and creditors in making correct decisions and “in assessing the amounts, timing and uncertainty” of future cash flows.² Therefore, there must be a timely association between financial performance and net future cash flows as well as a more direct association between security prices and financial performance. Fundamental analysis plays a crucial role in that it entails the use of information and disclosure in current and past financial statements in conjunction with macroeconomics and sector data to arrive at the firm’s intrinsic value.

The difference between the intrinsic value and the current market value drives the activity of the stock market, indicates the reward expected for investing in the security, and ultimately drives the economic allocation of resources. However, if Fama’s (1970, 1991) statement that “security prices fully reflect all available information” is correct, the reward from fundamental analysis, and therefore from accounting, would be greatly reduced, possibly leading to the collapse of markets because there would be little incentive to gather costly information, and trade and liquidity would disappear (Grossman and Stiglitz, 1980). Therefore, the knowledge of an informationally efficient capital market is enormously relevant for investors, regulators, and standard setters. In an efficient market, theoretically, the choice between disclosure in the footnotes and full disclosure in the financial statement does not have a relevant impact on the price of securities. Conversely, inefficient markets would require fundamental analysis and accounting standards.

After many years of studies and research and thousands of articles and papers, financial economists have not settled the issue about whether financial markets are efficient (for example, the efficient markets hypothesis). What has become relevant, however, is

2. FASB Statement of Financial Accounting Concepts, No. 1, 1978.

not the absolute concept of market efficiency, but rather the relative concept of efficiency. For example, a particular market might be efficient relative to other markets or to a certain type of information.

In the context of relative efficiency, numerous studies have been undertaken to analyze the link between accounting and capital markets. Ball and Brown (1968) study the impact of accounting numbers on capital markets; Ball and Kothari (1991) analyze the impact of earnings announcements on security prices; Ball (1972) looks at the impact of changes in accounting methods on security prices. The various studies show that capital markets are informationally inefficient and it would take years for prices to fully reflect all available information. The research has demonstrated that historical cost reporting and numbers in financial statement—including quarterly earnings—reflect information that influences security prices although it is not necessarily timely. This suggests that accounting, while relevant, does not constitute a monopoly source of information. This is confirmed by studies showing that prices lead accounting earnings (Collins et al., 1994). It also allows the conclusion that, even in an ideal efficient market, fundamental analysis plays a crucial role in guiding knowledge about what drives value. The research demonstrates that fundamental valuation—a function that goes beyond accounting—relies heavily, but not exclusively, on accounting as an instrument to compile and comprehend information, and can yield satisfactory rewards in an inefficient market. Financial statements and quarterly reports are inadequate, on a stand-alone basis, to anticipate the firm's expected revenues and therefore the prediction of future earnings. Information embedded in prices cannot be understood without the input of additional forward-looking considerations, which are the prerogative of the research analyst and of the market in general. At the same time, one of the basic principles of accounting, that is, the revenue recognition principle, makes financial statements unlikely to provide timely indicators of market value, which only valuation models can offer.

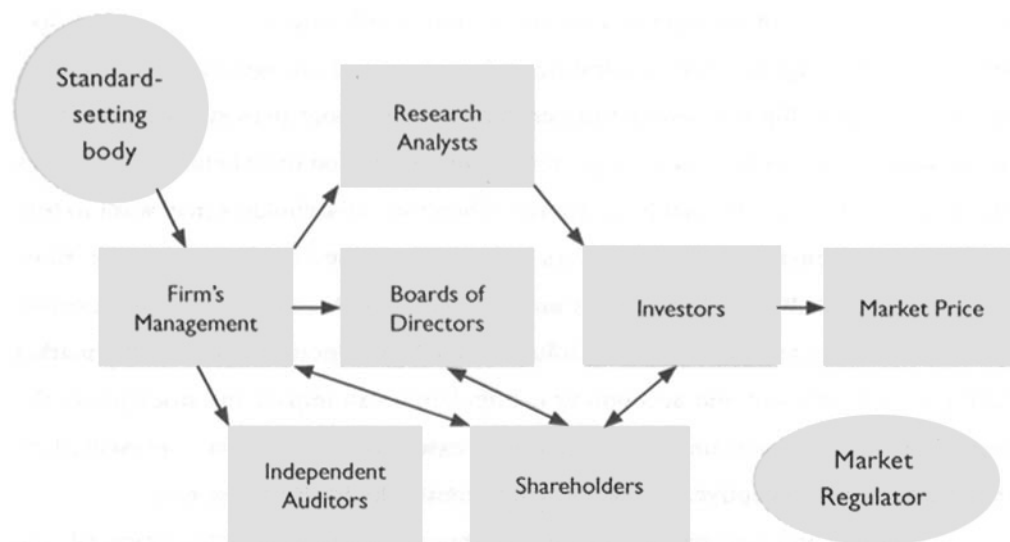
Recent events, from Enron to Tyco to WorldCom, that have shaken U.S. capital markets and investors' confidence, further confirm the limitations of capital markets and demonstrate how the misuse of accounting has a significant impact on stock prices and valuation. However, these events also illustrate that accounting is an instrument for organizing information according to certain rules; accounting is not, per se, responsible for financial disclosure. The crucial issue remains corporate governance and management selection and oversight. According to Jensen and Meckling (1976) and Watts and

Zimmerman (1978, 1979, 1983, 1986), accounting and auditing, in addition to helping to perform the valuation function, contribute to enhancing corporate governance by improving the accuracy of management disclosure and monitoring its behavior, and reducing corruption and agency costs. In dealing with an organization, agency problems exist, that is, the relationship is a contract under which one or more persons, the principals, engage another person, the agent, to perform some service on their behalf that involves delegation of some decisionmaking authority. Therefore, shareholders may want to link managerial compensation to shareholders' value as expressed by the stock price. However, shareholders also need to monitor management, which could manipulate accounting values, policies, and procedures to influence stock price performance.³ As the market is not perfectly efficient and accounting manipulation can impact the stock price, the proper functioning of accounting and auditing is essential to ensure that representations are not fraudulent, deceptive, or likely to compromise the health of the firm.

Accurate and transparent financial statements provide a practical form of contract verification among managers, owners, and lenders. Disclosure and accounting information as well as auditing are expected to ensure that asymmetric information between managers, owners, and investors is eliminated so that research analysts and investors have adequate information to monitor the performance of managers and assess the fair value of the firm. Timely disclosure has substantial merit regardless of whether the market is efficient. Timely disclosure links the relevance of accurate accounting and standards to governance and ultimately to investors' confidence, which is essential for capital market development. Figure 2.1 shows how accounting, corporate governance, and capital markets interact, and how accounting and auditing standards are instrumental to the functioning of corporate governance and to the determination of price and fair market value, which is the task of capital markets.

Given the relevance of generally accepted accounting and auditing standards and practices, should there be a uniform set of global accounting standards or diversity? Should the standards be developed internationally, or should the long-tested U.S. Generally Accepted Accounting Principles (GAAP) be the standards? Should standards be different across nations, given their cultural, political, and legal differences? How can countries incorporate the harmonization of standards into their legal systems? How should they deal with their existing legal national accounting rules? How would different levels

3. For instance, bonus plans in favor of management increase the probability of selecting corporate accounting procedures that shift accounting earnings from the future to the current period.

Figure 2.1. Accounting, Corporate Governance, and Capital Markets: Players and Links

of efficiency of domestic capital markets affect the nature of international standards? Who would be responsible for (and finance) the introduction of accounting standards in emerging countries?

The responses to these questions need to be tackled because accounting constitutes a mechanism for the public good of financial stability and development. The responses should also address the progress and advances made and steps under way by the two major existing standard-setting bodies to achieve a common accounting language.

Implementation of Accounting Standards for the Public Good

The financial crises of the 1980s, and particularly those of the 1990s, have prompted the financial literature to develop a line of reasoning that characterizes financial stability as a global public good because financial instability is a public bad. Financial instability spreads across countries and creates devastating economic and political costs, which, in many cases, are borne by the lower segments of the population.⁴ The reasoning, developed from the point of view of instability as a public bad, goes as follows: markets

4. The Bank for International Settlements (BIS, 1997) estimated that the cost of banking crises was 2 to 3 percent of gross domestic product (GDP) in the case of the savings and loans crises in the United States in the 1980s, and 55 percent of GDP in the case of the banking crises in Argentina during 1980-82.

are not perfect and market failure exists due to information asymmetries and leads to financial instability, which constitutes a public bad that in turn creates externalities in terms of spillovers (for example, contagion) of crises that spread from one country to another, generating cost and redistribution impacts. These externalities do not have a market price or a pecuniary equivalent. Under these circumstances, there is underprovisioning of the global good, financial stability, thereby creating externalities and costs.

Following this rationale, a series of instruments or mechanisms have been designed to promote financial stability.⁵ The promulgation of international standards—defined as minimally accepted practice that countries should meet in various areas, such as fiscal, monetary, banking, and securities supervision; auditing and accounting; bankruptcy; and corporate governance—is crucial for upgrading financial systems and achieving financial stability. Accounting standards constitute a critical device that supposedly would allow all economic agents to share a high level of information, thus realizing the economist's dream of perfect competition. Truthful, timely, and transparent reporting and auditing according to commonly agreed standards would certainly favor financial stability as well as the correct functioning of markets, and would provide large benefits to the entire society.

The economic crisis in Mexico in 1994 shows why accounting rules and practices constitute a relevant tool for financial stability. At that time, Mexican accounting rules permitted banks to recognize as past due amounts only those payments that were past due and not the outstanding loan balance. In addition, it was also widespread practice to roll over loans as well as to lend money to distressed creditors to make interest payments. These two accounting practices created severe underestimation of problem loans that were in excess of shareholders' equity.

The case of Mexico is just one example that shows the importance of effective accounting standards and monitoring by an auditing committee, and the need for adoption of common global standards that are universally understood. Increased globalization of financial markets will require uniformity of standards for disclosure and release of information to pave the road for financial stability as a global public good. However, this abstract notion has to be powerful enough to convince emerging economies that effective accounting standards would help them not only to achieve financial stability,

5. According to Wyplosz (1999), the primary mechanisms for promoting financial stability are adequate macro-economic and structural policies, a legal framework that recognizes and protects property rights, efficient and deep financial markets, regulation and supervision, and monitoring of capital flows.

but also to produce the political will and support and economic incentives to undertake reforms. A motivating factor is that financial crises are extremely expensive and create poverty and other negative outputs.

As a given country makes decisions about the effective implementation of accounting standards, the authorities of that country will need to consider the domestic political economy in selecting the appropriate set of standards. With respect to the latter, authorities must select from among competing accounting conventions—the U.S. GAAP, the International Financial Reporting Standards (IFRS), and national standards. This plurality has an impact on transparency because a single event can have two or more accounting interpretations and therefore can lead to different conclusions. This, in turn, involves a type of transaction cost, in adjusting the two accounting languages and making them comparable and acceptable to a wide range of market operators and agents. In other words, it represents the cost of transparency, given the different accounting methods. The use of competitive methods increases the cost of capital for those companies willing to undergo the reconciliation exercise. For example, some countries do not permit companies to use IFRS without a reconciliation to domestic generally accepted accounting principles, and may also discourage other companies from going the same route to tap capital markets for financing investments and innovation.

Evidently, the equilibrium of diverse sets of accounting standards is not efficient. Therefore, it should be helpful to explore the differences between the sets of standards and the actions under way for harmonization among standards and convergence.

United States, International, and National Accounting Standards and Principles

FASB and the International Accounting Standards Board (IASB) are the prominent standard-setting bodies.⁶ Developments over the past few years show that, while

6. FASB is a private, independent, nonprofit body, formed in 1973 and based in Connecticut, led by members of the accounting profession and industry, responsible for establishing and interpreting general accounting principles. The mission of FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information. Accounting standards are critical to the free enterprise system, the depth and liquidity of capital markets, and their efficiency. The information that results when the standards are applied is used to help allocate scarce capital resources and to provide a basis of corporate accountability.

IASB is an independent, privately-funded accounting standard setter based in London. IASB was preceded by the International Accounting Standards Committee (IASC, 1973-2001). IASB is committed to developing, in the public interest, a single set of high-quality, understandable, and enforceable global accounting standards that require transparent and comparable information in general purpose financial statements. IASB cooperates with national accounting standard setters to achieve convergence in accounting standards around the world.

each of the standard-setting bodies intends to preserve the validity of its choices, FASB and IASB are working together to resolve differences in standards and provide the global business community with a common language.

In appearance, U.S. GAAP and IFRS are similar, thanks to the efforts of the respective standard-setting bodies in eliminating differences. In reality, once the standards are applied within the context of national customs and policies, substantial differences remain. However, the IASB Constitution envisions a partnership between IASB and national bodies working together to achieve the convergence of accounting standards worldwide. The convergence between U.S. GAAP and IFRS continues to move at an accelerated pace, with FASB and IASB working in concert.⁷ On February 3, 2003, Paul Atkins, Commissioner of the SEC, at a seminar in Frankfurt announced that it is the goal of FASB to achieve, by 2005, the harmonization of the U.S. accounting rules with the IASB standards. For instance, it is becoming customary that when IASB decides to review a particular practice on its agenda, FASB immediately does the same.

FASB's objective for participating in international activities is to increase international comparability and the quality of standards used in the United States. FASB pursues that objective in cooperation with national standard setters and in particular with IASB. While U.S. GAAP and IFRS represent the main contenders, many emerging and nonemerging markets have their own solid accounting systems ruled by an independent body that follows the so-called local or national GAAP.

In March 2002, the European Parliament ruled that all companies listed on the European exchanges, approximately 7,000, must present their financial statements using IASB standards no later than December 31, 2005. Currently, the U.S. SEC—which has a crucial interest in the process of disclosure and in the integrity of the accounting system—does not accept the presentation of financial statements using IFRS, and requires conversion to U.S. GAAP.⁸ Approximately 50 foreign issuers listed on the U.S. exchanges must present such reconciliation. The new requirement of the European Parliament will

7. At the "Norwalk Agreement" on September 18, 2002 in Norwalk, Connecticut, USA in a joint meeting of FASB and IASB, each acknowledged their commitment to the development of high-quality comparable accounting standards that could be used for both, national and cross-border financial reporting. At the meeting, both standard setters pledged to use their efforts to the harmonization of the standards as soon as practicable.

8. In February 2000, the U.S. SEC issued a Concept Release (the first stage in a proposed change in its Rules), which discussed the use of IAS in U.S. capital markets. The release solicited comments regarding the quality of IAS and raised questions regarding what supporting infrastructure would be necessary in an environment where issuers and auditors often are multinational organizations, providing financial information in many countries. The release sought to identify what important concerns would be raised by acceptance of IASB standards; it asked for comments on whether the Commission should modify its current requirement that all financial statements be reconciled to U.S. GAAP.

affect approximately 600 European companies listed on the U.S. exchanges, which will have to file according to U.S. GAAP as required by the SEC. It is clear that the new ruling will put pressure on both standard setters to converge their systems as soon as possible.

Differences Between U.S. and International Accounting Standards

Resolution of the differences between the two sets of standards is complicated by philosophical, cultural, and political factors, such as the debate involving the fact that FASB uses a methodology based on rules, while IASB uses a methodology based on principles.⁹ Some proponents argue about the superiority of U.S. GAAP as a standard due to the fact that IFRS allows much more room for interpretation. However, opponents point out that the voluminous and detailed FASB guides were not enough to prevent the Enron disaster. The debate on whether Enron violated the 3-percent guideline of EITF 90-15, which defines control of special-purpose entities (SPEs) and the consolidation requirement, is regarded as meaningless.¹⁰ In fact, under IFRS, control is not defined quantitatively, but rather looks at the ability to exercise operating control, execution, and decisionmaking over the SPE. As a result of the Enron debacle, FASB has issued Interpretation No. 46 to correct the deficiency in reporting interests in SPEs.

In testimony before the U.S. Congress in March 2002, the SEC Chairman, supported standards based on principles (Pitt, 2002). This indicated that the SEC would use its power as regulator to insure that FASB, as the standard setter in the United States, would start using the methodology based on principles instead of the complex and detailed methodology based on rules. On October 21, 2002, FASB announced a proposal for a principle-based approach to U.S. accounting standard setting.

In some instances, elimination of the differences between U.S. GAAP and IFRS would require replacing some of the existing standards with completely new standards. Both FASB and IASB are focused on issuing quality standards and not just attempting to converge the standards. For example, both bodies allow the use of smoothing to determine the value of pension plan assets. This technique allows smoothing out the peaks

9. Standards based on principles would require more flexibility, but a much stronger audit function.

10. The guidelines require that only up to 3 percent of the SPE be owned by an outside investor to avoid classification of the SPE as a subsidiary, thus, forcing the entity to include the SPE's financial position and results of operations in its financial statement. The Emerging Issues Task Force (EITF) was formed in 1984 in response to the recommendations of FASB's task force for timely financial reporting guidelines and FASB's invitation to comment on those recommendations.

and valleys of the securities market in recognizing the value of the investments. It was impossible to decide which was the appropriate methodology allowed under standards *IAS 19* and *FAS 87*, and the replacement of both standards seems the right course of action.¹¹

In other circumstances, the cooperation and influence of one standard-setting body could favor the standard-setting process of the other, as was the case in the treatment of stock options. IASB has taken the position that stock options must be recorded as an expense. In 1993, FASB took the same initial position while drafting *FAS 123 Accounting for Stock Based Compensation*, but in its final version, the standard was changed due to lobbying by business interests and politicians. The standard ended up in a compromise, which opted for a disclosure in the footnotes of the financial statement rather than the recognition of stock options as an expense as suggested by FASB's initial position.¹²

Likewise, IASB is under pressure by political and business interests that may undermine its capability as an independent standard-setting body. In the process of convergence, it is essential that accounting standard-setting bodies, national and international, build in mechanisms that assure independence in the face of pressures exercised by various interest groups. This is crucial for ensuring that the capital market agents and operators have confidence in the pronouncements of the standard-setting body.

Characteristics and Applications

IASB and FASB have a mandate to operate in different environments (international and national, respectively), respond to diverse needs, and apply distinct standard-setting structures and processes. The difference between the two sets of standards is inevitable, but, if financial statements presented under IFRS are to be considered appropriate for cross-border filings, it is essential that IFRS satisfy the need of the world financial markets for high-quality financial information. In this respect, U.S. GAAP has a longer history of use and records, and has been repeatedly tested in the largest and most efficient capital market in the world.

11. Both standards allow the use of the asset smoothing method as an alternative mean by which a defined benefit pension plan measures its assets for funding and expense purposes. It spreads the impact of investment gains and losses over several years rather than incurring the impact in a single year as in the case of the market asset method. The resulting smoothed asset value must be within plus or minus 20 percent of market assets.

12. On March 31, 2004 FASB issued a proposed Statement, Share-Based Payment, an amendment of FAS 123 and 95. Under the proposal, all forms of share-based payments to employees, including stock options, would be treated the same as other forms of compensation by recognizing the related cost in the income statement.

Most of the controversy and debate surrounding the comparability of financial statements prepared under IFRS and U.S. GAAP revolve around four main themes. First, although IFRS and U.S. GAAP are broadly similar and, in many cases, the use of IFRS can provide results that are analogous to those obtained by using U.S. GAAP, the existence of alternatives creates the potential for different results. For example, under *IAS 23 Borrowing Costs*, the allowed alternative treatment requires capitalization of borrowing costs incurred in the purchase, construction, or production of certain assets in a manner similar to that of *FAS 34 Capitalization of Interest Costs*. However, *IAS 23* benchmark treatment requires that borrowing cost be expensed, which constitutes an alternative treatment with respect to U.S. GAAP. The existence of different alternative treatments and benchmarks creates a potential for noncomparability of financial statements.

Second, some experts argue that IFRS is too broad and general and cannot guarantee that similar accounting methods are applied in similar circumstances, or that similar results are consistently achieved. Arguably, this is true in some instances, although in others, IFRS is equally or more effective than U.S. GAAP. For example, both *IAS 2 Inventories* and *Accounting and Research Bulletin No 43: Restatement and Revision of Accounting Research Bulletins* provide broad, general guidelines on cost-flow assumptions in estimating the cost of inventories. However, with regard to accounting for the inventories of service providers, *IAS 2* provides more detailed guidance than does U.S. GAAP.

Third, in some circumstances, IFRS and U.S. GAAP standards are identical, but the lack of implementation guidance by IFRS creates differences when applying the standards. For example, *IAS 33 Earnings per Share* and its U.S. GAAP counterpart, *FAS 128 Earnings per Share*, resulted from a team effort between IASB and FASB. However, *FAS 128* implementation guidance is more detailed for some of the calculations required for determining earnings per share, as is the case in determining the impact of different types of contingencies related to contingent issuable shares. Consequently, there may be different results in the calculation of earnings per share between entities following *IAS 33* and *FASB 128*.

Fourth, the difference in reported results between IFRS and U.S. GAAP may be even more difficult to compare as more countries adopt IFRS as their national standard. The lack of consistency in the application and enforcement of the standard in some jurisdictions will make it difficult to compare an IFRS-based financial statement of an entity

in Germany with a comparable IFRS-based financial statement of an entity in Japan and, clearly, almost impossible to compare with a U.S. GAAP-based financial statement.

Agendas

At the top of IASB's agenda is the Improvements Project, which was undertaken following a request from the International Organization of Securities Commissions (IOSCO), the European Commission, and national standards setters such as FASB, and includes several changes, both large and small, in 14 international standards. The purpose is to eliminate alternatives, redundancies, and conflicts in existing standards, and align IFRS with U.S. GAAP in areas such as accounting for foreign exchange and investment in subsidiaries that are not consolidated.¹³ In other areas, a dramatic divergence continues to exist in standards such as the last in, first out inventory method, which is allowed under U.S. GAAP but not under IFRS.

The Improvements Project has also eliminated extraordinary items. Although in appearance this area seems to have significant differences between U.S. GAAP and IFRS, in reality, the differences are minimal because not many transactions are treated as extraordinary items. In the United States, reporting an extraordinary item has become an ordinary occurrence. FASB did not totally eliminate this category, but instead decided to rescind one of the principal sources of extraordinary items, that is, the early extinguishment of debt. When *FAS 4 Reporting Gains and Losses from Extinguishment of Debt* was issued, it constituted an extraordinary item. Now, with all the innovations in the financial market, most companies have greater flexibility on how to retire their debt and it is not considered an extraordinary item.

After debate among various stakeholders, FASB eliminated the standard that allowed use of the pooling-of-interest method for business combinations effective with acquisitions in 2001. IASB issued in March of 2004 *IFRS 3 Business Combinations* superseding *IAS 22*. *IFRS 3* requires all business combinations to be accounted under the purchase method, as under U.S. GAAP, except for combinations involving two or more mutual entities, and combinations in which separate entities are brought together to form a reporting entity by contract alone without the obtaining of an ownership interest.

13. On December 15, 2003 FASB announced a small but important move toward uniting accounting standards worldwide in an effort to bring U.S. GAAP closer to IFRS. The proposal will require U.S. companies to apply accounting changes retroactively. In addition, FASB proposal will narrow the gap with IFRS in the calculations of per-share earnings, valuation of certain exchanged assets and accounting for inventories.

Innovation coupled with the need to create global standards has generated the necessity for FASB and IASB to re-evaluate accounting standards. In addition, the creation of accounting standards is not static; rather, it has to be continually adapted to new commercial and financial transactions in a global environment.

The Impact of Standard Setting on Quality Control in Latin America and the Caribbean

Some emerging market countries have benefited by adopting either IFRS or U.S. GAAP as their national accounting standards. This is especially true for those countries that had no national standards, or whose national accounting standards did not provide adequate transparency.

In Latin America and the Caribbean, the adoption and convergence of the national standard-setting bodies to one of the existing standards has been mixed (see table 2.1):

- Two countries, Canada and Mexico, have convergence to IFRS on their agendas. Canada's policy is to conform to IFRS unless there is a fundamental disagreement or circumstances that warrant a different approach. In Mexico, Bulletin A-8 requires the use of IFRS in the absence of a Mexican standard.
- Brazil and Uruguay issue national GAAP standards influenced by IFRS. Argentina issues its own national standards and has announced that, in the future, it plans to base most, but not all, of its standards on IFRS.
- Peru, Costa Rica, Honduras, the Dominican Republic, Panama, Guatemala, Ecuador, El Salvador, Nicaragua, and Haiti have adopted IFRS in their entirety as the national accounting standards.
- Chile and Venezuela follow their own national GAAP and, in the absence of a national standard, require the use of IFRS. Colombia also follows its own national standard, which is influenced by U.S. GAAP.
- Bolivia and Paraguay follow their own national GAAP and there is no indication that they will adopt or converge to IFRS.

The diversity of the standard-setting process in Latin America makes difficult, if not impossible, the comparison of financial statements prepared under the national GAAP with IFRS or U.S. GAAP. The difficulty of the comparison includes those countries

Table 2.1. National Accounting Standards and Quality Assurance Policies

Country	National Professional Organization	Estimated Number of Public Accountants	National Accounting Standards	Quality Control System
Argentina	Federación Argentina de Consejos Profesionales de Ciencias Económicas (FACPCE) Federación Argentina de Graduados en Ciencias Económicas (FAGCE)	80,000	Argentinean GAAP. Plan to base future standard setting mostly on IFRS	No
Barbados	Institute of Chartered Accountants of Barbados (ICAB)		IFRS fully adopted as benchmark	
Bolivia	Colegio de Contadores de Bolivia Colegio de Auditores de Bolivia	7,680	Bolivian GAAP	No
Brazil	Conselho Federal de Contabilidade	340,000	Brazilian GAAP influenced by IFRS	Yes
Canada	The Canadian Institute of Chartered Accountants	65,000	Canadian GAAP - Convergence Project to IFRS	Yes
Chile	Colegio de Contadores de Chile	8,800	Chilean GAAP in absence follow IFRS	No
Colombia	Confederación de Asociaciones de Contadores Públicos de Colombia (CONFECOP) Instituto Nacional de Contadores Públicos de Colombia (INCP)	60,000	Colombian GAAP influenced by U.S. GAAP	No
Costa Rica	Colegio de Contadores Públicos	3,100	IFRS	No
Dominican Republic	Instituto de Contadores Públicos Autorizados	6,000	IFRS	No
Ecuador	Federación Nacional de Contadores de Ecuador	3,000	IFRS	No
El Salvador	Asociación de Contadores Públicos Corporación de Contadores de El Salvador	3,000	IFRS	No
Guatemala	Instituto Guatemalteco de Contadores Públicos y Auditores	4,000	IFRS	No
Haiti	Ordre des Comptables Professionnels Agrees d'Haïti	400	IFRS	No

Continued

Country	National Professional Organization	Estimated Number of Public Accountants	National Accounting Standards	Quality Control System
Honduras	Colegio de Profesionales Universitarios Colegio de Peritos Mercantiles y Contadores	7,300	IFRS	No
Jamaica	Institute of Chartered Accountants of Jamaica	490	IFRS	
Mexico	Instituto Mexicano de Contadores Públicos	27,000	Mexican GAAP - Convergence Project to IFRS	In-process
Nicaragua	Colegio de Contadores Públicos de Nicaragua	500	IFRS	No
Panama	Colegio de Contadores Públicos Autorizados de Panamá Asociación de Contadores Públicos de Panamá	5,500	IFRS	No
Paraguay	Colegio de Contadores de Paraguay	12,000	Paraguayan GAAP	No
Peru	Federación de Colegios de Contadores Públicos del Perú	24,000	IFRS in absence of IFRS follow U.S. GAAP	No
Puerto Rico	Colegio Contadores Públicos Autorizados	3,500	U.S. GAAP	Yes
Trinidad and Tobago	Institute of Chartered Accountants of Trinidad and Tobago		IFRS are adopted as national standards	
United States	American Institute of Certified Public Accountants (AICPA)	480,000	U.S. GAAP - Convergence Project to IFRS	Yes
Uruguay	Colegio de Contadores, Economistas y Administradores del Uruguay (CCEA)	3,500	Uruguayan GAAP influenced by IFRS	No
Venezuela	Federación de Colegios de Contadores Públicos	36,000	Venezuelan GAAP, in absence follow IFRS, Mexican GAAP, U.S. GAAP in this order	No
TOTAL		1,180,770		

Source: Authors' calculations.

adopting IFRS mainly due to the lack of consistency in the application of the standards and leniency of local regulatory enforcement of the standards.

Is a quality control system for firms in the practice of accounting and auditing necessary in Latin America and the Caribbean? A properly designed quality control system, which adapts to the culture and local practices of each country, is a requirement if the country wants to achieve the following:

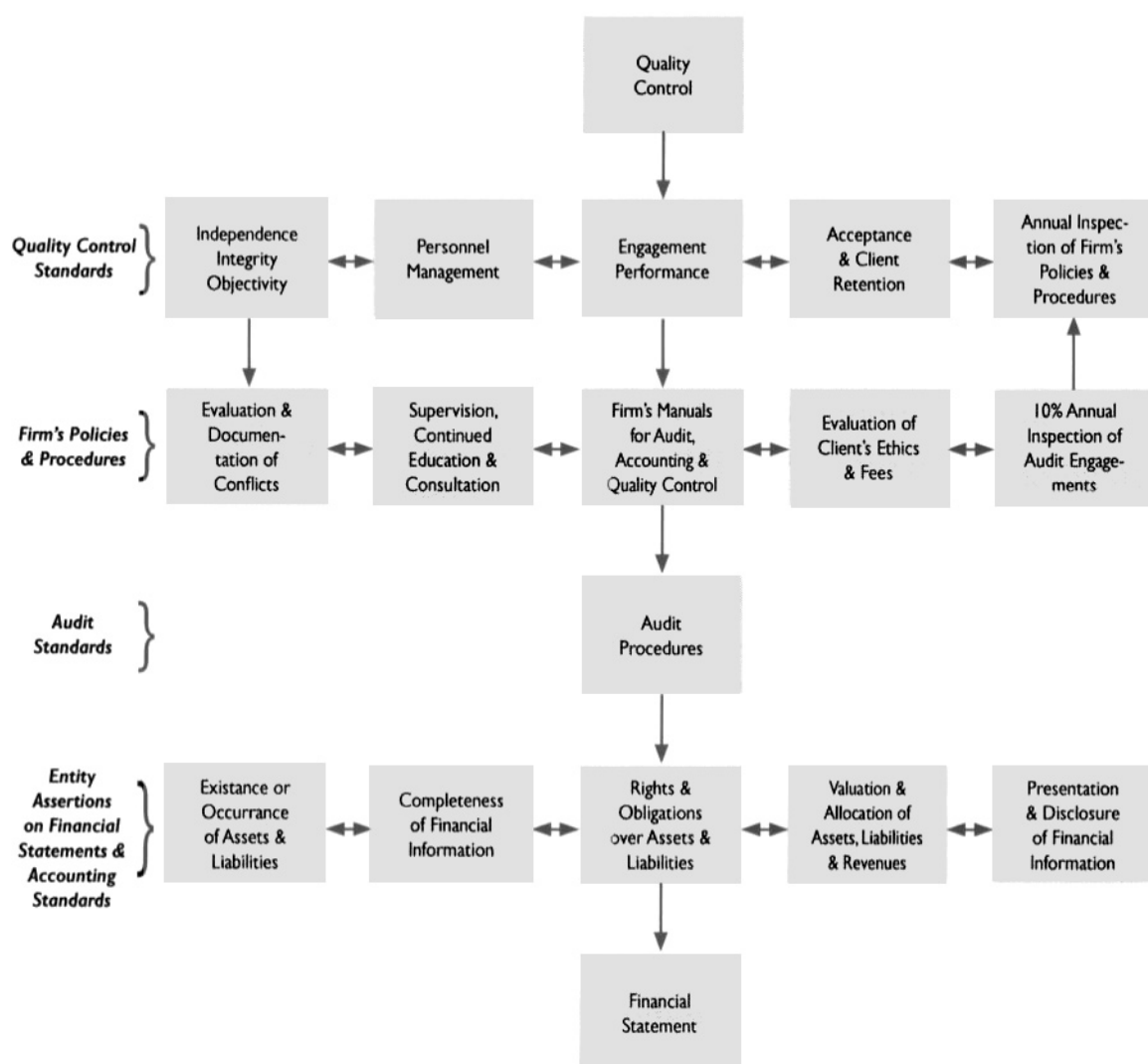
- Raise the competency level of its professionals;
- Improve the quality of audits;
- Ensure that financial information is transparent, timely, and relevant;
- Provide international and national investors with information that is useful in making business and economic decisions; and,
- Reduce the cost of capital, which in turn will promote economic progress and innovation.

The adoption of a quality control system by the individual countries would enforce consistency in the application of the standard, which, if coupled with local regulatory enforcement, would permit the comparison of financial statements prepared for those enterprises in the countries that have adopted IFRS or U.S. GAAP.

To implement quality in the preparation of financial statements, a country's quality control system must first create the enabling conditions and controls to assure integrity of the system through consistent application of the standards, mandatory continued education, and independent supervision and enforcement of the system (see Figure 2.2).

In Latin America and the Caribbean, the accounting and professional practice rules are enacted under a diverse set of mechanisms, which makes harmonization in the region difficult, but not impossible. Some countries enact the rules through the legislative process, while others have delegated the process to the country's regulators and professional accounting organizations. For example, a country in Central America adopted IFRS as its accounting standard and enacted it into law by authority delegated to the government accounting regulator. A small, interested group of accountants challenged the enactment on grounds of a constitutional technicality in the form of the enactment, rather than in the substance of the law. In an around-the-problem solution, the government opted for giving autonomy to its regulators, the Superintendent of Banks,

Figure 2.2. System of Quality Control for Audits



the Securities Exchange Commission, and the Insurance Commission, who require and enforce the use of IFRS for financial statements filed by the agencies under their jurisdictions, and represent approximately 90 percent of all filings. Thus, it is clear that Latin America and the Caribbean will have to implement enabling conditions and controls through a different mechanism in a coordinated effort with regulators.

A quality control system for accounting firms in private practice consists of the application of the quality control standards against which the structural organization of the firm and its established policies and procedures will be benchmarked. Such a system should be implemented to reasonably assure that professional accounting, auditing, and ethical standards are observed in the firms' business practices.

Figure 2.3 shows the flow of a system of quality control for an audit in which the quality control standards are applied against the firm's policies, and the auditing procedures test management's assertions on the financial statements and the consistent application of the accounting standards.

In those countries that have not adopted IFRS or U.S. GAAP in their entirety, a reconciliation of the financial statements prepared under the countries' GAAPs to IFRS and U.S. GAAP should be required for entities listed in the local exchange, banks, insurance companies, investment funds, and, in general, all entities of public interest. Table 2.2 presents a synopsis of the major differences between U.S. GAAP and IFRS.

Figure 2.3. Enabling conditions for Quality

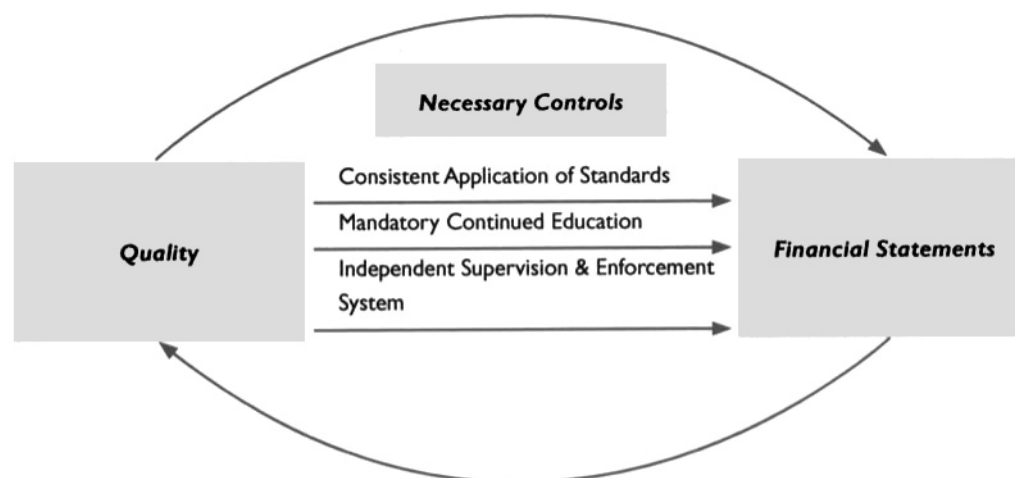


Table 2.2. Areas of Major Differences Between IFRS and U.S. GAAP

Area of Difference	IFRS	U.S. GAAP
<i>Stock compensation</i>	No accrual and no disclosure of fair values.*	The fair value of the stock option is recorded as expense or disclosed. The FMV of shares and the appreciation rights of the shares given to employees must be recorded as expense.
<i>Business combinations</i>	Pooling allowed under limited circumstances, but project to eliminate on agenda.	All combinations must be accounted under the purchase method.
<i>Goodwill</i>	Amortized over a period of 20 years and also subject to the asset impairment test.*	Generally is not amortized, but is subject to the asset impairment test.
<i>Research & Development – acquisitions in process</i>	Must be amortized.	Recorded as an expense.
<i>Financial Statement Consolidation</i>	Control test (could be with voting rights less than 50%).	Control test (majority of voting rights – over 50%).
<i>Asset impairment</i>	It is recognized if the discounted present value of future cash flows is below the asset's book value.	It is recognized only if the future cash flows (not discounted) are below the asset's book value.
<i>Provision for liabilities of uncertain timing and amount</i>	One comprehensive standard exist, discounting is required.	No general standard in effect. Some provisions are not discounted.
<i>Issuance of convertible debt</i>	The proceeds from issuance are divided between liability and equity.	The proceeds are recorded entirely as a liability.
<i>Hyperinflation</i>	General price-level adjustment of subsidiary's financial statements is required and gain or loss of net monetary position is recorded in net income.	Re-measure of subsidiary using parent's functional currency.
<i>Discontinued operations: Expectation for future operating losses</i>	No accrual	Accrual
<i>Direct initial costs for lessors</i>	Amortize or expense over the term of the lease.*	Recognized as an expense.
<i>Foreign exchange differences on monetary transactions</i>	Sometimes is added to the cost basis of the asset.*	Always recorded in net income.
<i>Segment reporting</i>	Business segments are lines of business and geographical areas. Must report using consolidated GAAP. Segment definition.	Segments are components for which information is reported to management and can use whatever GAAP is used for internal purposes. No segment definition.
<i>Property, plant and equipment</i>	Revaluation is allowed.	Revaluation is not allowed.

Continued

Area of Difference	IFRS	U.S. GAAP
Investment in property	Can use either fair value or cost model.	Only cost model is allowed.
Correction of errors	Either re-state or include cumulative effect in earnings.*	Re-state
Accounting changes – non-required	Either re-state or include cumulative effect in earnings.*	Re-state
Financial statement formats	Specific line items are required.	SEC regulations require specific formats but not under FASB.
Comprehensive income	Reporting not required.*	Reporting required.
Statement of Cash Flows	Interest received and paid could be recorded as operating, investing or financing.	Interest received and paid is recorded as operating.
Construction contracts for which the percentage of completion cannot be determined	Cost recovery method	Completed contract method
Capitalization of interest on constructed assets	Optional	Required
Preferred shares – mandatory redemption	Recorded as liability.	Split between liabilities and equity.
Investment in joint ventures – incorporated	Equity method or proportionate consolidation.	Equity method
Change in value on investments with not ready available market	Either in equity with recycling, or in earnings.*	In equity with recycling.
Special purpose entities (SPEs)	Must be consolidated if controlled.	Variable interest entities must be consolidated by primary beneficiary, “qualified SPEs” continue off the books.

*The IASB has currently a convergence project with U.S. GAAP.

Policy Considerations and the Role of Multilateral Financial Institutions

This chapter has shown how healthy development of the financial sector—and of capital markets in particular—depends on disclosure and timely information. The application of accounting standards in financial reporting constitutes a fundamental instrument for achieving the goal of releasing information according to the criteria of

accuracy, completeness, and comparability. These requisites allow the market to function and grow, introducing more effective market discipline, which results in proper valuation of business entities according to the risk-reward trade-offs.

Latin American and Caribbean countries are at a crossroads; if the countries in the region want to develop their financial markets, they must embrace the process of transparency and disclosure. It is likely that in the long run, through cooperation among national and international standard-setting bodies, the two relevant bodies of standards, that is, IFRS and U.S. GAAP, will converge. Nevertheless, countries in the region should aggressively pursue the political decision to effectively implement appropriate and internationally accepted accounting and auditing standards, and prepare themselves for the process of harmonization and globalization. Implementation requires more than just passing legislation. Making accounting standards a part of the routine of the local business community entails considerable efforts through setting up independent regulatory bodies, ensuring effective enforcement, providing training and education, and implementing quality control systems. It represents a long-term, continuous exercise that demands patience, commitment, and oversight.

Any change in a country's legal and regulatory system requires coping with the political, cultural, and social realities of that country. However, internationally accepted accounting standards have specific characteristics that facilitate their adoption and effective implementation. More than other standards, they are self-contained and stand alone, in that their application does not require that the domestic legal system necessarily be changed. This is the so-called interdependence of rule under which the rules have to be inserted and understood in the context of other legal concepts of the domestic system. The autonomy feature of the accounting standards facilitates their introduction in national systems as the rules embodied in the international standards make only limited reference to legal terms and concepts existing in the recipient legal system. The introduction of accounting standards constitutes a general instrument for transparency and disclosure and applies mostly to large companies. However they may also be a reference for small and medium companies. In addition, accounting standards are a crucial component of financial stability and therefore have important characteristics and benefits that go beyond an individual country.

It should be highlighted, however, that no matter how good and sophisticated the rules and practices that are put in place are, the system's success ultimately depends on the set of incentives that are designed around various stakeholders whose ultimate interest is the preservation of an efficient capital market system. Among those incentives, those that permit the competitive formation of the portfolio of assets of investors—not analyzed in this publication—are crucial.

The system also depends on the institutional settings that mold the behavior of the various players. In addition, policymakers must have a long-term view, and be aware that results will not come quickly and that there is a continuous need for oversight in introducing changes and adjustments.

Just as it is recognized that accounting is a mechanism for the public good of financial stability, it is also acknowledged that the effective implementation of accounting and auditing standards provides benefits at more than just the country level. Against this background of financial stability as an international or regional public good, the World Bank and the Inter-American Development Bank, in the context of their work on financial sector reform, provide advice (in the form of best or good practices) and financing to support countries introducing mechanisms, such as accounting and auditing standards, that favor financial stability and financial sector development.

The International Monetary Fund and the World Bank have been conducting Reports on the Observance of Standards and Codes (ROSC) that analyze country compliance with selected international standards, including those related to accounting and auditing. The accounting and auditing module of an ROSC assesses the status of the accounting practices in a given country and prepares a specific report for the government. The report helps to guide policy discussions with the relevant national authorities and is used by rating agencies in their country assessments, and by the private sector for risk analysis. As countries undergo ROSC assessments, the demand for assistance in accounting and auditing standards will increase.

In 2002, the Multilateral Investment Fund (MIF) of the Inter-American Development Bank approved the Cluster Action Plan: *Supporting the Competitiveness through the Application of International Accounting and Auditing Standards*. Given recent corporate mismanagement, the cluster program was seen as timely and critical at a mo-

ment when economies in the region are striving to improve their access to capital and financial markets.

The Program finances technical assistance in preparing country action plans including support for changes in laws; developing interpretations and guidance notes to support the implementation of new standards particularly among traded companies; improving the legal basis for adopting or improving corporate governance standards; developing training and certification programs by universities, accounting bodies, and securities regulators; assistance to national or sub-regional entities to establish or strengthen peer review or certification programs; disseminating results and best practices to increase awareness of newly adopted standards and promote programs to improve compliance.

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Valuation and Mergers and Acquisitions in Latin America: Accounting Rules and the Functioning of Capital Markets

William M. Casey and Pietro Masci*

The globalization of capital markets brings a new significance to the need for comparable and transparent financial reporting practices. A key reflection of this trend is the increasing number of foreign companies that are investing in emerging economies as part of their overall plan to expand production and operations. Additionally, individual investors are looking abroad to diversify their portfolios. Mergers and acquisitions (M&As) have increased significantly over the last 20 years, both domestically and internationally, in response to many factors.

Valuation of a company is essential for the functioning of financial markets and affects the process of asset acquisitions, mergers, and other related activities. Consistent and comprehensive accounting and financial reporting standards that provide a high level of transparency constitute the basis for valuation. Conversely, valuations are possible only if accurate financial and operating data and information is available, and if appropriate corporate governance and accounting practices and standards are in place to permit and encourage transparency and disclosure. Transparency is very relevant from the perspective of the acquirer as the acquirer is required to report financial information to his stockholders, creditors and auditors according to the accounting practices of the

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acquirer's home country. Local investors in emerging markets may also find it beneficial to invest their resources in domestic companies provided that accurate, transparent, and reliable disclosure is in place as this is necessary for meaningful valuation.

Investors generally include a risk premium when valuing companies in the Latin American and Caribbean region due to the volatility of market conditions, company and country risk, and the perceived and actual shortcomings of financial reporting and internal accounting control systems. Continued improvements in the transparency, consistency, completeness, and harmonization of financial reporting will increase the confidence in financial information and the overall valuations of companies. At the same time, these improvements support the efforts of many countries to provide more liquidity to the capital markets of the region and offer a possibility of an exit to venture capital early stage investors, that they would be able to realize their investments, make valuation possible and reduce the cost of capital. Under these circumstances, harmonization of accounting rules and practices may become crucial factors in attracting investors, particularly if the new rules become law in the emerging country and corporate actions, such as cross-border mergers and acquisitions, are greatly encouraged.

Investors evaluating business opportunities in Latin America and the Caribbean are faced with interpreting financial statements based on local generally accepted accounting principles (GAAP) as well as local currency, trying to compare them to U.S. Generally Accepted Accounting Principles (U.S. GAAP) and/or International Financial Reporting Standards (IFRS). In most instances, the accounting standards of an acquirer's home country differ from those of the target's home country. As part of a continuing effort to bring about convergence of global accounting standards, the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) have agreed on the need to produce common, high-quality accounting standards across the major international capital markets to increase the international comparability of financial reporting. The Boards will initially focus on current joint projects in the area of business combinations to address the accounting relating to the application of the purchase method and, secondly, on a joint project in the area of financial performance reporting.

In recent years there have been unprecedented changes in the national accounting standards of many Latin American countries. However, despite these changes—often described as 'international'—accounting standards and practices still remain

geographical, i.e., developed by local accounting rule-makers and influenced by local business practices. This chapter reviews the status of business and assets valuation as well as that of M&As in Latin America and the Caribbean. It focuses on selected accounting standards and practices in the region and the implications from an investor's perspective. It also discusses how the introduction and effective implementation of internationally accepted accounting principles and standards would facilitate the process of transparency and disclosure and harmonization of financial reporting standards, as well as play a significant role in the valuation of assets and their transfer, and in capital market development. While it is not intended to be a comprehensive comparison of local GAAP to U.S. GAAP and IFRS, the following discussion provides some insights into the key considerations in evaluating and comparing local GAAP with U.S. GAAP or IFRS, and the implications for investors on the valuation of the underlying business as well as making decisions on potential investments. The objective of the review of the main differences is to underline the existing gaps among the relevant accounting concepts, their effect in the outcome of the final business valuation and ultimately their impact in the development of a vibrant and liquid capital market.

This chapter also illustrates that the implementation of accounting standards according to international norms serves the objective of promoting transparency, disclosure, and harmonization; allows for the appropriate valuation of businesses, assets, and liabilities, which facilitates mergers and acquisitions activity in the region; and, serves the broader public policy agenda of improving the effectiveness and efficiency of local capital markets, thus enhancing the ability to attract investments by both local and international investors. This set of actions would likely be more effective in promoting foreign investments than the tax incentives and other subsidies, which governments normally offer to attract foreign direct investors.

The next section contains the main factors driving cross-border investments. Subsequent sections review the issues of transparency, disclosure, and harmonization and their impact on valuation; describe the valuation of target companies and analyze the quality of earnings; examine the main differences between Local GAAP and U.S. GAAP or IFRS. The final section provides conclusions and policy considerations.

Foreign Direct Investment and Mergers and Acquisitions

This section provides a background on foreign direct investment for mergers and acquisitions, and highlights the importance of enhanced financial reporting and valuation for Latin America and the Caribbean. It also identifies the implementation of accounting standards within the context of foreign direct investments (FDI) flows and M&A activities.

Foreign direct investments are defined as an investment involving a long-term relationship and reflecting a lasting interest and control of a resident entity in one economy (foreign direct investors, or parent company) with an enterprise resident in an economy other than that of the foreign direct investors (FDI enterprise or affiliate enterprise or foreign affiliate). FDI implies that the investor exercises a significant degree of influence over the management of the enterprise resident in the other economy.

Over the last few years, countries have continued to liberalize their economies in various forms. The abolishment of foreign exchange controls, privatization of state-owned companies, introduction of economic regulation, creation of regulatory bodies, competition, and tax-reforms, together with global strategies that companies have pursued, have resulted in an exponential increase in FDI and an expansion of international production. The main increase of FDI particularly in the late 1990s continues to be cross-border M&As that account for a very substantial share of the total flows, which are higher in developed countries and lower in emerging countries. The value of worldwide M&As rose from about US\$80 billion in the early 1990s to more than US\$1 trillion in 2000 and to decline to US\$593 billion in 2001 and further to US\$369 billion in 2002. Among the emerging economies, Latin America and the Caribbean have a share of cross-border M&As that fluctuates between 2 and 5 percent, with Brazil and Argentina being the main recipients. In 2002, M&As in Latin America fell to US\$ 56 billion. M&A activities in the Latin American and Caribbean region are primarily related to privatization and are concentrated in public utilities, banking and finance, transportation and communications. Clearly, the importance of accurate and consistent accounting for business combinations has never been greater due to the impact of M&As on the world economies (see Table 3.1.).

Various types of mergers and acquisitions have been identified based on experience and the structure of the market:

Table 3.1. Foreign Direct Investments (FDIs) Inflows and Mergers and Acquisitions (M&As) by Group of Countries, 1991-2002 (millions of US\$)

FDI Inflows by Group of Countries, 1991-2002 (millions of US\$)												
COUNTRY/GROUP	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
TOTAL WORLD FDIs	160,199.39	171,199.09	227,532.05	259,695.63	330,515.79	386,139.79	478,081.83	694,457.28	1,088,263.44	1,491,933.84	735,145.65	651,188.50
<i>Developed Countries</i>	113,098.77	107,288.29	137,152.91	144,685.95	203,311.00	219,907.63	267,947.15	484,238.99	837,760.71	1,227,476.32	503,143.97	460,334.40
Western Europe	80,111.66	72,201.41	74,431.91	82,481.35	118,265.25	115,863.41	137,889.80	274,738.83	507,221.71	832,067.37	336,209.98	384,391.00
European Union	77,734.64	72,342.68	73,428.26	76,832.96	114,438.65	110,376.29	127,918.61	262,215.91	487,897.53	808,518.82	322,954.21	374,379.80
Other Western Europe	2,377.02	(141.27)	1,003.64	5,648.40	3,826.60	5,487.12	9,971.19	12,522.91	19,324.18	23,548.55	13,255.77	10,010.83
North America	25,679.96	23,945.74	55,394.59	53,299.11	68,026.77	94,088.76	114,975.02	197,243.32	307,811.32	367,529.29	151,899.87	50,624.80
Other Developed Countries	7,307.15	11,141.14	7,326.42	8,905.48	17,018.98	9,955.45	15,132.34	12,256.84	22,727.67	27,879.66	15,034.12	25,319.01
<i>Developing Countries</i>	44,395.52	59,238.41	83,293.55	108,698.61	112,537.12	152,685.02	191,021.53	187,610.61	225,139.97	237,894.44	204,801.28	162,145.10
Africa	3,306.69	3,840.23	4,420.43	6,126.63	5,743.29	5,835.15	10,744.19	9,020.88	12,821.21	8,693.98	17,164.53	10,997.72
Latin America and the Caribbean	16,713.23	22,147.41	19,805.59	33,737.82	30,866.10	52,855.78	74,298.91	82,203.25	109,310.80	95,405.42	85,372.57	56,018.50
Asia and the Pacific	24,375.61	33,250.77	59,067.53	68,834.15	75,927.73	93,994.08	105,978.42	96,386.49	103,007.95	133,795.03	102,264.18	95,128.82
Asia	24,271.71	32,964.69	58,716.42	68,508.70	75,216.55	93,331.15	105,827.94	96,109.18	102,779.44	133,706.62	102,066.10	94,989.12
West Asia	2,230.11	2,776.34	3,634.61	1,790.64	3.24	2,897.70	5,645.21	6,704.64	323.58	688.30	4,132.75	2,341.13
Central Asia	19.62	120.40	1,418.20	923.88	1,484.39	2,590.06	3,844.44	3,152.18	2,466.34	1,895.14	3,568.78	4,034.92
South, East and South-East Asia	22,021.98	30,067.95	53,663.61	65,794.18	73,728.91	87,843.39	96,338.29	86,252.36	99,989.52	131,123.18	94,364.57	88,613.07
The Pacific	103.90	286.08	351.11	325.45	711.19	662.94	150.48	277.31	228.51	88.41	198.08	139.70
Central and Eastern Europe	2,705.10	4,672.38	7,085.59	6,311.07	14,667.67	13,547.14	19,113.14	22,607.68	25,362.77	26,563.08	27,200.40	28,709.04
Mergers and Acquisitions, Purchases by Group of Countries (millions of US\$)												
TOTAL WORLD M&As	80,713.10	79,280.30	83,064.30	127,109.90	186,592.90	227,022.70	304,847.60	531,648.40	766,044.00	1,143,816.00	593,960.03	369,789.00
of which Latin America and the Caribbean	3,529.00	4,196.00	5,110.00	9,950.00	8,636.00	20,508.00	41,103.00	63,923.00	41,964.00	45,724.00	35,837.00	22,433.00

Source: UNCTAD, Foreign Direct Investment database: <http://www.unctad.org/>

- Horizontal mergers involving two or more companies working in the same line of business;
- Vertical mergers involving companies which are in different stages of production and operations;
- Conglomerate business involving companies that are engaged in unrelated forms of activities trying to achieve diversification.

Cross-border investments or acquisitions take place between two or more countries and are becoming increasingly frequent and present varying degrees of complexity. In fact, cross-border investments involve various fundamental factors such as choice of currency, calculation of the cost of capital, form of discounting the cash flow, appropriate treatment of certain risks, and, obviously, the way to deal with the different accounting principles and practices, which is the main focus of this article.

Depending on the characteristics of a merger or acquisition, the business combination would be accounted for either under the purchase method or the pooling of interest method. The purchase method of accounting requires the acquirer to record in its financial statements the value of all the assets acquired, both tangible and intangible, as well as the liabilities. The value of assets and liabilities is normally the market value. Under these circumstances, the cost of acquisition is shared proportionally among the various identifiable assets. They include both tangible assets as well as intangible (e.g., patents). In the purchase method, any excess or residual purchase price over the fair value of the identifiable assets is recorded as “goodwill,” which is recorded as an asset and amortized over a certain period. Goodwill represents the potential of an entity to earn above normal profits. The reported income of an acquiring entity includes the operations of the acquired company after acquisition. In the pooling of interest method, no acquisition is recognized because the combination is accomplished without disbursing resources of the constituents. Ownership interests continue and the former bases of accounting are retained. The recorded assets and liabilities of the constituents are carried forward to the combined entity at their recorded amounts. Income of the combined entities includes income of the constituents for the entire accounting year in which the combination occurs. The reported income of the constituents for prior periods is combined and restated as income of the combined entity.

Table 3.2. M&As: Comparisons of reporting practices in selected countries and International Financial Reporting Standards

Country, Group, or Standards	Purchase Method	Pooling-of-Interest Method	Goodwill accounting	
			Capitalize or Amortization	Direct Write-off
Argentina	Yes	---	---	---
Brazil	Yes	Yes	Yes	No
Mexico	Yes	No	10 years	Yes
United States	Yes	No	Yes	No, but asset impairment test
IASB Standards	Yes	Yes	20 years	Yes
European Union	Yes	Yes	Yes	Yes

Source: Ferris and Petitt (2002).

FDI and M&As have significant costs and benefits associated with them and thus have an important bearing on the policy decisions and actions aimed at attracting resources to the local economy.

Literature Review

The flow of FDI has been selectively directed to various countries with a significant increase in the 1990s and a decline in the past few years. Mergers and acquisitions are part of this trend and are included in the statistics on direct investment. The literature has regarded FDI as an important factor for economic growth. However, various researchers have cautioned against some features of FDI that can displace domestic resources.

On the positive impact of FDI, the literature (among others, Caves, 1996; Hanson, 2001; Wolf, 2001; Lipsey, 2001; Reinicke, 1998; Vial and Cornelius, 2002) point out that FDI and M&As may enhance national social welfare, depending on the magnitude of the improvement of productivity and other spillovers that FDI and/or M&As generate, versus their negative impact on domestic industry. In other words, there is evidence that if the host country has the capability to promote policies directed toward increasing the competitive environment, favoring capital market development as well as introducing

and enforcing rules of competition and antitrust,¹ FDI and M&As facilitate a more efficient use of resources (Gillis et al., 1996). FDI and M&As could complement domestic savings, raise the productivity of domestic factors, and allow for technological advances (Cardoso and Dornbusch, 1989). Moran (2002) recognizes the possible negative impact of FDI on the recipient economies, particularly looking at the perspective of workers, but he concludes that the cost of restrictions on foreign operations would be higher than the costs of an open economy.

Concerns are expressed that FDI, and consequently M&As activities, do not add to productive capacity as, for example, a greenfield project would. This school of thought states that FDI and M&As simply represent a transfer of ownership and control at headquarters. This may entail layoffs of workers or crowding out of domestic firms, and reduction and closing of activities (e.g., research and development), all of which can be transferred abroad. Moreover, FDI and M&As could lead to situations in which competition is restricted or reduced, and a monopoly or an excessive market power is established that is detrimental to consumers and the economy.² Cardoso and Dornbusch (1989) and Grieco (1986) find that instead of filling the gap between savings and investment, foreign investment can lower domestic savings by extracting rents, including the preferential treatment to access domestic capital markets and foreign exchange. Bello (2000) argues that FDI gravitates to areas related to the stock market, consumer finance, and real estate. In the case of real estate, FDI can prompt crises and “bubbles.” Malhotra (2000) states that financial flows are a crucial component of financial crises in emerging-market countries and urges controls not only of short-term flows but also of long-term direct investment. Along the same lines, Woodrooffe (2000) advocates a framework for the regulation of FDI.

International organizations—for example, the UN Conference on Trade and Development (Lall and Streeten, 1977), the Organization for Economic Cooperation and Development (Reuber, 1973), and the Overseas Development Council (Encarnation and Wells, 1986)—offer independent studies of many FDI projects using cost-benefit methodology to evaluate the impact on recipient economies. The conclusions of the studies are

1. Effective rules for competition and antitrust with enforcement constitute a fundamental pillar in any public policy toward FDI and M&As.

2. In the host country, fears may go beyond the pure economic ones and touch upon the social and political sensitiveness because M&As may lead to expanded foreign control of domestic assets, the erosion of national sovereignty, and the importation of foreign cultural models.

mixed in terms of the costs and benefits for the recipient countries, but on balance, FDI tends to be seen as beneficial to recipients—and unequivocally so when there is competition in the markets in which the FDI is embedded.

The motivations for FDI have been studied, particularly from the supply side, that is, the investors. In this respect, the globalization of capital markets and the liberalization of many economies favor the increasing number of foreign companies that are investing in emerging economies as part of their overall plan to expand production and operations. Additionally, individual investors are looking abroad to diversify their portfolios. FDI and M&A have grown enormously during the past 20 years, both domestically and internationally, in response to technological changes; increased liberalization, particularly of foreign exchange controls; privatization of public companies; regulation of activities in the public utility sectors; and international competition. Along these lines, various contributions have explored the motivations of investors. Moran (1974) and McKern (1993) identify imperfect competition (e.g., barriers to entry, a typical push of foreign investment). Dunning (1993) and Rodrik (1988) find a high correlation between market imperfections and FDI.

Less research has focused on the internal factors and policies of the recipient countries to attract FDI. Moran (1999) reviews the status of FDI and emphasizes the role of policy in having effective FDI and incorporating foreign investment into a country's development agenda.

The introduction and effective implementation of accounting standards has several effects:

- It removes some of the asymmetric information between domestic and foreign investors, which is often used to justify subsidies, mostly in the form of tax reductions or exemptions to foreign capital, which comes as direct investment rather than portfolio investment.
- It favours transparency, disclosure, and harmonization, which not only promotes local capital market development but also the valuation of assets as well as mergers and acquisitions, which is the specific focus of this chapter.

Disclosure, Transparency, and Harmonization of Financial Reporting Standards and Their Impact on Valuation

The interplay between macroeconomic, monetary, political, and regulatory factors generates trade-offs and raises public policy issues. This interplay ultimately affects the motivation, implementation, and nature of M&A activities. Accounting standards foster transparency, disclosure, and harmonization and constitute primary factors for capital market development and permit accurate valuations of business as well as of M&As.

The gains derived from a merger or acquisition are impacted by the final valuation and the purchase price. Decisions based on bad valuation practices may lead to a price paid that is too high and trigger shareholders' losses that may offset gains in other segments. The acquirer will find it difficult to assume and the merger or acquisition may ultimately fail. If the price were too low, the forces around the target company, i.e. competitors, consumers and general public, could resent the unlawful advantage given to the acquirer and may ultimately be in a position to make the deal fail. Appropriately priced mergers and acquisitions, assuming that the benefits are passed on, lead to better products at lower prices as well as efficiency gains. This underscores the importance and relevance of attaining a fair price utilizing transparent and well-defined accounting practices for financial reporting.

To assure disclosure and transparency and contribute to a meaningful valuation as well as capital market development, the financial reporting must possess at least four critical characteristics: information availability, reliability, comparability, and enforcement. The features of availability, reliability, and comparability are somewhat self-explanatory. Reporting has to be reliable and material to reflect circumstances that have an impact on the valuation of the company. Investors have to be able to understand the financial reports and make comparisons with other information so that they can make educated decisions. Enforceability is the crucial ingredient, which validates the other three factors. Enforcement needs to be integrated in the local legal system and requires an adequate number of qualified and independent professionals able to attest to the reliability of the accounting information that the companies provide.

Independence in the process of setting accounting standards is also a crucial feature to promote greater transparency. Independence is fundamental to provide confidence and fairness of the process, to reassure investors and issuers, and to encourage

participation in the capital markets. At the international level, independence is equally sensitive. An international standards setter has to be able to provide confidence by being independent, credible, and strongly objective and its members have to be selected based on these criteria.

The issue of harmonization is particularly relevant with respect to the introduction of international accounting standards as well as to enforcement. While the discussion of harmonization vs. regulatory competition applies to the area of accounting, harmonization of accounting standards and practices would reduce transaction costs, prevent inefficiencies related to fixation of unilateral rules, greatly improve transparency and disclosure, foster integration, commerce, and trade and flows of resources that would help their efficient utilisation and, most importantly, allow the comparability of value and performance among similar enterprises in a cross-border environment. At an early stage, international accounting standards would constitute the interface among different jurisdictions and, once adopted by a country, companies would have the option of using them. Moreover, once a supra-national body is established—the International Accounting Standard Board (IASB)—the political policy of adopting the standards in each country might be less of a problem.

The fundamental function of accounting standards based on international practices is therefore not only to help establish efficient capital markets but also to permit the valuation of assets and companies and their transfer. In the sections below, the most significant aspects of accounting disclosure affecting valuation are reviewed.

Valuation of Target Companies in M&A Activities

Approach to Valuation of Target Companies

In M&A activities, the financial information provided to investors by the target company is analyzed to determine the value of the target company. Such information is typically prepared in accordance with the local accounting standards of the country where the target company resides. Business valuation methodology is built on certain basic principles derived from varying sources including discounted cash flow models, comparisons of recent sales of similar entities in related markets, multiple of sales, volumes,

multiple of earnings before interest, taxes, depreciation and amortization (EBITDA) or market value of assets. In reality, the value of a business is equal to the present value of the future benefits of ownership, which must include in its financial model the correct assumptions of discount rate risk as depicted in Table 3.3. In addition, valuations must determine a base line level of working capital needed to support continuing operations of the enterprise. The valuation is based on the target company's expected cash flow and the investor must understand the key accounting policies related to revenue and expense recognition, as well as the classification and determination of debt, in order to derive an accurate stream of flows to evaluate. In particular, the investor should also understand the terms of any long-term leases, commitments, contingencies, and any other type of off-balance sheet financing.

When evaluating a potential target's financial information, investors consider (1) the country (or countries) in which the target company has operations; (2) the target company's industry; and (3) whether the target is a public or private company. These three "background" factors impact the accuracy and transparency of the financial information provided to investors and their advisers during the due diligence stage of a merger or acquisition.

Accounting standards vary from country to country in their basic approach to the purpose of financial statements, the definition of the basic elements (e.g., assets, liabilities, equity, income and expenses), whether they include particular items in measuring the 'accrual basis' financial statements, and how the items included are presented in information ultimately disclosed in the financial statements. Investors should be aware that the disclosure requirements vary significantly among countries in Latin America and are generally less stringent than U.S. GAAP and IFRS disclosure requirements.

For example, companies in Colombia may account for inventories and intangible assets differently from companies in Peru. Companies in Argentina and Chile are required by law to disclose a statement of cash flows whereas companies in Brazil, Venezuela, and Mexico are not required to do so by local regulatory agencies or under local GAAP. Companies in Mexico must restate prior yearly financial information to adjust for inflation, if the inflation effect from the prior period to the current date is material, while other companies in other countries are not required to do so.

Table 3.3. Discount Rate Risk Matrix

Unsystematic or Subjective Risk	
Market risk	<ul style="list-style-type: none"> • Barriers to market entry • Market size or share constraints • Strength of competition • Buyer product or service acceptance • Shifting buyer preferences
Financial risk	<ul style="list-style-type: none"> • Illiquidity • Unfavourable contractual obligations • Excessive debt
Management risk	<ul style="list-style-type: none"> • Depth of management talent • Key employee dependence • Management's past experience with product or service
Product risk	<ul style="list-style-type: none"> • Key supplier dependence • Obsolescence • Reliance on specific patents and licenses • Lack of productive capacity • Commercial impracticality of production
Company sales risk	<ul style="list-style-type: none"> • Key customer dependence • Lack of product diversification • Lack of geographic sales diversification
Business environment risk	<ul style="list-style-type: none"> • General economic conditions • Government regulation
Base Rate	
Systematic risk	<ul style="list-style-type: none"> • General equity risk premium • Beta coefficient for the subject industry to modify the general equity risk premium • Company size premium
Risk free	<ul style="list-style-type: none"> • U.S. Treasury bond, note or U.S. Treasury bill yield

Target companies, in particular industries, may be responsible for certain statutory or fiscal requirements that other companies in different industries are not. Financial institutions such as banks, broker-dealers and insurance companies are generally required to disclose additional financial information to inform investors about risks specific to their industry. Whether a company is public or private can also make a significant difference in the nature and quality of the financial information available to potential investors. Public companies are more likely to report financial information in compliance with local accounting standards than private companies. However, the records of

private companies are often maintained primarily for tax purposes resulting in significant differences with records maintained in local GAAP (e.g., cash basis vs. accrual basis accounting). Additionally, public companies generally have more resources and better information systems to provide more detailed financial information.

Understanding how the factors discussed above impact a company's financial information is vital to analyzing and valuing a target company in Latin America. Therefore, all valuations require adjustments to take into consideration the many different accounting and financial reporting practices.

Analyzing the Quality of Earnings

One of the most important assessments that are performed on a target company is a quality of earnings analysis, which attempts to calculate a target company's adjusted earnings for the years or periods of time under review, based on the observations and findings from the financial due diligence. Buyers incorporate the financial advisers' proposed adjustments into their valuation models. In transactions where the purchase price is being calculated as a multiple of earnings before interest, taxes, depreciation, and amortization, or EBITDA, such analysis can have a significant impact on the final purchase price.

A quality of earnings analysis usually provides answers to the following questions:

- What is the market structure under which the company operates?
- Does a company's business generate profits and are the profits sustainable?
- Does a company's pricing model generate adequate margins for the goods and services being sold?
- Is there excess capacity?
- Does the company need to rationalise certain business segments/products?
- What are the 'normalized' earnings or EBITDA that should be used to properly value a target company?
- Have historical earnings been overstated? Have certain costs been deferred or capitalized to improve current year earnings?
- Have historical earnings been positively impacted by changes in accounting principles?

- Have historical earnings been understated, creating cushions available to offset future losses?
- What is the sustainability of revenues?
- Are there assets and liabilities that are off-balance sheet and therefore excluded from earnings?

A financial adviser must be knowledgeable of the accounting practices that a target company applies to properly address the questions above and to determine a target company's adjusted earnings and EBITDA using a quality of earnings analysis.

The adjustments proposed by the financial advisers, which are generally included in a quality of earnings analysis, can generally be categorized as follows:

- Adjustments made to comply with U.S. GAAP or IFRS;
- Exclusion of the impact of inflation accounting included in historical operating results;
- Exclusion of noncash revenue and expense items recognized under local GAAP;
- One-time, nonrecurring adjustments;
- Analysis of the classification of revenue and expense items and exclusion of nonoperating revenues and expenses; and,
- Errors in the application of local GAAP.

Principal Differences Between Local GAAP and U.S. GAAP/IFRS

In this section we utilize a microlevel analysis to identify the main practical problems of applying local GAAP for cross-border M&A activities and illustrate the differences relative to U.S. GAAP/IFRS. The most common types of adjustments proposed by financial advisers while performing a due diligence on a target company are adjustments to correct misapplications of local GAAP that have had an impact on the final valuation. These adjustments attempt to restate historically reported earnings in order to reflect recurring revenues and expenses or normalised EBITDA of the target company in local GAAP and in local currency. For example, companies may have overstated earnings by improperly recognizing revenues from a prepaid contract entered into at the end of the fiscal year. An adjustment to pro-rate the revenues earned in the appropriate years will be needed to restate earnings.

Although financial reports from different countries may appear to be similar, significant differences in national requirements and the resulting financial statements still exist. Users of financial statements need to be alert to the potential for differences between requirements (e.g., this can be done by referencing the national requirements adopted in the notes to the audit reports).

Most major companies in Latin America (particularly those whose shares are publicly traded or that have public debt issuances listed in the United States or in other international markets) include a footnote in their financial statements reconciling their results from operations and their net asset position in accordance with local GAAP to their results from operations and their net asset position in accordance with U.S. GAAP or IFRS.

Transaction and Post-Transaction Considerations

In the context of an investment, it is not common practice for purchase and sale agreements to properly designate the governing GAAP in order to settle any subsequent disputes or price adjustments. As discussed previously, there are significant differences between U.S. GAAP/IFRS and local GAAP that can impact the value of closing net assets or the overall valuation of the entity.

Business valuation models used to determine the enterprise value of the target company are typically stated in the local currency and local GAAP of the investor/acquirer. More sophisticated models attempt to include the effects of inflation and devaluation of the local currency against the acquirer's functional currency. More simplistic models convert historical data into the acquirer's functional currency and exclude the effects of inflation and devaluation of the local currency. An understanding of local GAAP inflation accounting and the reporting of foreign currency transactions is critical to understanding the basis for the reported results and cash flows.

There are also relevant post-transaction financial reporting considerations. Acquirers should take note of the target company's capability to continue to report under these standards on a timely basis. Compliance with the reporting standards of U.S. GAAP and IFRS often requires capturing significantly more data than required under local GAAP. Many companies in Latin America do not utilize sophisticated accounting systems

and procedures that would be capable of periodically converting financial results from local GAAP to financial results using U.S. GAAP or IFRS. For publicly traded companies in the United States that acquire entities in Latin America, the ability to rely on the internal controls of a target company's systems and to quickly close the quarter- and year-end books to report earnings to shareholders and the SEC is extremely important. During the post-merger transition period, the acquirer should develop implementation plans to ensure that the target company can meet reporting deadlines.

The following sections highlight the principal areas in which local country GAAP differ significantly from U.S. GAAP and IFRS.

Consolidation and Investment in Common Stock

There is considerable variability among local GAAP related to consolidated financial reporting. Under U.S. GAAP and IFRS, if the parent company controls, directly or indirectly, more than 50 percent of the voting stock of the subsidiary, the parent company must prepare consolidated financial statements. The Financial Accounting Standards Board (FASB) is currently exploring an economic concept of control by which consolidation would be required if significant influence over the investee is exercised.

An investment in a subsidiary which represents significant influence over the investee, and generally controlling less than 50 percent but greater than 20 percent of the voting stock, requires use of the equity method. Under the equity method, the parent company recognizes its proportionate share of the earnings/losses of the subsidiary. In the cost method, the investment is recognized at historical cost and it is never adjusted, unless impaired. The investor recognizes income from investment only to the extent that the investor receives distribution from accumulated net profits of the investee arising after the date of acquisition. The cost method is generally used for investments of less than 20 percent in the subsidiary.

Local GAAP in many Latin America countries allow for the separate reporting of holding companies and wholly-owned operating subsidiary operations. Potential investors evaluating wholly-owned operating subsidiaries should request detailed financial information on the financing and investing activities of the holding company to properly assess the current and future capital requirements of the target company. In addition, important financial information and disclosures regarding commitments and

contingencies and other information generally presented with consolidated financial information may be excluded from unconsolidated financial statements and bear a significant impact on the target company's final valuation.

The following paragraphs highlight certain variations in reporting consolidated financial information in Latin America.

Brazil

In Brazil, publicly traded companies are required to prepare consolidated financial statements. Brazilian GAAP also provide for separate reporting by parent companies. Nonpublicly traded Brazilian entities may use either the equity or the cost method to account for their investments in subsidiaries.

Publicly traded Brazilian companies must apply the equity method for relevant investments in related companies in which the investor has a 20 percent or greater interest, or a 10 percent or greater interest if the investor also has influence in the administration of the company. The equity method is required for book and tax purposes if the investment is made in a controlled company or in certain related companies and is deemed to be a 'significant' investment. An entity is considered to be related to a company if it holds a 10 percent or greater interest in the shares of the company. An investment is considered significant if it represents at least 10 percent of the investors' equity, or if the investor has several investments equal to 15 percent of equity.

Mexico

Consolidation practices are similar to U.S. GAAP and IFRS.

Argentina

In Argentina, consolidated financial statements must be presented as supplementary information if a company holds a voting interest of more than 50 percent in another company. Equity accounting, rather than consolidation is required if the company holds a voting interest of more than 50 percent, while cost accounting is used for investments of less than 50 percent.

Venezuela

In Venezuela, if one company holds an interest of more than 50 percent in another company, the financial statements of the two companies must generally be con-

solidated. However, consolidation is not required if the parent is a holding company or if the parent is in a completely different industry from the subsidiary (for example, one is a manufacturing company and the other is an insurance company). An investor owning between 20 and 50 percent of the investee must use the equity method of accounting, under which the investor's share of the investee's net income must be included as a separate item in the investor's income statement.

Colombia

In Colombia, an economic entity that holds more than 50 percent of the equity, or has important administrative influence in other economic entities, must present, together with its basic financial statements, consolidated financial statements together with the respective notes. When performing due diligence, specific attention should be placed on whether the subsidiaries are directly or indirectly owned by the parent.

Business Combinations

In the USA, the accounting rules for mergers and acquisitions changed dramatically on June 29, 2001, with the issuance by the FASB of Statement of Financial Accounting Standards (SFAS) No 141, Business Combinations and SFAS No 142, Goodwill and Other Intangible Assets. Collectively, the two statements ended the pooling of interest and goodwill amortization, and substituted a framework for analyzing goodwill for impairment under SFAS No 144, Accounting for the Impairment or Disposal of Long Lived Assets. Consequently, the only acceptable method to account for business combinations in the United States today is the purchase method. The purchase method accounts for a business combination as the acquisition of one company by another. The acquiring corporation records the cost of the acquired assets less liabilities assumed. The difference between the cost of an acquired company and the sum of the fair values of tangible and identifiable intangible assets less liabilities is recorded as goodwill. Until July 2001, when FAS No 142 was issued, goodwill was required to be amortized over a period not to exceed forty years. Under FAS No 142, goodwill and indefinite life intangible assets are no longer amortized but are reviewed annually, or more frequently for impairment.

Local accounting standards in Latin America allow companies to account for acquisitions using a variation of the purchase method of accounting described above.

In Argentina, for instance, the acquiring corporation records cost of the acquired assets less liabilities assumed. However, goodwill recognized on the transaction is the difference between the sum of the net book value of tangible and intangible assets less liabilities. Goodwill is amortized over a 'reasonable' period. Similarly, in Brazil and Mexico the goodwill recognized on the transaction is the difference between the sum of the net book value of tangible and intangible assets less liabilities. The different accounting norms have a significant impact on valuation as they influence the timing and amount of depreciation, the tax liabilities, and the cash flows.

Inflation Accounting

Various Latin American countries that have experienced high rates of inflation require or permit financial statements to comprehensively include the effects of price level changes in accordance with local GAAP. The most commonly used approach is historical cost/constant currency, which restates comparative period amounts into equivalent units of current purchasing power using a general price-level index. In some countries, a current (replacement) cost approach may be used.

Potential investors must understand the application of inflation accounting principles. In countries that use inflation accounting, financial statements are typically reported at historical costs and restated under the respective inflationary accounting rules. The potential investor must identify whether detailed supporting financial data is presented in historical or inflation-adjusted amounts. Often times, foreign investors will eliminate the effects of inflation from the historical financial statements and convert the local currency to the foreign currency at the historical rate to eliminate the impact of inflation. The classification of inflation adjustments in operating results differs by country and clearly has an impact on valuation. Some countries require that inflation adjustments be shown net as a nonoperating expense item while others require the net inflationary effect to be recorded (accumulated) in shareholders' equity.

Pension Accounting and Other Post-retirement Benefits

Private pensions funded by contributions from employees and/or employers are not widespread in Latin America as most pension programs are sponsored and administered by the government and programs vary from country to country. Appropriate valu-

ation requires that investors carefully evaluate the respective country's labor laws, as well as the investees' benefit programmes, in order to determine the extent and nature of termination payments, pension obligations and other post-retirement benefits, and possible contingent liabilities.

Under U.S. GAAP, FAS No 87, Employers' Accounting for Pensions, requires that pension expense be calculated using accrual accounting, based upon a designated actuarial approach, with amounts reflected in the income statement systematically over the estimated working lives of the employees covered by the plan. Companies with unfunded or under-funded pension obligations are generally required to report a liability in the balance sheet. Similarly, any excess of contribution paid over the cumulative pension obligation is recorded as an asset.

IAS No 5 on financial statement disclosure requires disclosure of the method of accounting for pension plans. Brazilian GAAP do not include an equivalent requirement for disclosure of the method of providing for pension plans.

Under Colombian GAAP, a pension liability is required to be calculated using actuarial computations, based on a nominal discount rate, expected future salary increases, and mortality rates. Labor laws in most Latin American companies require the payment of termination or severance benefits. The benefits are typically based on years of employment and the employees' monthly salary. However, the calculation of the actual payment by employees can be quite complex. Due to frequent changes in labor laws, the severance liability is adjusted by the legal changes throughout the employee's term of employment. Companies may accrue part or all of the severance liability, depending on whether the employees are vested in the benefit. In many Latin American countries, local GAAP do not require either the recognition of the severance liability obligation or provide guidance for the calculation of the accrued liability. All these different rules add to the complications and complexity and to the cost of valuation in Latin America.

Intangible Assets

The valuation of intangible assets is probably the most striking feature of the last wave of mergers and acquisitions in the United States, where the attraction of target companies rests with their valuable intellectual property and intangible assets (e.g., trademarks, patents, copyrights). The technology dynamics coupled with new international

markets and the changing global environment have greatly impacted the valuation of M&A and can confuse even experienced financial analysts. The highly complex reality of evaluating intangibles is compounded by the existence of different accounting standards that add to the complexity and make the valuation challenging. As an example, under Mexican GAAP the cost of intangible assets acquired from others is recorded as an asset and amortised over the estimated useful life of the asset up to a maximum of 20 years. According to U.S. accounting standards, intangibles can be amortized over their estimated useful life. In addition, in an attempt to provide guidance to the recognition of identifiable intangible assets and to support its financial model, FASB has classified assets apart from goodwill in the five categories shown in Table 3.4.

Deferred Taxes

Historically, Latin American countries did not require the recognition of deferred taxes. However recently there is a trend within the region whereby regulatory agencies now require the recognition of deferred taxes for local GAAP purposes. Countries like Mexico and Brazil require the recognition of deferred tax assets and liabilities. The recognition of deferred taxes is generally based on the liability method. The standards for recognition of deferred tax assets is typically not as restrictive as U.S. GAAP and, therefore, investors should carefully evaluate the recoverability of the deferred tax assets. While deferred income tax accounting is acceptable in most Latin American countries, it is not consistently applied. In Argentina, for instance, deferred income taxes may be accrued, but such accrual is neither mandatory nor a common accounting practice. No specific standards have been established. Most companies accrue only the annual income tax payable.

Under U.S. GAAP, the liability method is used to calculate the income tax provision, as specified in FAS No 109 Accounting for Income Taxes. Under the liability method, deferred tax assets or liabilities are recognised with a corresponding charge or credit to income for differences between the financial and tax basis of assets and liabilities at each year or period-end. Net operating loss carry-forwards arising from tax losses are recognized as assets and valuation allowances are established to the extent that such assets will likely not be recovered. There may be differences in timing with respect to the recognition of the effects of changes in enacted tax rates.

Table 3.4. Corporate Assets—Apart from Goodwill—as Classified by the Financial Accounting Standards Board

Marketing-related intangible assets	Trade marks, trade names Service marks, collective marks, certification marks Trade dress (unique color, shape, or package design) Newspaper mastheads Noncompetition agreements
Customer-related intangible assets	Customer lists Order producing backlog Customer contracts and the related customer relationships Noncontractual customer relationships
Artistic-related intangible assets	Plays, operas, and ballets Books, magazines, newspapers, and other literary works Musical works such as compositions, song lyrics, advertising jingles Pictures and photographs Video and audiovisual material, including motion pictures, music videos, and television programs
Contract-based intangible assets	Licensing, royalty, standstill agreements Advertising, construction, management, service or supply contracts Lease agreements Construction permits Franchise agreements Operating and broadcast rights Use rights such as landing, drilling, water, air, mineral, timber cutting, route authorities and so forth Servicing contracts such as mortgage servicing contracts Employment contracts
Technology-based intangible assets	Patented technology Computer software and mask works Internet domain names Unpatented technology Databases, including title plants Trade secrets including secret formulas, processes, recipes

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In Brazil, the tax law is sometimes significantly altered by provisional measures that remain in force for three months and expire automatically if they are not extended for an additional three-month period. The provisional measures are not enacted by the legislature and should not be used as the enacted rate for the purpose of recognizing the tax effect of temporary differences under FAS No 109.

Prior to 2000, Under Mexican GAAP, income taxes were recorded following inter-period allocation procedures using the partial liability method. Under this method, deferred income taxes are recognized only for identifiable, nonrecurring timing differences between taxable and book income (i.e., those that are expected to be reversed at a definite future date). This substantially eliminated all deferred taxes under Mexican GAAP. Nevertheless, the deferred effect of timing differences that were not recorded was disclosed in a footnote. Also, the benefit from utilizing tax loss carry-forwards and tax credits is not recognized until it is realized, at which time it is presented as an extraordinary item. In 2000, Mexican GAAP were changed to substantially comply with the requirements of FAS No 109.

Leases

Under U.S. GAAP, leases are identified as capital leases or operating leases, depending on the nature of the lease as determined through a series of tests. In Brazil, lease contracts are recorded as rental expenses by lessees and as property, plant, and equipment by lessors, regardless of whether the contract provides for a capital lease or an operating lease. In other words, no capital leases are recorded under Brazilian GAAP. As such, if a purchase price of a transaction is based on EBITDA, the accounting for leases under Brazilian or U.S. GAAP could significantly impact the valuation.

Additionally, from a due diligence perspective, operating lease commitments can represent significant off-balance sheet financing for financial institutions, telecommunication companies, utilities and airline companies. Lease transactions are often structured to avoid the quantitative criteria used to determine if a lease should be capitalized on the balance sheet (with related effects of discounting the liability and depreciation of the asset) or affect earnings only on a cash basis (or average payment basis) as an operating lease.

Property, Plant and Equipment

Property, plant, and equipment constitute the typical and traditional tangible fixed assets of a company. Normally, the value of these assets has to be independently estimated, as the book value in the balance sheet constitutes a first approximation of the market value. The proper valuation of fixed assets has a significant impact on valuation, but the accounting controversies can probably be relatively easily reconciled with additional analysis.

Colombian GAAP

Third parties at the close of the period in which they are acquired or formed must determine the realizable market or present value of assets.

U.S. GAAP

Fixed assets are recorded at their historical cost and depreciated over their economic useful life. The historical cost includes the purchase price and all related costs necessary to place the asset in use.

FAS No 121, Accounting for the Impairment of Long Lived Assets and for Long-lived Assets Disposal, requires the measurement of any impairment loss for such assets and certain identifiable intangibles. The measurement is based upon the fair market value of the assets. If there is other than a temporary decline in the value of an asset, its value must be written down.

Mexican GAAP

Fixed assets are restated for each reporting period for the impact of inflation. The adjustment to the historical cost is amortized to the operations over the remaining life of the asset.

Deferred Charges

In accordance with most Latin American accounting standards, organizing and pre-operating expenses may be capitalized and amortized, generally, over a period of five years, while under U.S. GAAP, pre-operating costs in general are not allowed to be deferred and are expensed as incurred. This different treatment requires adjustments to reach an appropriate reconciliation, useful for valuation purpose.

Overall rules for capitalization of nonrecurring and development costs are subjective and require matching of capitalized costs to future revenues. Most countries do not require a periodic review for impairment of capitalized assets. Investors should inquire as to whether intangibles and deferred costs have continued economic viability in the business.

Equity

The equity section of the balance sheet for Latin American entities typically contains accounts for the revaluation of assets or inflation adjustments, reserves for legal contingencies, future capital expenditures, and dividend payments, and it is far more complex than the U.S. equity section. Therefore several adjustments need to be made to identify the value of equity that is excluded due to these charges and arrive at the basis for valuation. Local tax rules or corporate laws generally drive local GAAP for stockholders' equity accounts. A clear understanding of the local tax and legal environment is required to properly convert these balances to U.S. GAAP and IFRS.

In many Latin American countries, within the equity accounts is a "Restatement" account, which represents the effect of restating capital stock to an inflation adjusted constant currency. It is not uncommon to transfer these reserves to capital stock and issue new shares to existing shareholders on a pro rata basis. These transactions are similar to a stock split or stock dividend, since each stockholder's pro rata ownership and total shareholder's equity remain unchanged. For financial reporting purposes, these issuances should be treated as if they were outstanding for all periods presented in the financial statements for basic and diluted earnings per share.

Argentine corporations and limited liability companies must establish a legal reserve amounting to a minimum of 5 percent of their annual profits, until the legal reserve equals 20 percent of registered capital. Such reserve may not be distributed among shareholders and partners during the existence of the company.

Potential investors should always seek the assistance of local legal counsel to properly evaluate the shareholders' rights in each country throughout Latin America since shareholder and minority interest shareholder rights vary significantly within the region. In general, minority shareholders' rights tend to be limited in comparison to U.S.

standards. Many countries require mandatory dividends and legal and capital reserves for potential contingencies or for future capital expenditures. In addition, investors must understand the amount of capital available for distribution within and outside of the country.

Profit Sharing

Mexican companies are required by law to share with employees 10 percent of their pre-tax profits, determined without considering the effects of inflation and loss carry forwards. Generally, profit sharing expense is not deductible for tax purposes. For Mexican GAAP, profit-sharing expenses ("PTU") are included as a component of income tax. For U.S. GAAP purposes, these expenses are generally included as a component of operating income. Additionally, most Mexican companies do not recognize deferred taxes and/or deferred profit-sharing expenses related to the temporary differences between assets and liabilities reported for financial reporting purposes and the calculation base for PTU. For U.S. GAAP, deferred profit-sharing expenses would be recognized for these differences.

Non-recurring Items

Financial statements are generally prepared based on numerous management estimates and judgments. Areas particularly prone to estimation include the allowance for loans and receivables, investments, inventory valuation, warranty and environmental obligations, labor, legal or other significant reserves, guarantee obligations, capitalization of overhead, and depreciation and amortization (i.e., capitalization vs. expense). Special attention must be given in the valuation of account receivable where inadequate reserves for doubtful accounts are always a sensitive issue for management. The role of a financial adviser during due diligence is to evaluate the estimates used by the target company to prepare its financial statements and assess the reasonability of such estimates.

Other adjustments include restructuring costs, severance payments, discontinued products or business lines, special projects/sales contracts, etc.

Prior Period Adjustments

Colombia

Items corresponding to the correction of accounting errors from preceding periods derived from mistakes in mathematical computations, from deviation in the application of accounting rules, or inability to quantify items in the period they occurred must be included in the results of operations of the period they are known and quantifiable.

U.S. GAAP

Prior period adjustments are charged to the opening balance sheet or retained earnings and excluded from the determination of net income for the current period if the adjustments relate to the following:

- correction of an accounting error in the financial statements of a prior period; or
- adjustments that result from realization of income tax benefits of a pre-acquisition operating loss carry-forward from the purchased subsidiaries.

Additionally, if financial statements are presented for one of the years being corrected, revised financial statements must be disclosed.

Conclusions

Policy makers in emerging economy countries should realize that the introduction of an effective transparent and harmonized accounting system, particularly in the areas illustrated in this paper, would have a momentous and lasting impact on attracting FDI. It would also favor M&As while at the same time improving the economic environment, allowing proper valuation of assets, and ultimately, favoring capital markets development and lowering the cost of capital. FASB and IASB have made a priority the convergence of accounting principles in the area of business combinations, which resulted in the repeal of the pooling of interest by IASB and the adoption of a similar accounting treatment as in SFAS No 141 and No 142. In March 2004, IASB issued the *IFRS 3 Business Combinations* superseding *IAS 22* (see Chapter 2, page 41.) Moreover, it would let the host government revisit the existing structure of incentives to foreign investors. The current trend in the region to expand and harmonize financial reporting and introduce international accounting standards is a significant stride toward breaking down barriers.

Generally accepted accounting standards have to be understandable and in line with those applied internationally in order to attract cross-border investments as well as local investments, and to avoid costly adjustments and reconciliation. Of course, to be useful and effective and facilitate valuation, internationally accounting standards not only have to be adopted but also effectively implemented and enforced so that common valuations of business and assets as well as of mergers and acquisitions can be performed. Furthermore, internationally accepted accounting standards have important specific characteristics that facilitate their adoption and introduction and, possibly, implementation.

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4

Accounting Harmonization in the European Union and Its Implications for Spain

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Accounting harmonization in Europe is far from being fully completed; however, from the basic guidelines approved thus far, it is possible to establish its immediate consequences for the European and Spanish accounting models and for the objective of harmonizing information. In this sense, accounting information should present a business's financial situation, as well as the results achieved.

In this context, the phenomenon of globalization calls into question the idea of national entrepreneurship because, even when management is centralized and operates in a particular country, the economic environment extends beyond territorial boundaries. Thus, there is a need to provide any user harmonized information to understand a company's economic situation and compare it with information issued by other firms.

Increasingly, the process of corporate internationalization is advancing the idea of attaining a higher level of harmonization within the supranational framework so that users—investors, workers, creditors, and financial entities—who are influenced by their own countries' accounting practices and standards, can compare statements from companies in various countries. Within this context this chapter describes the European accounting situation and the steps that Spain is taking to conform to international standards.

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European Union Context

Over the past decade, the issue of harmonization has led the European Union (EU) to consider whether European companies that complied with the standards set forth through Accounting Directives¹ were disclosing comparable information in any EU market, especially, if this European economic information was equally interpreted by markets outside member states. These questions have several answers. The multiplicity of options in the Accounting Directives makes it difficult to compare accounts prepared according to local laws in the member states. Obviously, Directives allow for only one legal option. Furthermore, while European corporations listed in international stock markets prepare their annual statements based on the Accounting Directives, they also compile another set of data, as required by targeted markets, in which these Directives are not generally accepted.

This undesirable situation presents the need for harmonization beyond the EU boundaries. Thus, in November 1995, the European Commission (EC), executive body of the EU, in its effort to harmonize the international situation with EU legislation, adopted what is known as *Accounting Harmonization: A New Strategy vis-à-vis International Harmonization*. This task was undertaken by EU administrative bodies, particularly the Directorate-General for Internal Market and Financial Services.

EU institutions in charge of setting and developing standards are:

- *Contact Committee*. Under the Directives, the Contact Committee was established with representation from member states and the EC. The Committee's mission is to facilitate the harmonized application of the Directives and advise the EC, if needed, on complementary provisions or amendments. The Committee makes proposals to the EC, which decides their legal standing and procedures for implementation.
- *Technical Subcommittee*. To enhance the Contact Committee's functions, a Technical Subcommittee was created, consisting of representatives from bodies in charge of accounting regulations from each member state. This task force studies specific accounting aspects or issues that might arise in the European context.
- *Accounting Advisory Forum*. With the intention of settling matters and issues not

1. The European regulatory scheme (i.e., legal regulations eventually passed in the European Union) entails the following principles: (1) Regulations are general in nature, directly applicable, and binding for all member states (this provision has not been used to regulate accounting matters); (2) Directives are binding for all member states, leaving the choice of form and means to local authorities; (3) Decisions are binding in all their parts for all member states (this provision has not been used in accounting matters); and (4) Recommendations and opinions are not binding.

addressed in the Directives, the EC established, in 1990, the Accounting Advisory Forum, together with the Technical Subcommittee task force. The Forum is composed of representatives from national bodies that set accounting standards and European organizations of accounting users and professionals. Although its work does not carry enough weight to influence the development of accounting activities, the task force's objective is to produce nonbinding interpretations and studies of specific aspects of EU accounting standards.

To implement the above-mentioned accounting strategy, due consideration was given to works undertaken by the International Organization of Securities Commissions (IOSCO),² which resulted in a request to the International Accounting Standards Board (IASB) (formerly the International Accounting Standards Committee [IASC]) to prepare a basic set of accounting standards to be accepted by international financial markets. Consequently, on May 17, 2000, after completing preparation of studies on international standards, IOSCO expressly recommended their use.

The EC has endorsed the IASB and the International Accounting Standards (IAS) (now called International Financial Reporting Standards [IFRS]). The Commission undertook an initial comparability analysis of IAS/Directives, which has produced, among other accomplishments, the following six documents.³

- *Examination of the Conformability between International Accounting Standards and European Accounting Directives:*⁴ This document only includes IAS dealing with matters covered by Accounting Directives and those that pose issues regarding the general principles embodied in the Directives.⁵ Those IAS being revised at the time of document preparation were not included.⁶ Therefore, this study analyzes the compatibility between IASB standards and EC Directives from the perspective of

2. IOSCO comprises most stock and security-markets associations.

3. To this end, it was first decided that a task force on Accounting Directives should be created under the Contact Committee. This task force is in charge of analyzing the compatibility of IASB standards with Directives and then facilitating, if needed, member states' allowing their larger companies to prepare consolidated accounts according to the IASB model, as long as they do not conflict with Accounting Directives.

4. See http://europa.eu.int/comm/internal_market/en/company/account/ias/index.htm.

5. This is the case for IAS No. 7 (cash-flow statements), No. 10 (accounting treatment of events after balance-sheet date), No. 14 (financial segment reporting), No. 15 (information reflecting effects of changing prices), No. 17 (lease accounting), No. 18 (revenue), No. 19 (accounting treatment of employee benefits in employer financial reporting), No. 20 (accounting for government grants and disclosure of government assistance), No. 24 (related party disclosures), No. 26 (accounting and reporting by retirement benefit plans), and No. 29 (financial reporting in hyperinflationary economies).

6. Specifically, IAS No. 1 (information on accounting practices), No. 4 (amortization accounting), No. 5 (information that financial statements must contain), No. 12 (income-tax accounting), and No. 13 (reporting of current assets and liabilities).

consolidated accounts because the parties interested in applying those standards are groups of companies listed on stock exchanges.

- *Examination of Conformity between IAS 12 and European Accounting Directives*⁷ includes issues that need to be considered if IAS 12 is applied according to the Directives on taxation.
- *Examination of Conformity between IAS 1 and European Accounting Directives*⁸ covers the application of this IAS within the context of European legislation.
- *Examination of International Accounting Standards Applicable to Accounting Periods Beginning before July 1, 1999, and the European Accounting Directives*⁹ summarizes all information compiled from the four previous documents.
- *Examination of Conformability between IAS 10 (as amended in 1999) and the European Accounting Directives*¹⁰ provides guidelines for events that occur after the balance sheet closing date.
- *Examination of Conformity between Rulings by the Standing Interpretation Committee of the IASC and European Accounting Directives: SIC* [Standing Interpretations Committee] 1-3, 5-11, 13-15.¹¹

From a practical perspective, the conclusion of these documents is that, IAS and European Accounting Directives have no major differences. However, international standards establishing treatments not allowed by the Directives, or vice versa, have been properly noted. Obviously, such a flexible approach is feasible only within the Directives, which makes it possible to consider the different treatment options contemplated.

The notion of no major incompatibilities might lead to conclude that there is no need to amend the Directives. However, a few, highly important incompatibilities have been detected. One is the issue of fair value in financial instruments. It is well known that IASB standards—namely, *IAS No. 39, Financial Instruments*—require that certain

7. See http://europa.eu.int/comm/internal_market/en/company/account/ias/index.htm.

8. See http://europa.eu.int/comm/internal_market/en/company/account/ias/index.htm.

9. See http://europa.eu.int/comm/internal_market/en/company/account/ias/index.htm. Because of the date stated in the examination document (accounting periods beginning before July 1, 1999), those IAS effective afterwards (as well as the amendment they introduced to other international standards) have not been considered. Therefore, it does not include the requirements of *IAS No. 36* (asset deterioration), *No. 37* (provisions, contingent liabilities, and contingent assets), *No. 38* (intangible assets), *No. 10* (accounting treatment of events after balance-sheet date), and *No. 39* (financial instruments: identification and measurement) or amendments to *IAS No. 16* (property, plants, and equipment), *No. 22* (business combinations), *No. 28* (accounting for investments in associates), and *No. 31* (financial reporting on joint ventures). The same happened with the examination of readings by the Standing Interpretations Committee.

10. See http://europa.eu.int/comm/internal_market/en/company/account/ias/index.htm.

11. See http://europa.eu.int/comm/internal_market/en/company/account/ias/index.htm.

financial instruments be recorded at their fair value. Because they did not address this standard, the European Directives had to be amended to minimize incompatibilities between European accounting standards and the IFRS.

However, one must refer to EU Accounting Directives in order to analyze the reasons for their amendment. To that end, it is necessary to define which standards have an accounting content within the EU. Key directives are:

- Directive 78/660/EEC (July 25, 1978), with regard to annual statements for certain types of companies (Directive IV).
- Directive 83/349/EEC (July 13, 1983) regarding consolidated accounts (Directive VII).
- Directive 90/604/EEC (November 8, 1990), which amended Directives 78/660/CEE and 83/349/CEE with regard to exceptions in favor of small- and medium-sized enterprises, as well as disclosure of annual statements in European currency units (ECUs).
- Directive 90/605/EEC (November 8, 1990), which amended the scope of application for Directives 78/660/CEE and 83/349/CEE.
- Directive 94/8/EEC (March 21, 1994), which amended Directive 78/660/CEE with regard to amounts expressed in ECU.
- Directive 99/60/EEC (June 17, 1999), which amended Directive 78/660/CEE with regard to audits of sums expressed in ECU.

Additionally, the EU approved Directive 2001/65/EEC (September 27, 2001), which amends Directives IV and VII accepting fair value as a valuation standard for financial instruments. Directive 2001/65/EEC modifies Directives 78/660/CEE, 83/349/CEE, and 86/635/CEE with regard to applicable accounting valuation standards to annual and consolidated statements for certain types of corporations. This results directly from *IAS No. 39* on financial instruments mentioned above, and has led to adoption of the fair-value accounting method as the only acceptable treatment for evaluating certain financial instruments. It is possible to infer the compatibility of these Directives with IASB standards based on their characteristics. Specifically, the Directives:

- Offer multiple options;
- Belong to the European business legislation with mandatory application;

- Formulate general principles;
- Lack regulation on such matters as foreign currency, taxation, and business combinations; and
- Seek to regulate matters related to creditor protection, earnings distribution, and taxation.

Evolution of events has created a need for the EU to review the above-mentioned 1995 accounting strategy and adapt it to new realities. This was realized in the June 13, 2000 EC Communication to the Council and European Parliament, which include three key points.

First, comparability of financial information allows proper valuation and ensures appropriate functioning of markets. Thus far, comparability information in EU countries has been insufficient and must be improved. Second, the preference to integrate the IASB standards into the framework of European financial information is maintained, despite noting certain problems (e.g., the IASB is a private organization without EC representation). It is also necessary to establish a specific European mechanism granting legal coverage to users of those standards in the EU to protect shareholder and investor interests. Third, the objective is to integrate IFRS into the European accounting framework, taking into consideration that:

- The goal of comparability will be achieved to a higher degree if IFRS application to consolidated statements of listed companies is mandatory. The EC has established 2005 as the deadline for achieving this target.
- This solution will be binding, in principle, for listed companies. Subsequently, it should be extended to companies that prepare information about initial public offerings of securities and, perhaps, to organizations in specific sectors (e.g., supervised financial entities).
- EU member states will have the additional option of allowing or requiring application of international standards to individual accounts since their application is deemed acceptable.
- Integration must be coordinated, safeguarding conformity to Directives and creating a European mechanism, known as EFRAG,¹² that, with full knowledge of adoption of new standards and interpretations, can intervene when those standards fail to meet European framework requirements.

- In this way, the IFRS applied in the region must be those accepted by the aforementioned European mechanism.
- These measures should be complemented by adequate enforcement mechanisms to ensure standards compliance in member states.

The above-mentioned procedures have been under EU discussion, through a European Community Regulation to have been adopted in June 2002, requiring that, by 2005, all statements—or at least annually consolidated statements of listed companies—in all member states be prepared in compliance with IASB standards and any specifications that may be later added. Key aspects of this Regulation are:

- Formal incorporation of IASB standards into EU law, composed of Directives (as noted above).
- Ways to apply IASB standards; that is, whether they apply to companies that the Regulation does not list. Because member states are free to adopt the standards, co-existence of standards—other than those applied by the large groups listed—is not recommended.
- Consideration of creating an Accounting Regulatory Committee, whose several functions would include identifying which IASB-standards options will not apply to European companies (a process also known as “filtering”).

In this way, standards used in the EU are those approved through the mechanism explained above, regardless of any eventual amendment made to Directives when incompatibilities with IASB standards are detected.

The Case of Spain

Within the European context of accounting harmonization, what is Spain, an EU member, doing about the EU-proposed solution? From the perspective of Spanish accounting standardization, comparability of economic information must extend beyond country boundaries. Yet, the process of implementation must include necessary guarantees.

Under these assumptions, if the EU required large groups to disclose information according to previously filtered IASB standards, member states would have to ob-

serve regulations contained in the Regulatory Proposal. The question is whether other companies would also have to follow those types of standards.

In the case of Spain, accounting standards are relatively recent. The country implemented a mandatory accounting system 12 years ago. Since then, all Spanish companies, regardless of size, have had to disclose financial information with homogeneous criteria, although the information breakdown in yearly statements varies, depending on a company's standing size and public interest in the information. Thus, any decision eventually adopted should consider this aspect.

To adopt the new accounting strategy, Spain's Ministry of Economy and Revenue established an Experts Commission, consisting of accountant associations, auditors, university professors, analysts, business organizations, and government representatives. In June 2002, the Commission's report on Spain's accounting situation on the issue was published. Known as the *White Book of Accounting in Spain*, the report evaluated past events that warrant consideration in relation to the accounting model adopted (currently in force):¹³

- Internationalization of Spanish companies has turned operations considered unique only a decade ago into everyday fare for managers. This is true to such an extent that no definite set of standards can be applied.
- Furthermore, Spain's joining a single-currency system may cause the information submitted by its companies to conform to those of other countries in the European Monetary Union. This issue should be considered (although no single country should undertake the task).
- Because Spanish corporations issue information for both domestic and foreign users, a debate has arisen on international accounting harmonization, currently the object of discussions within the EU. Obviously, issuers of information should not have to remake it according to the recipient country.
- In recent years, financial instruments have appeared in which the application of historical costs, a criterion upon which the current Spanish General Accounting Plan (GAP) is based, does not permit an accounting treatment that suitably reflects those operations. This issue should be considered in relation to the above-mentioned harmonization process.

13. The structure of the Spanish Accounting Model basically consists of statutes (Code of Commerce and consolidated version of the Act of Business Corporations) and regulations (General Accounting Plan [GAP]).

- Relevance of intangible assets—a fact that most companies recognize—requires analysis that will allow for a more accurate, updated regulation than the one currently found in accounting standards.
- Any potential shortcoming discovered in the current accounting law must be corrected through general regulatory reform.
- With regard to small- and medium-sized enterprises, the advantages of applying an accounting standard with fewer information requirements and reduced formal duties should be analyzed, given the small number of targeted users.

As an initial hypothesis, the following points should be considered:

- Spanish accounting standards should aim to disclose comparable information, in line with the EU approach.
- The IASB model is accepted, with the amendment, where necessary, of current accounting standards that conflict with IASB standards. Also, efforts should be made to adopt IASB standards considered appropriate for integration into a complete accounting model. This process should occur within a framework properly attuned to European directives.
- In order to uphold the internal harmonization already accomplished in Spain, it is desirable that all economic units use the same valuation standards, without bias toward adjustments needed for reasons of size, sector, or listing in secondary markets. Of course, certain informational details will differ because of those differences.

To determine the best way to incorporate the new accounting strategy in Spain, the Instituto de Contabilidad y Auditoría de Cuentas (ICAC), a body that sets accounting standards, prepared a study on potential differences between the IFRS and local ones. This evaluation was contained in a report published in March 2000 in ICAC's official bulletin (BOICAC, No. 41). In short, basic differences stem from the following treatments of IFRS:

- In general, it is established as a reference treatment, based on the acquisition price. Yet equity elements are valued according to their fair value, particularly in the case of certain financial equity elements. Because this is a relevant divergence, it should be resolved by an amendment to Directive IV, which currently allows this exceptional treatment.

- As an option, an equalizing procedure is allowed for reporting financial investments in subsidiaries and associates and co-participation in individual accounts of the parent company.
- Exchange differences in foreign currency (other than the euro) are considered income or payouts for the same fiscal year.
- Initial identification of assets and liabilities acknowledges the tax effects inherent in the operation.
- It is established that, as a reference treatment, mistakes must be charged to reserves.
- In the case of subsidiaries whose businesses differ greatly from those of the rest of the group, IFRS consider that this circumstance does not justify exclusion from consolidation because of global integration.
- Goodwill becomes negative if future losses or expenses are booked as income distributed over several fiscal years.
- With regard to reorganization costs, IAS require a formal, detailed plan and valid expectations among affected parties on the reorganization being accomplished—either because the plan is already being executed or because its key points have been made public.

Finally, some aspects are regulated by certain IASB standards outside the Spanish context. These include:

- *Cash-flow statements*;
- *Related party disclosures*, which define relationships more broadly than the GAP;
- *Earnings per share and financial segment reporting* (national standards require both only through sectoral adjustments to the plan); and
- *Corporate mergers and spin-offs* (a draft of accounting standards applicable to corporate mergers and spin-offs was published in the BOICAC bulletin, No. 14).

Obviously, certain discrepancies warrant resolving; however, they are relatively few. Potentially, a model has emerged that differs little from the one intended. Its achievement represents a long-term effort involving many institutions.

Evolution of Spanish Accounting Laws

The evolution of Spanish accounting laws occurs in seven stages.

First, in its introduction, the GAP points to the opening up of Spanish account-

ing toward international guidelines, stating:

In itself, the Plan is an open document and, therefore, it *is prepared to admit any amendments arising from evolutions* in EEC corporate law, accounting advancement, financial instruments development, scientific research and technological innovation, changes in business environment, etc. This openness should be aware of information requirements from different economic agents, savers and investors, labor, consumers, public sectors, etc.

It should be noted that many standards included in the GAP are derived directly from international proposals.

Second, those suggestions were considered via a set of directives that complement the GAP, similar to the case of *Standards for the Preparation of Consolidated Annual Accounts*. The GAP's introduction (which, curiously, mentions the IASC) states:

Further to the requirements set forth in the VII Directive and the Commercial Code and, following as much as possible this body of provisions, decisions by other regulatory entities, for example, standards 27 and 28 of the *International Accounting Standards Committee (IASC)*, in order to issue *these standards*.

Third, with regard to certain drafts on standards that the ICAC is currently preparing, international guidelines are given much consideration. For example, with regard to corporate mergers and spin-offs (1993), IASB guidelines are basically accepted regarding business combinations.¹⁴ Regarding futures and options (1995), the Financial Accounting Standards Board (FASB) acted as reference because the IASB had not yet considered the issue.¹⁵

Fourth, treatment of goodwill funds amortization, dealt with in Article 194.2,¹⁶ has been amended by Regulation 15, Section XI of Act 37/1998 (November 16). This last ruling reforms the Stock Market Act, introducing a maximum term of 20 years for goodwill funds amortization. It should be noted that this regulation deals with an issue not addressed by IAS regarding amortization procedure, establishing that it "cannot be

14. IAS No. 22, *Business Combinations*.

15. SFAS No. 40, *Financial Futures*.

16. Rehashed version, Act on Business Corporations, approved by Royal Executive Decree 1564/1989 on December 22.

incremental.” This new requirement, deemed necessary by the legislature, highlights the close relationship with IASC standards, but within a critical approach.

Fifth, with regard to environmental accounting, adaptation of the GAP to electric power companies includes a series of general aspects (i.e., the modified GAP standard is applicable to all types of companies). These regulations incorporate International Standards of Accounting and Reporting and IASC decisions, among others. Spain generally complies with the current EC recommendation that sets forth reporting requirements in that respect.

Sixth, for regulated companies (whose pricing policies must be approved by an administration that undertakes to add into future prices certain costs currently incurred and accrued), the treatment followed has been that of the FASB.¹⁷ The Board was fully incorporated when the GAP was adapted for application to toll-road companies. The FASB introduction states:

Finally, it is a question of associating that part of financial expenditure, which is considered related to earned income, always taking into account its recouping via pricing (toll rates) related expenditures. Otherwise, it would not be feasible to apply the system under consideration, and expenditures would be entered in the same fiscal year in which accrued. This treatment is *in accordance to specific international standards, wherein it is stated* (1993, 1998).

Seventh is Spain’s admission to the euro area (1998). As regards the accounting treatment expounded, the only reference was an EU recommendation. In this case, it was an exceptional event that the GAP model logically had not considered.

Based on these factors, it is possible to conclude that, in relation to international harmonization, Spanish accounting laws have, until now, been characterized as follows:

- The possible incorporation of international accounting practices is accepted as basic treatment for Spanish accounting standardization.
- This potential integration, which has recently considered the IASB as a basic reference results from influences exerted by the EU.

17. SFAS No. 71.

- Incorporation of these standards is, in some cases, being carefully considered (i.e., standards are not being adopted as a bloc, but if, after their analysis). It appears that there are already better local standards or guidelines (including goodwill funds amortization and financial expenditure capitalization) that will be upheld. Whether to maintain this critical attitude should be evaluated in the course of debates such as this.

Looking Ahead

The future of Spanish accounting standardization will be shaped and influenced, the following considerations:

- European and international harmonization process have resulted from globalization trends in which the world economy is immersed and will continue to do so.
- Internationalization of Spanish companies, increased cross-border operations, opening up of international capital markets, and creation of a European common market and single currency trigger a Spanish accounting standardization that is adapted to the global harmonization process.
- Spanish corporations already disclose information for both resident and non-resident users underscores the convenience of international accounting harmonization because today's information issuers must recreate reports according to the recipient country.
- Spain will have to actively participate in the IASB, either directly or through the EU.
- The establishment of an European body in charge of analyzing and selecting IASB standards (via the EFRAG, the office in charge of "filtering" IASB standards) is reason for optimism; that is, an accounting model, based on the IASB, is influenced by a European point of view, allowing for appropriate comparability.
- Following EU guidelines, Spain will achieve an accounting standardization that ensures the comparability of information, at least by those groups of companies listed in secondary markets.
- Yet Spain should go a step further. The model should be the same, at least regarding equity valuation and formats of annual statements.

The above conditions presents no obstacle to accepting any sectoral adjustment that may eventually be needed (mainly, in the financial sector) or fewer prerequisites (by reason of size or users) that affect the annual statements of small enterprises to enable these companies to prepare financial information at lower administrative costs.

To reiterate, the *White Book of Accounting of Spain* provides a detailed, technical perspective on resolving these issues. In addition, it elaborates on what could be called the best course of action in this regard: enabling the Government of Spain to decide which path is best suited to reforming the country's accounting laws using a harmonization-oriented approach.

Conclusions

Based on the preceding sections, the following important considerations can be drawn.

The European Union is aware of the need to establish an accounting framework that enables European companies to disclose harmonized economic information. This harmonization will have the IASB model as a regulatory foundation.

The incorporation of European standards into accounting legislation is performed through legal regulations that are mandatory for all firms listed on stock markets. In the case of other firms, each EU member state will define the scope of application.

The European Union push has induced member states to introduce changes. To this end, countries have appointed experts to identify the best decision, taking into consideration the peculiarities of each jurisdiction.

Since IASB standards will constitute the engine driving EU accounting standardization—and therefore EU member states harmonization—it is imperative that eventual standards result from a process that truthfully embodies various interests and to this end, the EFRAG will prompt comments from members states.

Large Accounting Firms' Survey Explores Efforts in Latin American Countries to Converge National Accounting Standards with IFRS

Donna L. Street, Salvador Ruiz de Chavez, and Javier Cocina*

In February 2003, the six largest accounting firms published the findings of their most recent survey aimed at encouraging convergence of national accounting standards with International Financial Reporting Standards (IFRS).¹ While the firms' first two reports, *GAAP 2000* and *GAAP 2001*, focused on identifying differences between national accounting standards and International Accounting Standards (IAS), *GAAP Convergence 2002* explores the extent to which 59 nations have developed country plans to converge their national accounting standards with IFRS. *GAAP Convergence 2002* additionally identifies the impediments faced by the 59 surveyed countries, or that they anticipate facing, in their efforts to converge with IFRS. This chapter includes a brief overview of the *GAAP 2000* and *GAAP 2001* findings for five of the Latin American countries included in the 2002 survey. More importantly this chap-

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1. Standards issued by the International Accounting Standards Board (IASB) are called IFRS. Standards issued by the IASB's predecessor, the International Accounting Standards Committee (IASC), are called International Accounting Standards (IAS). The IASB collectively refers to standards issued by both the IASB and IASC as IFRS.

ter provides a discussion and analysis of the 2002 survey findings for Latin America and extends the narrative provided in *GAAP Convergence 2002*.²

The survey findings presented here reveal that in recent years Argentina, Mexico and Peru have made significant progress in bringing their national standards more in line with international standards. Each of these three nations has developed, and is in the process of implementing, a country plan that focuses on furthering its convergence efforts. While progress toward convergence with international standards has been more limited in Brazil, the intent of several participating constituents, including regulators and the accounting professional bodies, is to develop a country plan and various efforts are underway which are directed at convergence with IFRS. While the long-term goal in Venezuela is to converge with IFRS, the survey findings further reveal that additional efforts should be directed at developing a formal country convergence plan.

For Latin American markets to grow and stabilize, more effort is needed to converge national accounting standards with IFRS in order to enhance regional and international comparability. The resulting benefits associated with improving the credibility of the financial reporting system include growth of local markets, broader access to international markets, and stimulation of regional and cross-border corporate activity.

Background: The GAAP 2000 and GAAP 2001 Surveys

In *GAAP 2000*, the largest accounting firms provided a “status report” on the extent to which, at the end of 2000, national accounting standards in 53 countries were aligned with international standards for some 60 accounting measures. *GAAP 2001* similarly provided an overview of local written accounting rules in 62 countries benchmarked against 80 international measures and disclosures, in effect at the end of 2001. For each country surveyed, *GAAP 2001* also highlighted progress in converging national standards with international standards since the publication of *GAAP 2000*. Both *GAAP 2000* and *GAAP 2001* are downloadable from the International Forum on Accountancy Development’s website at www.ifad.net.

2. *GAAP Convergence 2002* provides an overview of the questionnaire responses received from 59 countries. For five of the surveyed Latin American countries, this report provides country specific information for each major question included in the 2002 survey and, more importantly, a discussion of comments provided by the respondents.

The Gap Between National GAAP and International Standards

For five of the Latin American country surveyed in *GAAP 2001*, Table 5.1. (see Panel A) indicates the total number of differences between IFRS and national GAAP that would affect most enterprises as of the year-end 2001. These differences include instances where national accounting may differ from that required by IFRS because of the absence of specific national rules on recognition and measurement, lack of specific national rules requiring certain IFRS disclosures, and inconsistencies between national and international rules that could lead to differences for many enterprises in specific areas.

In describing the limitations of the *GAAP 2001* survey, the large accounting firms note that the differences listed for each country may range from absence of an overall standard ("no requirement for segment reporting") to a detail of inconsistency ("no requirement for disclosure of segment liabilities"). Therefore, the total number of differences noted is not fully indicative of the extent of variation between national rules and IFRS. While Panel A provides an indication of the extent to which the national GAAP of the five Latin American countries differed from international standards as of December 31, 2001, the large firms caution that a complete review of the specific differences listed in *GAAP 2001* is required to truly appreciate the full significance of these differences. Nonetheless, Panel A does reveal that as of the close of 2001 a significant number of differences existed between the international benchmark and the national accounting standards of Argentina, Brazil, and Venezuela as of year-end 2001. As discussed in more detail later in this chapter, Argentina made progress in eliminating a significant number of these differences.

GAAP 2001 also provides valuable information regarding national efforts to converge with IFRS by indicating:

- Differences recorded in *GAAP 2000* which have been eliminated or minimized as a result of national requirements that came into force prior to December 31, 2001 (Panel B of Table 5.1.)
- National requirements and published drafts coming into force after 2001 that would eliminate or minimize the differences listed in *GAAP 2001* (Panel C of Table 5.1.)

Table 5.1. Efforts to Eliminate Differences Between National Standards of Latin American Countries and IAS as of December 31, 2001 (based on GAAP 2001)

Country	Panel A Differences that could affect many enterprises as of Dec. 31, 2001	Panel B Differences recorded in GAAP 2000 that were eliminated or minimized by a new national requirement that became effective in 2001	Panel C National requirements and published drafts effective for years ending after 2001 that would affect GAAP 2001 differences noted in Panels A and B (new requirements/drafts labeled GAAP 2001 were issued during 2001 but became effective for financial statements prepared in later years)
Argentina	33	None	GAAP 2001: 4 Technical Resolutions that would affect most differences, except those relating to IAS 39, approved in some provinces and awaiting approval in others. Update: As of 2002, all jurisdictions have ratified 5 Technical Resolutions which to a large extent make Argentine GAAP compatible with IFRS.
Brazil	30	None	GAAP 2001: Changes to requirements bring Brazilian rules in line with IAS 19 on accounting for employee benefits in 2002.
Venezuela	26	None	GAAP 2001: None
Mexico	9	None	GAAP 2001: Exposure drafts propose reducing differences concerning capitalization of pre-operating and set-up costs and impairment of long-lived assets Update: During 2002 the above mentioned exposure drafts were approved. Additionally, standards related to measuring contingencies, agriculture, segment reporting, and financial instruments were also approved. As of June 2003, IAS 18, 20, 22, and 31 are viewed as supplementary as Mexican GAAP does not cover these areas.
Peru	5	Intangible assets Impairment of assets Capitalization of set-up costs Provisions in context of acquisitions Consolidation of special purpose entities Primary/secondary split for segment reporting	GAAP 2001: Standards approved to remove differences concerning investment properties (in 2002) and financial instruments (in 2003.) Update: During 2002, the National Accounting Standards Board approved application of IAS 1 to 41 with the exception that adoption of IAS 32, 39 and 41 became effective January 1, 2003.

During 2001, Argentina, Brazil, Mexico and Peru issued new national standards or proposals aimed at removing significant differences with IFRS.³

Peruvian national accounting standards differed from IFRS in only a relatively small number of the 80 accounting measures and disclosures reviewed in *GAAP 2001*. Additionally, during 2001, new national requirements eliminated differences with international standards associated with intangible assets, impairment of assets, capitalization of set-up costs, provisions in the context of acquisitions, consolidation of special purpose entities, and the primary/secondary split for segment reporting. Working toward further convergence with international standards, by year-end 2001, Peru approved new accounting standards to eliminate differences concerning investment properties (effective January 1, 2002) and financial instruments (effective January 1, 2003). Hence, as of year-end 2001, *GAAP 2001* indicated that only one primary difference between Peruvian GAAP and IFRS remained to be addressed: accounting for inflation. Indeed the *GAAP Convergence 2002* survey indicated that by January 1, 2003 full convergence with existing IFRS had been achieved as the National Accounting Standards Board of Peru had approved application of IAS 1 to 41.

Similar to Peru, as of December 31, 2001, the Mexican national accounting standards differed from international standards for only a relatively small number of the accounting measures and disclosures considered in *GAAP 2001*. Prior to that date, Mexico had issued exposure drafts aimed at reducing differences associated with capitalization of pre-operating and set-up costs and impairment of long-lived assets thereby bringing national standards more in line with IFRS. These exposure drafts were approved in 2002, and additional standards were issued to eliminate differences associated with measuring contingencies, agriculture, segment reporting, and financial instruments. As of June 2003, IASs 18, 20, 22, and 31 are viewed as supplementary as Mexican GAAP does not cover these areas.

While *GAAP 2001* identified numerous differences between Argentine accounting standards and international standards as of year-end 2001, the report noted that four technical resolutions that would affect most of the differences with international standards, except those relating to IAS 39 (Financial Instruments), had been approved in some Argentine provinces and were awaiting approval in others. According to the 2002 survey, all jurisdictions had ratified five technical resolutions (the four noted above plus

3. Although issued during 2001, the effective date of these new standards/proposals ranged from 2002 to 2003 as noted in Panel C of Table 2.

one additional) by year-end 2002, which to a large extent make Argentine GAAP compatible with IFRS.

GAAP 2001 identified numerous differences between IFRS and the national GAAP of Brazil and Venezuela as of December 31, 2001. During 2001, Brazil issued a new requirement to bring national standards more in line with IAS 19 (Employee Benefits) and other national standards are currently being developed or updated to achieve further convergence between Brazilian GAAP and IFRS.

The 2002 Survey

Introduction

Based on the 2001 survey, the large accounting firms concluded that many countries exhibited numerous and major differences from international standards and that more effort is needed in these countries to identify differences from international standards and to plan for their removal over time. Hence, the 2002 convergence survey was designed to learn more about each country's plans—or lack of plans—to promote and achieve convergence with international standards. *GAAP Convergence 2002* provides an overview of convergence plans in 59 countries and seeks to answer three key questions:

- Is there a plan to adopt IFRS or to converge national accounting standards with IFRS?
- What is the nature of the convergence plan?
- What difficulties have been faced to date and what are the obstacles to further convergence?

Partners representing the participating accounting firms in each of the 59 countries completed the survey questionnaire. For each country, the findings represent the consensus view of the participating partners and not necessarily those of the national governments or standard setters. *GAAP Convergence 2002* is downloadable at the IFAD website at www.ifad.net.

In describing the limitations of the 2002 survey, it is explained that the survey questionnaire instructed respondents to focus on listed companies. If requirements for

listed and nonlisted companies differed, partners were encouraged to provide appropriate additional information for nonlisted companies in the space allotted. Thus, figures included in *GAAP Convergence 2002*, and most of the discussion included within this report, categorize countries based on the scenario for listed companies. Limited comments are made about nonlisted companies. The questionnaire did not seek to address any different or additional requirements that may apply to financial services or other specialized industries.

In addition to providing answers to questions in the survey, respondents were encouraged to provide explanatory comments. These comments are the source of much of the discussion that follows. A copy of the 2002 questionnaire is included in the *GAAP Convergence 2002* report.

This section extends the discussion provided in *GAAP Convergence 2002* by providing a focused description of the survey findings associated with five of the participating Latin American countries. Plans to converge with IFRS in each country are discussed. Additionally, differences experienced or anticipated by these Latin American countries in working toward convergence with IFRS are explained.

Convergence Strategies in Latin America

GAAP Convergence 2002 reveals convergence is underway worldwide. Ninety-five percent of the surveyed countries have either adopted IFRS or intend to converge with them, thereby indicating that IASB is viewed as the appropriate body to develop a global accounting language. In most surveyed countries, a formal plan has been developed to achieve convergence, which typically takes the form of a governmental or other regulatory requirement or a policy announced by the national accounting standard setter. The following is a description of the convergence plans of five of the Latin American countries included in the survey (see Table 5.2).

Governmental or Other Regulatory Requirement to Converge⁴

As shown in Table 5.2, *GAAP Convergence 2002* reports that the country plan in Peru is to converge with IFRS through time-phased governmental/regulatory mandates. In accordance with General Corporate Law, financial statements must be prepared

4. When completing the *GAAP Convergence 2002* questionnaire, respondents were asked to categorize the convergence plan as being the result of a government/regulatory mandate/decreed (i.e., issued by national or regional regulatory bodies such as the European Commission and stock exchange listing requirements) or a plan of the national accounting standard setting body.

Table 5.2. Convergence Strategy as of December 31, 2002 (based on GAAP Convergence 2002 Survey)

Country	Basis for Convergence Plan	Approach to Convergence
Governmental or Other Regulatory Requirement to Converge		
Peru	Regulatory rule applies to all corporations. National Accounting Standards Board established that Peruvian GAAP corresponds to IFRS.	Adopt IFRS into national GAAP "word for word" on standard-by-standard basis, supplemented only by Governmental Regulatory and Control specific rules.
Other Types of Convergence Plans		
Mexico	Policy of the Mexican Council for Research and Development of Financial Reporting Standards (CINIF, the national standard setting body).	Eliminate differences between IFRS and national GAAP by converging with IFRS when possible and practical. Additionally, IFRS supplementary to Mexican GAAP in areas not covered by the latter.
Argentina	Policy announced by government or other regulatory body. Policy announced by the Argentine Federation of Economic Sciences Professional Council (FACPCE, the professional body that proposes accounting standards).	Eliminate differences by converging with IFRS when possible and practical. Argentine GAAP has been re-written to generally agree with IFRS, but not on a "word-by-word" basis. Consequently, some differences will remain.
Brazil	Project in Congress aimed at authorizing Brazilian Securities Commission (CVM) to update accounting principles prescribed by Corporate Law to align the principles with IFRS. Project also aims to create a National Accounting Standards Board responsible for developing standards harmonized with IFRS.	Eliminate differences between IFRS and national GAAP by converging with IFRS when possible and practical.
Venezuela	Policy announced by the Venezuelan Federation of Accountants Outcomes of agreements among the Venezuelan Federation of Accountants, Caracas Stock Exchange (CNV), the banks, and insurance superintendences will determine the extent to which national regulatory bodies and standard setters address convergence.	Eliminate differences between IFRS and national GAAP by converging with IFRS when possible and practical. IFRS will be considered on a standard-by-standard basis. IFRS adopted by default if not contemplated under Venezuelan standards. Local Federation of Accountants has ongoing project to adapt and adopt certain international standards.

in accordance with applicable laws and Peruvian GAAP. In a rule that applies to all corporations, the National Accounting Standards Board has agreed that Peruvian GAAP correspond to IFRS. As of year-end 2002, the National Accounting Standards Board had approved IAS 1 through 41 with the adoption of IAS 32, 39, and 41 becoming effective January 1, 2003.

In the case of publicly traded companies, the rule for preparing financial information issued by the National Commission for Enterprises and Securities (and in accordance with the General Corporate Law) establishes that the preparation of financial statements must be in accordance with IFRS as approved in Peru. Some government supervisory and control entities, such as the Superintendent of Banks and Insurance Companies and the Pension Funds Administration, are allowed to issue accounting standards that may, in some instances, deviate from IFRS as approved in Peru.

According to the survey, convergence in Peru will continue to take the form of adopting IFRS on a standard-by-standard basis supplemented only by specific government regulatory and control rules. IFRS will be incorporated into Peruvian GAAP on a "word-for-word" basis with no changes. The timing of the issuance of future Peruvian standards will depend on the availability of the local Spanish translation of any newly issued IFRS and the timing of its distribution among the local business community.

Other Types of Convergence Plans

In Mexico, the Mexican Council for Research and Development of Financial Reporting Standards (CINIF) developed the convergence plan for the country. Indeed CINIF, the new independent accounting standard-setting body, was created to work with the IASB to set globally harmonized standards. The intent of Mexico's convergence strategy is to gradually eliminate differences between IFRS and Mexican GAAP when possible and practical. IFRS will also be supplemented by specific national accounting rules to meet specific Mexican environmental issues not covered by the former. While listed companies may voluntarily adopt IFRS, they must first obtain authorization from the Mexican securities authority (The National Banking and Securities Commission, CNBV), but, to date, few listed companies have requested permission to use international standards.

Argentina's convergence strategy is shaped by both the accounting standard-setting body and the governmental/regulatory body. In 1998, the Argentine Federation of Economic Sciences Professional Councils (FACPCE) decided to revise Argentine GAAP

by taking international standards as one of its main sources of reference. Since then, the Argentine professional body has issued the five Technical Resources referenced previously. As of year-end 2002, all provincial jurisdictions had ratified the five Technical Resolutions, although some (particularly Buenos Aires City) incorporated certain amendments.

The Technical Resolutions have different effective dates depending on the decision of the provincial Professional Council. For example, the Professional Council of Buenos Aires City, where most listed companies are domiciled, made the Technical Resolutions effective for fiscal years beginning July 1, 2002, or later. The adaptation of Argentine GAAP to international standards will continue in the future taking into consideration the evolution of IFRS and how well the process of implementing the new standards proceeds in Argentina.

The Argentine Securities Commission (CNV) is the governmental regulatory and oversight agency for listed companies. The CNV issues its own standards, which are generally in accordance with the FACPCE Technical Resolutions. The CNV has approved the five Technical Resolutions with minor modifications introduced by the Economic Sciences Professional Council of Buenos Aires City and has introduced additional minor amendments. The newly approved CNV standards are effective for financial statements of fiscal years beginning January 1, 2003, or later.

After the *GAAP Convergence 2002* survey was complete, several new developments took place. First, a new technical resolution covering business combinations, consolidation and related party disclosures was issued by FACPCE and approved by several jurisdictions. The resolution eliminates several minor differences with IFRS. This resolution is yet to be approved by the CNV. Second, a new proposal covering the accounting treatment of long-term employee benefits is under review by the FACPCE. The proposal covers aspects of long-term employee benefits that are not currently covered by Argentine accounting standards.

The new Argentine GAAP is based on eliminating differences between national GAAP and IFRS when possible and practical. Hence, while Argentine GAAP has been re-written to generally agree with international standards, the standards are not copied "word for word," and some differences will continue to remain between Argentine GAAP and IFRS. Table 5.3 provides a summary of remaining differences between Argen-

tine GAAP and IFRS. The differences noted are based on information collected during the 2002 survey updated for areas where amendments to the Technical Resolutions introduced by the Economic Professional Council of Buenos Aires City and the CNV created additional differences or eliminated differences with IFRS. Amendments are noted in Table 5.3 with an asterisk.

Clear messages from regulators and the accounting professional bodies in Brazil indicate that the intent is to harmonize national standards with IFRS. Brazil's strategy, which is currently being developed, will likely be aimed at eliminating differences between IFRS and national GAAP by converging with IFRS when possible and practical. For example, while the new Brazilian standard on employee benefits is based on IAS 19, minor differences remain in order to reflect the nature of local benefit plans.

There is a project in Congress to update the accounting section in the Corporate Law. The proposal under consideration would update the accounting principles prescribed by Corporate Law to align the local GAAP with IFRS. Additionally, there are discussions to create an Accounting Standards Board, to be formed by accountants, financial statement preparers, analysts, academics, and regulators, which would be responsible for developing accounting standards harmonized with IFRS. The CVM has also been working to implement standards for listed companies that are harmonized with IFRS.

The survey indicates that there are clear intentions from the Brazilian Accountants Council (CFC) and the Brazilian Institute of Auditors (IBRACON) to support harmonization. While waiting for the approval of the changes to the Corporate Law, the various constituents are discussing the creation of the Accounting Standards Board, as mentioned above. The CVM plans to include on its agenda a project aimed at issuing accounting regulations for all international standards which are not in conflict with the current version of the Corporate Law practices (to include but not limited to segment information and discontinued operations). All new accounting pronouncements issued by IBRACON during the past five years are harmonized with international standards, and most of the accounting pronouncements issued by IBRACON have been adopted by the CVM for listed companies. IBRACON currently has a very busy agenda that is aimed at converging all its existing pronouncements with IFRS by 2004. The agenda further includes development of new standards including one addressing accounting for financial instruments. CFC is working toward the same objective.

Table 5.3. Differences between Argentine GAAP and IFRS Identified by GAAP Convergence 2002 Survey (Differences between IFRS and standards approved by FACPCE as amended by the Economic Sciences Professional Council of Buenos Aires City and the CNV)

Issue	According to IFRS	According to Argentine Technical Resolutions
Adjustment to reflect effects produced by change in currency purchasing power	Required for financial statements stated in currencies within a hyperinflationary environment. Optional, in inflationary, deflationary environments or one with stable prices.	Required for those financial statements stated in currencies of hyperinflationary, inflationary or deflationary environments. The adjustment is not allowed in an environment with stable prices.
Rate for the calculation of financial costs to be included in the production cost of assets	Calculated based on costs of general loans.	Calculated based on costs of general debt.
Deferred taxes on revaluation of fixed assets (without tax effect)**	Recognized with a debit made to an equity lead.	Not recognized.
Deduction of selling expenses in determination of current values of monetary assets and of fixed assets and investments in similar nature fixed assets destined to be sold.	Not allowed.	Required.
Recognition of equity effects from unfavorable contingent events	When estimated it is more probable for the events to take place than not to occur (for instance 51% and 49% respectively).	When there is a high probability the events and their equity effects will take place (Probability of occurrence significantly higher than 50%).
Measuring contingencies	When the financial effect is important, contingencies should be measured by amounts expected to be paid with a discount.	Within a stable environment, it is allowed not to discount amounts expected to be paid within 12 months from the date of the financial statements.

Continued

Issue	According to IFRS	According to Argentine Technical Resolutions
Intangible assets	Expenses incurred as initial start-up costs (organizational and pre-operative) are not recognized as intangible assets. Amortize over estimated useful life, subject to rebuttable presumption that such lives should not exceed 20 years. The useful life of an intangible asset is always finite.	It is allowed to recognize as intangible assets organizational and pre-operative costs (which are directly applied to a new activity and are incremental and which do not correspond to be included as a component of a fixed assets cost). The assets should depreciate within five years. *May have an indefinite life; consequently, amortization expense may not be recorded.
Financial statement conversion	For foreign entities only the "adjust-convert" method is allowed.	For foreign entities, the application of either the "adjust-convert" or "convert-adjust" method is allowed.
Fixed assets recoverable value	Calculated considering each fixed asset individually, or otherwise, if not possible, through cash generating area. Recoverable amount test based on higher of net selling price (net realizable value) and value in use (discounted future cash flows). Recoverable amounts measured at level of individual asset or cash generating "unit" to which asset belongs.	Small entities are allowed to perform the calculation on each activity level. *Recoverable amount test based on undiscounted future cash flows (in line with US GAAP). *The more general concept of cash flow generating "activities" is used as opposed to IFRS's cash generating "unit."
Layout of balance sheet	IFRS does not prescribe a standard balance sheet layout. The Framework specifies that balance sheet elements include assets, liabilities, and shareholder's equity.	*Deferred charges are classified between liabilities and shareholder's equity.

*Denotes a difference arising from amendments made by the Economic Sciences Professional Council of Buenos Aires City and/or the CNV.

** Standards approved by EACPCE additionally differed from IFRS in that Deferred Tax Assets and Deferred Tax Liabilities were dis-counted. An adjustment has removed this difference with IFRS.

The São Paulo Stock Exchange has created a New Market⁵ (*Novo Mercado*) where companies can be listed if they prepare financial statements in accordance with U.S. GAAP or IFRS. While this does not change the Corporate Law financial statements, creation of the New Market does represent a tread in the market for convergence.

Venezuela intends to converge with IFRS as evidenced by a policy announced by the Venezuelan Federation of Accountants, which has an ongoing project to adapt and adopt certain international standards. Additionally, the Comisión Nacional de Valores (CNV) has stated its intention of establishing that public companies must adopt IFRS. The survey suggests that an agreement among the Venezuelan Federation of Accountants, the Caracas Stock Exchange, the Banks, and Insurance Superintendences among others, is needed to push these convergence initiatives forward. The survey indicates that once it is finalized the convergence strategy will likely take the form of reviewing IFRS on a standard-by-standard basis and eliminating differences between IFRS and Venezuelan GAAP when possible and practical. Currently, in the absence of a corresponding Venezuelan standard, IFRS is adopted in Venezuela by default.

Obstacles to Convergence

In *GAAP Convergence 2002*, the large accounting firms also report that, while much process is being made, there are still obstacles to convergence. Notably over half of the 59 surveyed countries express concerns regarding the complicated nature of particular international standards, particularly those associated with fair value accounting. Slightly less than half of the countries note that the tax-driven nature of a national accounting regime impedes convergence. Approximately one-third indicate that either a disagreement with certain significant IFRS, insufficient guidance on first-time application of IFRS, or limited domestic capital markets represent a barrier to convergence. About one-fifth indicates that satisfaction with national accounting standards among investors and financial statement users or translation difficulties represent an obstacle to convergence.

Based on the findings, *GAAP Convergence 2002* concludes that, in addition to addressing the obstacles identified above, capital market participants need to join forces

5. The New Market is a listing segment of the São Paulo Exchange designed for the trading of shares issued by companies that voluntarily abide by corporate governance practices and disclosure requirements in addition to those requested by Brazilian legislation. These rules, consolidated in the Listing Regulation, increase shareholder's rights and enhance the quality of information commonly provided by companies.

to address two key concerns. First, the coverage of IFRS in the education and training of accountants needs to be increased. Secondly, national language translations of IFRS, including interpretations, need to be made available on a timely basis.

Table 5.4 lists the obstacles to convergence faced by five of the surveyed Latin American countries. These are further explored in the Discussion of Findings section of this chapter.

Table 5.4. Concerns Expressed About Impediments to Achieving IFRS Convergence (based on *GAAP Convergence 2002*)

Country	Impediment
Argentina	<ul style="list-style-type: none"> Disagreement with certain significant IFRS. Differences between Argentine GAAP and IFRS are reported in Table 5.3.
Brazil	<ul style="list-style-type: none"> Tax-driven nature of the national accounting requirements. Legal content of the Corporate Law, which is currently the source of accounting standards.
Mexico	<ul style="list-style-type: none"> General satisfaction with national accounting standards and a lack of interest from investors and other users to change national standards.
Peru	<ul style="list-style-type: none"> Insufficient guidance on first time application of IFRS. Disagreement with certain significant IFRS including the adverse effects of the first application of IAS 12, 17, 36, and 38. Translation difficulties / Difficulties in obtaining Spanish translation of the standards on a timely basis, which complicates official publication and distribution.
Venezuela	<ul style="list-style-type: none"> Insufficient guidance on first time application of IFRS. Tax-driven nature of the national accounting requirements / legal and tax implications . Desire to wait until the IASB has been operating for a longer period before evaluating the merits of IFRS. Disagreement with certain significant IFRS including presentation of financial statements adjusted for inflation, development stage enterprises, and income tax. Complicated nature of a particular standard including IAS 19 and IAS 39.

Education and Training Issues

Availability of IFRS in the National Language

The 2002 survey indicates that a national language version of IFRS is widely available in Mexico, Peru and Venezuela (see Table 5.5). Although Spanish is the national language, dialects vary considerably throughout Latin America; therefore, the IASB's "official" Spanish translation (based on European Spanish) needs to be modified for local usage. Accordingly, in Peru, new IFRS and interpretations are not translated as issued and are not available for official publication and distribution on a timely basis. This time lag is viewed as problematic as it can delay the effective date of new international standards in Peru. Likewise in Mexico, there is also a time lag of approximately one year between the issuance of a new IFRS or Interpretation and its availability in Mexican Spanish.

Table 5.5. Availability of IFRS in the National Language as of December 2002 (based on GAAP Convergence 2002)

Country	Comments
Widely available	
Venezuela	Translated version widely available. New IFRS and Interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC) translated as issued.
Widely available / Lag in translation of new IFRS	
Brazil	Newly translated version widely available as of 2003. New IFRS and Interpretations issued by the IFRIC not translated as issued (the recently translated version replaced the 1998 version / the version translated for Portugal cannot be used in Brazil as there are significant differences between the Portuguese used in these two countries).
Mexico	Translated version widely available. New IFRS and Interpretations issued by the IFRIC not translated as issued (normally a lag of approximately one year).
Peru	Translated version widely available. New IFRS and Interpretations issued by the IFRIC not translated as issued.
Not widely available	
Argentina	Translated version not widely available. New IFRS and Interpretations issued by the IFRIC not translated as issued (only IASB's annual official translation is available / FACPCE publishes and distributes this official translation annually).

As of 2003, a newly translated version of IFRS is widely available in the national language in Brazil.⁶ However, it is important to note that the last authorized version of international standards in Brazilian Portuguese was published in 1998. While IFRS is translated annually in Portugal, this version cannot be used in Brazil due to significant differences between the Portuguese used in these two countries. Accordingly, as Brazil must await a local translation, the survey indicates new IFRS and interpretations are not available in Brazilian Portuguese on a timely basis.

The survey indicates IFRS is not widely available in the national language in Argentina, since a local language translation is not undertaken. The FACPCE publishes and distributes the IASB sanctioned Spanish translation (from Spain) throughout Argentina on an annual basis; therefore, a review of new standards and interpretations is delayed until the IASB's annual official Spanish translation is published. While the IFRS Spanish translations utilized in Argentina are understandable, they are not precise enough for careful review and debate.

Education and Training

The survey indicates that IFRS are included in the education and training of accountants in Mexico and Peru. In Peru, IFRS are included in the university curricula (see Table 5.6). Additionally, professional organizations and the large accounting firms provide IFRS training in local Spanish, and IFRS training programs are available to financial statement preparers (see Table 5.7). The survey further indicates that ensuring consistent application of IFRS in Peru is partly achieved through seminars organized by the National Accounting Standards Board and the Peruvian Federation of Public Accountants. The aim of these seminars is to provide an update on new IFRS and developments at the IASB.

In Mexico, IFRS is also included in the university curriculum and IFRS training is provided by professional organizations in local Spanish. However, the availability of IFRS training for preparers of financial statements is insufficient and other sources of IFRS training, while available, are limited.

Gaps also exist in Argentina and Venezuela in terms of education and training. In Argentina, there is no common curricula at universities, as some include IFRS this subject while others do not. On a more positive note, professional organizations in

6. This effort was coordinated by IBRACON. The translation was reviewed by professional accountants, academics, and preparers.

Table 5.6. IFRS Inclusion in University Curricula (based on GAAP Convergence 2002)

Panel A: Yes	
Mexico	
Peru	
Panel B: Yes, But Limited	
Argentina	There is no uniformity. Some universities included IFRS in their curriculum.
Panel C: No	
Brazil	
Venezuela	

Table 5.7. Availability of IFRS Training (based on GAAP Convergence 2002)

Country	Offered by professional organizations in the national language	Available to preparers of financial statements	Available from other sources
Panel A: IFRS Training Available			
Argentina	Yes	Yes	No
Peru	Yes	Yes	Accounting Firms
Venezuela	Yes	Yes	No
Panel B: Training Offered by Professional Organizations			
Mexico	Yes	Insufficient	Limited
Panel C: Training Not Available			
Brazil	No	No	No

Argentina provide IFRS training in Spanish, and IFRS training programs are available to preparers of financial statements.

In Venezuela, professional organizations provide IFRS training in the national Spanish and IFRS training programs are available to preparers of financial statements. However, IFRS is not included in the university curricula, creating an important gap.

In Brazilian universities, IFRS is not a mandatory subject in the curricula, and IFRS training programs are not provided by professional organizations in the national Spanish/Portuguese or to preparers of financial statements.

Discussion of Survey Findings

Country Convergence Plans

In *GAAP Convergence 2002*, the six largest accounting firms report that the Latin American countries included in their survey all intend to converge with IFRS. The survey findings described in our follow-up report reveal that Argentina, Mexico and Peru have adopted convergence plans based on “managing change over time.” In these countries, national accounting rules have been modified over a period of time in order to gradually move toward national GAAP that are more in line with the international benchmark. As a result, Peru had adopted all existing international standards (IAS 1 through 41) as of 2003, and Mexico eliminated all but a few of the key differences identified in *GAAP 2001*. While implementation of Argentina’s convergence strategy has removed many differences between national GAAP and international standards, unfortunately conflicts have been encountered, and the current view is that several key differences will likely continue to exist.

The firms believe countries and their national standard setters need to actively participate in the IASB’s due process and contribute to the international debate which will lead to the development of high-quality global standards. However, once an international standard is finalized, each country should accept the standard as the global solution. If countries around the world refuse to accept certain IFRS, international convergence will not be achieved. Active participation in the IASB’s due process calls to attention the importance of an issue highlighted in this report. Specifically, access to IFRS, as well as discussion papers and exposure drafts, translated in the national language is of paramount importance.

In line with the plan pursued by Peru, each country’s convergence plan should be based on replacing national GAAP with IFRS supplemented only in rare instances if national issues are not properly addressed by IFRS. Otherwise, the Babel Tower will continue to stand and international comparability will be negatively impacted. National departures from IFRS should be the exceptions and not the norm.

Achieving global standards requires global solutions. Accordingly, Mexico should continue to implement its country plan and remove the remaining differences

with IFRS. More importantly, Argentina needs to reconsider and revise its strategy of eliminating differences with IFRS “where possible and practical,” and it should build on its very significant achievements and work to remove the remaining differences with IFRS highlighted in Table 5.3.

The large accounting firms endorse the basic strategy followed in Mexico and Peru, whereby, differences between national GAAP and international standards are gradually removed. Adoption of IFRS in a country where numerous differences exist might be effective if applied to a limited number of companies (i.e., only to listed companies in a country with a manageable level of such companies) and in the context of a highly trained accounting profession. However, a “big bang” approach to convergence poses a much greater threat to short-term quality of the application of new standards. Proper application of IFRS requires adequate time to address issues such as infrastructure, education and training. Numerous examples of the consequences of inadequate preparation by various countries are detailed in several of the Reports on Observance of Standards and Codes (ROSC) reports published by the World Bank (see http://www.worldbank.org/ifa/rosc_cg.html).

The *GAAP Convergence 2002* survey reveals that in Venezuela the convergence plan is based on an informal plan announced by the national standard setter to review IFRS on a standard-by-standard basis and eliminate differences when possible and practical. To date, few differences between national GAAP and IFRS have been addressed and numerous differences remain. In Brazil changes in the Corporate Law, which are currently being considered in Congress, are needed before convergence efforts can progress at a reasonable pace.

Venezuela and Brazil should consider developing formal convergence plans that incorporate target dates for removing existing differences with IFRS within the next few years. Otherwise, not only will numerous existing differences remain, but the gap with IFRS will also grow considerably as these countries will not be adequately prepared to converge with nor participate in the discussion of forthcoming IFRS. Given the inter-relationships among accounting standards, basic conceptual differences with existing international standards must gradually be removed in each country to pave the way for convergence with forthcoming international standards.

Impediments to Convergence

Each of the surveyed Latin American countries notes various impediments to convergence. In Peru and Venezuela, insufficient guidance on the first-time application of IFRS has been problematic. Fortunately, the IASB has issued IFRS 1 addressing first-time application, so this issue should cease to be a major obstacle once the new IFRS is translated.

Argentina, Peru and Venezuela indicate that the complicated nature of a particular IFRS and/or disagreement with certain significant IFRS has represented a barrier to convergence. The large firms encourage the IASB to be aware of their findings regarding these issues as 51 percent and 39 percent, respectively, of the 59 countries participating in the 2002 survey indicate similar concerns. The IASB is encouraged to make IFRS both functional and operational and to strike a balance between the need to improve IFRS on a priority basis and the practical difficulties countries and companies face in implementing the Board's standards. Based on their findings, the firms encouraged the IASB to prioritize its project on addressing issues faced by Small and Medium Enterprises (SMEs) and by countries in emerging economies. The IASB's project on SMEs is currently progressing, and an exposure draft is anticipated during late 2004.

Venezuela expresses a desire to wait until the IASB operates for a longer period before evaluating the merits of IFRS. *GAAP Convergence 2002* reports that 95 percent of the participating countries intend to converge with IFRS, thereby suggesting the "wait-and-see period" is over. Now is the time for all countries to join forces and work toward global accounting solutions. Those electing not to participate may find that they are unable to take advantage of regional and global opportunities.

As to the "wait-and-see" position and concerns expressed about the complicated nature of a particular IFRS or disagreement with significant IFRS, these issues should be addressed at the national level in a timely manner. It is important to reiterate that countries should not procrastinate, and national efforts to remove existing differences with IFRS should continue ahead. Otherwise, as new IFRS are issued, the gap between national and international standards will likely increase. National standard setters should work with the IASB and provide feedback regarding the development of global solutions. However, once an IFRS is issued, countries are encouraged to realize the consequences associated with nonconvergence. Global solutions will not be

achieved if countries selectively adopt only those IFRS that suit their national position or reflect current practice.

Mexico indicates that a general satisfaction with national GAAP poses a barrier to convergence. While this represents the scenario in over 20 percent of the countries included in the survey, a worldwide cooperative endeavor is needed to achieve global standards. For example, a similar scenario exists in the United States, yet, a Memorandum of Understanding between the IASB and the U.S. Financial Accounting Standards Board (FASB), issued in October 2002, formalizes the commitment of both Boards to converge their standards based on high-quality solutions. Expectations are that the Memorandum of Understanding will result in several changes to U.S. GAAP during the next few years. While some of these will represent important improvements in U.S. GAAP, others will simply be in the interest of convergence. Standard setters worldwide should embrace the spirit of this agreement in order to accelerate the achievement of global standards.

Brazil and Venezuela state that the tax-driven nature of national accounting standards serves as a significant barrier to convergence. In Brazil, this is particularly true for nonlisted entities. *GAAP Convergence 2002* reveals this concern is shared by 47 percent of the 59 countries participating in the survey. The firms encourage governments to acknowledge the differing objectives of tax accounting and financial reporting. In jurisdictions where the two are linked, firms request that governments consider approaches that accommodate the differing objectives. Otherwise, convergence may not be feasible, especially for SMEs.

Education and Training

In Brasil, Mexico, Peru and Venezuela, IFRS are widely available in the national dialect. Alternatively, Argentina relies on the official IASB Spanish version originally translated for Spain. The countries also indicate new IFRS and Interpretations are not translated as issued. The accounting profession and international organizations, such as the World Bank and the Inter-American Development Bank, should work in cooperation with the IASB to address this important barrier to convergence. Timely national language translations of IFRS are a necessity if convergence efforts are to move forward in a timely manner throughout Latin America.

Additionally, if Latin American countries are to effectively participate in the IASB's due process, it is crucial that IASB discussion papers and exposure drafts be made available in the national languages. While it may not be feasible to translate the entire document in a timely manner, it is important that the primary concepts set forth in IASB proposals be circulated in the national language. Countries throughout Latin America must join others worldwide (such as Australia, Hong Kong, United Kingdom, United States, etc.) and provide input to the IASB; otherwise, they will have little if any impact on the development of IFRS.

In *GAAP Convergence 2002*, the large accounting firms state that a high priority should be assigned to accelerating efforts to address training of practicing accounting professionals and higher education of those entering the accounting profession. The firms conclude that IFRS should be a significant part of the accounting curricula at all universities worldwide. While Mexico and Peru report that IFRS are included in the university curricula for the training of accountants, the four other countries indicate that instruction on IFRS is limited or that IFRS is not included at all in the curricula.

Argentina, Peru and Venezuela report that IFRS training is offered by professional organizations in the national language and that IFRS training is available to the preparers of financial statements. Alternatively, Mexico indicates the availability of IFRS training for preparers is insufficient, IFRS training in the national language is not available in Brazil on a regular basis. Accordingly, in Latin America, a high priority should be assigned to accelerating efforts to address both higher and continuing education of accounting professionals in countries where deficiencies exist.

Successfully addressing IFRS education and training deficiencies in Latin America is dependent on the accounting profession, international organizations, governments, and educators joining forces to address this issue. We recommend that these constituents cooperate to develop a model university curricula. Once finalized, the model curricula can be modified to fit various local environments. After being pilot tested at selected universities within each country, the curricula can be modified as needed and replicated in other institutions of higher education throughout the country. This initiative should also encompass offering retraining programs for accounting instructors and the development of learning materials in the national language to include textbooks on the practical application of IFRS.

International organizations should also join with the International Federation of Accountants (IFAC) and the accounting profession to focus on the development of high-quality IFRS training programs. Regional and national professional organizations, governments, and educators should then pledge their support to this important effort and assist in translating these training programs into various languages and with proper modifications to address the needs, culture, and language of specific countries. Once sufficient regional and national support is achieved, the accounting profession and international organizations should participate in sponsoring and delivering these training programs to preparers and auditors in those countries committed to both convergence with and appropriate application of IFRS. High-quality national language education and training programs are necessary to ensure that convergence efforts throughout Latin American are supported by a profession that is adequately trained in IFRS. All constituents should assign a high priority to participating in cooperative endeavors to address IFRS education and training needs in Latin America.

Summary and Conclusion

All Latin American countries included in the *GAAP Convergence 2002* survey intend to converge with IFRS, and significant progress has been made in Argentina, Mexico and Peru to eliminate differences between national GAAP and international standards. However, Argentina needs to reconsider its convergence strategy and work to remove the remaining differences with IFRS. Other Latin American countries included in the survey should develop formal convergence plans and intensify their efforts to eliminate existing differences with IFRS as the road to convergence will likely become even more challenging. As IFRS is a “moving target,” convergence not only requires “catching up” with existing international standards but also with new IFRS. Completion of current IASB agenda items such as Performance Reporting and Business Combinations will create even more convergence challenges and, as opposed to converging, the gap between national and international standards may widen if efforts to removing existing differences are not accelerated.

According to Paul Volcker, Chair of the IASB Trustees, “The rapid development of global financial markets has greatly reinforced the desirability of—indeed now de-

mands—international consistency in accounting standards and auditing approaches.” *GAAP Convergence 2002* reports that 95 percent of the 59 countries surveyed by the large accounting firms either plan to adopt IFRS or converge their national GAAP with IFRS. Accordingly, countries worldwide have acknowledged the benefits associated with adopting high-quality global standards.

Historically, a lack of robust capital markets throughout Latin America resulted in a heavy reliance on debt financing and a high cost of capital. Fortunately, there are signals that this scenario is changing as represented by the growth of active local stock exchanges, increased access to low-cost US dollar/LIBOR-based borrowings, a growing number of US American Depository Receipts (ADRs), and significant regional and cross-border activity.

The emergence of local active exchanges in the region and the impact of recent accounting developments worldwide have emphasized the urgency for Latin American countries to carefully reconsider the nature of their financial reporting models and infrastructure. To encourage further growth of local capital markets, there is a need for the effective implementation of strategies directed at developing a solid enforcement infrastructure, improving overall and accounting education, converging local accounting and auditing standards to IFRS and International Standards of Auditing (ISA) as issued by the International Federation of Accountants, and upgrading information systems. It is crucial that Latin American countries adopt the view that financial reporting is a critical information delivery system that anchors local capital markets. To anchor local markets, the financial reporting system will require both adoption of high quality accounting standards and a solid, effective enforcement mechanism.

It is important that countries in the region reap the tremendous benefits associated with the adoption of IFRS. By improving transparency, high-quality global standards can reduce risk for investors and motivate additional foreign investments in the region, thereby stimulating the economy, and aiding the population in general. Furthermore, by enhancing comparability and investors' ability to make informed decisions, adoption of IFRS can lead to lower the cost of capital. Companies utilizing IFRS can also save both time and money by being able to report all financial information under the same set of accounting and reporting rules. Combining the benefits of greater access to capital markets, reduced cost of capital, and reduced internal costs will reward Latin American countries that improve their financial reporting by utilizing high-quality global standards.

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6

Benchmarking: Identifying Gaps Between National Practices and International Standards

Richard Findlater*

The purpose of this chapter is to emphasize the need for progress in improving the transparency of financial reporting and to set out a structure and some ideas for achieving progress at the country level. The basic question is “How persuasive is the case for change in financial reporting?”—particularly in the context of “an integrated financial world moving to a common language of finance and a common language of reporting.”

It is always easy to discuss the need to change when you are far above the ground. At 25,000 feet, it is a nice intellectual argument, with which many can agree, that change is a good thing and that we really must make it. But as you get nearer to the ground, the consequences and discomforts of change become much clearer and the process becomes uncomfortable. Things will be different, and change will affect governments, regulators, companies, the accounting profession, and each of us as individuals.

However compelling macro-level arguments for change to achieve international accounting standards, real changes can only happen through substantial and detailed actions at the country level. There will be changes that will increase accountability. Transparency, though essential to a robust financial framework, brings with it increased tensions. In practice, proposed changes often come to a halt long before they reach

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implementation—it is the execution of change that is the really hard part. Yet there is little dispute that the worlds of financial reporting and financial stability need international standards and that those standards must reflect the needs of an increasingly global world.

There also needs to be the incentive to improve. It is interesting how standards can suddenly improve when there is such an incentive. For example, countries hoping to join the European Union are now seeking to accelerate performance to a point at which they will reach a much higher plane of financial reporting. It is similar to seeking to join a better golf club that demands higher standards; suddenly, your handicap gets a lot better because you have practiced hard and worked hard to improve. Improvement is not easy; it is tough.

The role of national government in catalyzing and implementing change is absolutely critical. The importance of integrating different change activities is a recurring theme. There are a number of aspects for which action is needed, but certainly those of accounting, auditing, corporate governance, and regulation need to be quite closely integrated. The need is for an integration of actions rather than just the improvement of any one process.

Finally, it should be recognized that this is a long game. No country is going to make significant improvement in a year, or perhaps even in two. It takes determination to succeed over a long period. Sometimes there is a really pressing need because of a financial crisis, but it is not easy to change the major processes during such a time. As things improve, the need for change will get less emphasis, and it will require a determined effort to really make things happen.

Anatomy, Physiology, and Psychology

This is a chapter about financial stability, not human medicine. However, the parallels between the various medical disciplines and financial stability are worth considering. For instance, the International Forum on Accountancy Development website (www.ifad.net), titled “The Accounting Profession and the International Financial Framework,” was created to demonstrate how the international financial architecture operates. It is built on three basic premises.

The first premise is the need for an anatomy—a basic structure of institutions. Most countries already have these institutions, for example, central government functions, a stock exchange, debt and equity providers, and an accounting profession. The next stage is physiology, i.e., the processes to make the institutions viable—laws, regulation, and accounting standards. Processes are essential, and standards are an integral part of good processes. A lot of people think that once the standards are in place, the change is done. But the third premise, which is essential, is a change in psychology, bringing with it a common desire to change to meet the expectations of transparent financial system.

The lack of financial transparency is not an accident. It came about because cultural and other influences within a country made it very uncomfortable to be transparent. In reality, transparency is only attractive if it comes with sufficient commercial or other advantages. Better standards are essential for change. But in any change program, if there is not also a shift in behavior and ethics, nothing much will really happen. In any change program, the benefits have to be clear up front, and those who are affected by the change need to buy into it.

Country Action Plans—The Process

The first fundamental aspect of a country action plan is the objective of strengthening financial stability through improved standards and practice. What is needed is a combination of robust standards rather than just fixing problem A or problem B. It is essential to get the overall physiology working coherently.

The second fundamental aspect is the country management team. This team is not a group of accountants; it is a strong, well-balanced group representing all the key parts of a financial economy. In the view of many accounting and auditing professionals, it needs to be led by government, because if government is not supporting an activity as a sponsor or leader, it is extremely hard to make and sustain changes.

The key elements of a plan are (1) a fundamental analysis and fact finding about where things are at the present time, (2) a clear vision of the desired end result, and (3) building an action plan to get there from here. These activities need to comprehend the broader picture, not just accounting or auditing. For example, in looking at accounting,

it is necessary to consider the profession's historical background, how standards are set, the existing regulations that affect financial statements, and other relevant matters.

Fact finding is usually the first set of actions that the country team would undertake. Then the future state needs to be thought through and designed, then this will aim to achieve best international practice. Thereafter, a gap analysis is carried out and on the basis of this work, action steps are created and implemented.

The first few stages—that is, establishing the country team (getting the right team is difficult but not very time consuming) and fact finding—can be done rather quickly, as can the gap analysis. The last two stages—deciding the action steps and implementation—and particularly the last, are the ones that are really time consuming. They require stamina and determination. Things do not improve all at once, but it should be possible to track the actions and the benefits.

The Financial Stability Forum

At this point, it is useful to again reflect on standards. Some readers will be quite familiar with the activities of the Financial Stability Forum (FSF). Just to summarize, starting in early 1999 and through to the end of that year and into early 2000, an FSF task force set out to establish the standards that are necessary to improve the financial stability of a country's economy. They went through a large number of potential standards and identified 12 as the core standards. If one looks at the FSF task force's report, one sees about another 30 or 40 standards identified, which are not considered core standards but are quite useful supporting ones.

The 12 core standards can be divided into three groups. First are those related to the elements of macroeconomic behavior: the activities of central banks, financial policies, fiscal transparency in government, data dissemination, and systematic implementation of payments systems. Second are standards dealing with money laundering, insolvency law, and the regulation of both banking and insurance; though these are also important, they are not quite at the center of the debate on financial reporting.

Third are the standards most directly relevant to the subject of this volume: those that fundamentally affect financial reporting. These standards pertain to securities regulation, corporate governance, accounting, and auditing. They are separate, and

different groups are responsible for setting them. However, they are closely interrelated, and change will be most effective and sustainable if they are considered together.

The Key Standards

Important commentators have paid considerable attention to the need to improve the quality of accounting and auditing. However, fixing accounting and auditing alone will not do the whole job. In fact, it could be argued that in the absence of other changes, very limited real progress will be made. If corporate governance is not strong, if there is no enforcement through securities or banking regulation, the framework is quite fragile.

Therefore, in building an action plan, to ignore the other interdependent standards is probably the wrong approach. In the end, it is best for preparers of financial statements to operate under proper conditions—effective corporate governance, good accounting standards to turn data into sound financial reporting, effective auditing, sound regulation, and an enforcement mechanism.

If I reflect on my own country—where we have had accounting standards, which we thought were close to world class, or certainly of good standing, since the early 1970s—it was only when serious enforcement began in the early 1990s that the quality of financial reporting really improved. Behavior changed, and there were significant improvements in the application of standards. The enforcement mechanism thus was very important in making things work.

Benchmarking

Considerable work has been done on analytic or benchmarking tools that can help countries take the first steps toward improving their accounting standards and thus meeting international expectations. These tools identify the most important elements of international standards and thereby assist the country team in comparing international standards with local standards and practices.

A prime example of such tools is the Reports on the Observance of Standards and Codes (ROSC) program. ROSC is the voluntary review mechanism created by FSF, and it applies to all FSF core standards. Through ROSC, the World Bank and the International

Monetary Fund are carrying out country assessments, which are essentially benchmarking processes. The responsibility for the ROSC reviews is divided between the IMF and the World Bank. The World Bank has completed about twenty-one country reviews on accounting and auditing, and it has plans to undertake quite a few more in the next few years.

The ROSC work is important for the progress of benchmarking and action plans. At present, it focuses mainly on accounting and auditing. In my view, if it also considered all the related financial reporting elements at the same time, that would be helpful to countries in developing more effective action plans.

There is still work to do in linking the work in corporate governance, accounting, and auditing with the enforcement activities of regulators so that the tools are integrated. At the moment, there are separate tools for accounting, auditing, and corporate governance. There needs to be a more integrated approach to focus on the overall picture and on the cooperative ROSC venture with the World Bank. IFAD has worked quite well, and common methodologies have been agreed on.

It is useful here to examine how the benchmarking process works for just the accounting and auditing aspects. First of all, there is a tool, which is often referred to as the environmental scan. It is a relatively brief document that helps to summarize the background of the economy, the profession, and regulation, insofar as it affects financial reporting. So there are questions about the size of the profession, the training of accountants, regulation of the market, the rules on filing financial statements, and the accounting standards generally in use and who sets them. It gives a good part of the necessary background. It is not a huge piece of work, particularly for someone who knows the economy well, but it is an important step.

Second, there are separate tools for accounting and auditing that compare written standards with international standards. In the case of auditing, the benchmarking process includes significant facilitated discussion on auditing practices.

The third tool is a perception survey, which is currently in draft. It can be carried out through a telephone survey or personal interviews with people who use the financial statements produced in the country being studied. It asks for their views on certain key aspects of the quality of financial reporting—for example, the effectiveness of regulatory enforcement. The respondents will be informed users, analysts who cover

the market, bankers, and knowledgeable financial journalists. The views of outside users give a reality check and can point to problems that will become barriers to change if not addressed.

Fourth, in a ROSC, there is a review of a number of financial statements within the country to look at disclosures and at compliance with local standards. Benchmarking is the means of gathering information; the next key stage is to hold one or more facilitated discussions. These discussions focus both on the implications of the initial findings of the benchmarking and on what is actually happening in practice. Fifth, where the benchmarking is being carried out under the ROSC program (which many will be), there will be a report, which is likely to be a matter of public record.

By the end of this benchmarking process, the country team should have created an action plan to address the issues that have been raised. Another tool available to teams is a country action plan guide, which gives a fairly detailed description on how to go about the overall process and is useful background at the planning stage.

It is good here to provide a few thoughts on the practical side. In looking at benchmarking, there needs to be a good understanding of the overall context. Although it is obviously important to compare standards with international benchmarks, this should not be done in a vacuum. For example, understanding how standards are set, how people learn about accounting, what happens in filing financial statements, and how seriously regulation is taken all are important for gaining a real understanding of what is happening and what action will likely be needed.

It is also important to have some direct factual comparisons. Having a good set of standards in itself does not improve performance, but it is hard to improve performance without it because there is no benchmark to aim for. No matter how tedious this factual comparison may be, it has considerable value and is an important step to take before moving forward to improve performance.

Facilitated discussions are extremely important parts of this understanding. What happens in practice? Many “soft” issues about why things operate in a particular way are critical. The perceptions of users provide additional soft information that will either challenge or support the information that comes out of the basics comparisons. Their perceptions may not be “right,” but users make up the readership for financial reporting, and understanding their views is an important part of moving the plan forward.

Other Benchmarking Issues

Beyond the core standards, what else might need to be considered? Much discussion has taken place concerning independence. For instance, the International Federation of Accountants (IFAC) completed its revised Code of Ethics at the end of 2001. This tool was developed to assist in looking at what needs to be done to benchmark local ethics and standards of independence with IFAC standards.

Quality control in the auditing profession really applies on two levels. First, considerable work is going on with peer review of accounting firms—which is an important part of quality assurance. The second level is the quality control of IFAC members and IFAC Institutes. Their actions in implementing IFAC standards will become the focus of the newly formed IFAC compliance committee. Its role will be to monitor and encourage the improvement of standards by member bodies. This element of quality control is needed to accelerate improvement.

Benchmarking of the education, training, and qualification of accountants is not yet as advanced as one would like. This is a difficult task because each country starts from a different level. Many of the issues arise from the quality of secondary and tertiary education in the country. Thus, it is difficult to confine the issue of standards for education and training provided for the accounting profession to the profession itself. Eventually, a tool will emerge that can deal with the governance of accounting institutes and particularly their investigation and disciplinary procedures.

Conclusion

To conclude, it is useful to offer some final thoughts on anatomy, physiology, and psychology—to return to the medical metaphor given above. The anatomy of necessary institutions usually already exists in a country; they may need to improve, but they are usually established. There are still some countries with no accounting profession and some with no auditing profession, but they are in a small minority, and these professions will eventually evolve.

The physiology is very significant. Much of what is discussed in the present chapter in relation to accounting, auditing, and corporate governance involves processes. Those processes are incredibly important, and they need to be developed.

Then there is the question of psychology—of common values and beliefs. Psychology can be changed in many ways. Sometimes it is through enforcement. If there is a really effective enforcement system, it does change behavior. Countries should be encouraged to look closely at what they mean by enforcement and at how enforcement actually works. Much will depend on the belief in some of the fundamentals—“Do government and the institutions really believe in fairness to shareholders through consistent transparent reporting?” If they believe in change, if they are really determined, then much progress will be made. If they do not, “progress” will be glacial.

Do government and the institutions also believe that they can achieve economic progress and reduce the potential for crisis through a more robust financial framework? Economic turbulence is probably inevitable. Stability is an excellent concept for encapsulating these activities, because it suggests the ability to cope with turbulence in an orderly manner. When one looks back at what happened in Asia or Russia during recent financial crises, and when one looks at what happened in other parts of the world, it becomes apparent that many of the problems were caused by inadequate financial structures and inadequate processes, and thus the countries could not cope when the seas got rough.

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Current and Future International Harmonization of Accounting Standards

José Antonio Laínez, Susana Callao, and José Ignacio Jarne*

Growth of international financial and commercial markets, together with multinational companies' performance and investors' behavior, have contributed to globalization of economic activity. Ongoing expansion of international commercial markets has been promoted through improved transportation and technology and the needs of corporations to penetrate new markets and increase their customer base. Likewise, the search for financial resources to fund new investments has led to increased international capital mobility and the development of money markets. Through a sound productive, commercial, and financial investment network, multinationals have branched out in many countries, taking competitive advantage of the situation. To promote the penetration of companies in markets for their goods or services, many governments have favored trade and financial operations.

The globalization process has extended the operating framework for multiple economic agents. In turn, this situation has projected the interests and operations of every business unit beyond national borders, appealing not only to users and customers in the country where a company is located, but also those abroad. Thus emerges the concept of international user.

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It is difficult to analyze corporate reports in the country where they are disclosed, owing to the subjectivity implied in certain accounting practices and the flexible standards allowed in preparing statements. Thus, analysis of information from several countries has created problems that should have been addressed in past years from academic and professional standpoints.

With regard to analysis of accounting information, the variety of national accounting systems, which hinders comparability of information across countries, has become a key point. Different languages, currencies, and especially standards used to prepare and disclose information are ever-present obstacles in this new international dimension of information. Accounting information is variously evaluated, analyzed, and construed, according to the peculiarities of each country; these differences, in turn, affect the messages international users engaged in cross-border information analysis receive.

Moreover, as a consequence of internationalizing economic activity, accounting information—understood as a means of communication or language between a company and the various agents involved in its operations—has had to evolve in terms of identification and valuation methods, as well as the volume of data to be disclosed. All of this is necessary in order for a company to adapt itself and meet the requirements of the new environment, information needs, and user requirements.

Since the first technical accomplishments related to double-entry bookkeeping, this common language has revealed its international nature. This characteristic has become obvious over time through either slight differences or deeper discrepancies with regard to the methods and procedures used in various countries and regions. Despite universality of the language, multiple dialects have sprung up, thus making lack of international comparability of information an issue not easily resolved.

Over the past three decades, countless academic studies have expounded upon the accounting problems inherent in international corporate operations. These studies have analyzed the variety of criteria for identifying, valuating, and reporting business information at the international level, as well as the legal, political, economic, cultural, and professional factors underlying such differences. Some researchers have attempted classifications in an effort to offer, in a systematic and structured way, an international

outlook on accounting concepts. Others have analyzed the effects of accounting diversity on the international analysis of corporate information.

Along with pursuing accounting's international nature and scope and the effects on information users, proposals have attempted to answer those questions. Several professional organizations and institutions have made efforts to achieve a higher degree of comparability in international information to allow the various agents involved—companies, capital markets, and other users—to fully understand corporate data, whatever their geographic origin. Since the early 1970s, accounting harmonization has been envisaged as a solution to information comparability, through efforts by various international organizations—mainly the International Accounting Standards Board (IASB) at the global level and the European Union (EU) at the regional level.

This chapter analyzes major efforts in Europe and Latin America and the Caribbean (LAC) to adopt IASB standards to lessen the effects of international accounting diversity.

Scope and Effects of Accounting Diversity

Differences in principles, standards, and practices are likely considered key obstacles to appropriate interpretation of foreign financial statements and therefore the international comparability of data. Coexistence of different accounting systems involves conflicting operative criteria for reporting information and, in turn, disagreements about its disclosure.

Diverse Criteria for Preparing Information

The recognition and valuation standards companies use to reveal, through their accounting information, relevant economic events vary by country. Thus, resulting data pose key comparability problems. Based on a study by Callao (1996), Table 7.1 sums up examples of alternative standards most commonly used at the international level for which a higher degree of diversity has been detected. The examples presented are simply representative and are not intended to be comprehensive.

Table 7.1. Alternative Standards Most Commonly Used at International Level

Diversity Areas and Aspects	Options at International Level
Frozen Intangibles	
Recognition	<ul style="list-style-type: none"> • Activate • Recognize an expense on income (profit-and-loss report)
Valuation	<ul style="list-style-type: none"> • Historical costs • Fair-value costs
Depreciation	<ul style="list-style-type: none"> • By working life • By terms, as per regulations
Frozen Tangibles	
Valuation	<ul style="list-style-type: none"> • Historical cost • Fair-value cost
Depreciation	<ul style="list-style-type: none"> • Straight-line method • Reducing-balance method • Per-product unit • By digits added
Financial Investments	
Valuation	<ul style="list-style-type: none"> • At lowest between cost and market value • Market value
Operative criteria to assess outflows	<ul style="list-style-type: none"> • Average weighted price • FIFO (first in, first out) • LIFO (last in, first out)
Goodwill Fund	
Positive goodwill-fund recognition	<ul style="list-style-type: none"> • Capitalize • Eliminate, charging to reserves
Depreciation	<ul style="list-style-type: none"> • By established terms (5, 10, 20, or 40 years) • On terms not limited by regulations
Negative goodwill-fund recognition	<ul style="list-style-type: none"> • Pay against reserves • Deferred income, charge systematically on profit-and-loss account • Specific liabilities occasionally chargeable to results (profit and loss)
Inventory	
Operative criteria to assess outflows	<ul style="list-style-type: none"> • Average weighted price • FIFO • LIFO • Others (standard cost, base stock ...)

Diversity Areas and Aspects	Options at International Level
Financial Leases	
Recognition	<ul style="list-style-type: none"> • Recognize assets and liabilities • Charge expenditure to income report (profit and loss)
Asset valuation	<ul style="list-style-type: none"> • Cash value • Fair value • Current value of minimum leasing installment • Lowest between aforesaid
Debt valuation	<ul style="list-style-type: none"> • Equal to amount of asset • For total amount payable, plus interest
Research and Development Expenses	
Recognition	<ul style="list-style-type: none"> • Capitalize • Recognize on income/outcome report
Capitalized expenses amortization	<ul style="list-style-type: none"> • According to product's future profits • For an established standard term (usually 5 years)
Financial Expenses Related to Frozen Assets	
Recognition	<ul style="list-style-type: none"> • Capitalize • Recognize expenditure on income report
Grants and Subsidies	
Recognition of capital grants related to frozen assets	<ul style="list-style-type: none"> • Spread income among several fiscal years • Financed assets lower value
Operative subsidies recognition	<ul style="list-style-type: none"> • As the related expense accrues • As collection rights are due
Long-term External Resources	
Valuation	<ul style="list-style-type: none"> • Nominal value • Reimbursement value
Income Recognition	
Recognition of prompt-payment discounts	<ul style="list-style-type: none"> • Financial expenses on collection date • Lower earnings from sales
Refunds recognition on probable return of goods sold	<ul style="list-style-type: none"> • Recognize income from sales and provisions • Postpone sales recognition
Recognition of uncertain collection from installment sales	<ul style="list-style-type: none"> • Recognize income from sales and provisions • Postpone sales recognition
Interest recognition from installment sales	<ul style="list-style-type: none"> • On profit-and-loss accounts as they accrue • Deferred income
Tax on Corporate Profits	
Method to calculate accrued taxes	<ul style="list-style-type: none"> • Payable rates method • Tax-effects method
Tax-effects accounting	<ul style="list-style-type: none"> • Capitalization method • Debt method

Continued

Table 7.1., continued

Diversity Areas and Aspects	Options at International Level
Tax on Corporate Profits	
Appraisal of temporary differences	<ul style="list-style-type: none"> • Global method • Partial method
Recognition of tax savings from losses compensation	<ul style="list-style-type: none"> • As loss occurs • As compensation occurs
Exchange Rate Differences	
Recognition	<ul style="list-style-type: none"> • Charge to profit and loss • Defer • Capitalize, if linked to fixed assets
Conversion of Foreign-Subsidiary Balance Sheets	
Conversion	<ul style="list-style-type: none"> • Closing exchange-rate method • Monetary/non-monetary method*
Recognition of exchange differences	<ul style="list-style-type: none"> • Charge on consolidated income statement • Charge to consolidated net worth
Consolidation	
Valuation of subsidiaries excluded from global integration applications	<ul style="list-style-type: none"> • Like any financial investment • Equate
Valuation of multinational companies	<ul style="list-style-type: none"> • Like any financial investment • Equate • Proportional integration
Pension Plans	
Assessment of pension expenses in defined benefit plans	<ul style="list-style-type: none"> • According to accrued benefits • According to expected benefits
Recognition of costs on account of prior services	<ul style="list-style-type: none"> • Recognize expenditure on income statement • Defer and amortize
Long-term Contracts	
Income recognition method	<ul style="list-style-type: none"> • Fulfilled contract method • Completion percentage method
Probable Contingent Profits	
Recognition	<ul style="list-style-type: none"> • Not recognized in accounting • Recognize on profit-and-loss reports
Items from Past Fiscal Years	
Recognition	<ul style="list-style-type: none"> • Adjust initial reserves • Charge adjustment to profit-and-loss account of current fiscal year
Changes in Accounting Criteria	
Recognition	<ul style="list-style-type: none"> • Adjustment of initial reserves • Charge adjustment to profit-and-loss account of current fiscal year

* In the case of subsidiaries that are an extension of a parent company, a third option is the temporary conversion method.

Diversity of Information Disclosed in Each Country

Along with the differences observed at the international level in the criteria for preparing accounting reports, disagreements arise in the cataloging, formatting, and creation of contents of the statements companies are required to prepare in each country to accurately disclose their financial and economic positions and operations. Within the regulatory framework in force in each country, Callao and Jarne (1995) found that the preparation of accounting reports is generally homogeneous in terms of the legal duty to disclose balance sheets and income statements. However, the local formats used differ, even within the EU, since Directive IV is flexible, allowing member states to choose between two balance-sheet and four profit-and-loss formats. In other countries, such as the United States, regulations do not require a specific format and only set forth general instructions.

Likewise, the notes added to accounting statements are considered mandatory information to be disclosed by companies in most countries. However, given its flexible content and character, the substance of this information varies considerably by country. Diversity with regard to publication of other reports (e.g., cash-flow statements and mandatory disclosures of social and environmental information) is also remarkable.

Conversely, in relation to the reporting practices companies follow, Laínez, Callao, and Jarne (1999) examined the accounting information disclosed by European companies. They found a certain degree of homogeneity in the preparation of basic accounting statements, although diversity was relevant in certain aspects, such as classification of expenses by nature or function on the profit-and-loss account. Likewise, there were discrepancies with regard to the relevance that annual reports assign to certain items, such as statements on profit distribution, placement of segmented information (i.e., information on a firm's various lines of business and geographical areas of operation), and stock-market data.

Effects of Accounting Diversity on Key Agents

As noted above, diversity of accounting principles and practices is a paramount obstacle to international interpretation and the comparability of accounting reports. The key affected agents are the users, who must undertake the analysis of data if they are to

support decision-making, and the companies that disclose information, whose comprehension at the international level is hindered by the same accounting diversity. In Chapter 3, Casey and Masci show the implications of different accounting rules on valuation.

Moreover, according to Choi and Levich (1990), who analyzed the effects of accounting diversity within a capital-market decision framework, regulators' decisions are also affected by lack of homogeneity in accounting principles in various countries—particularly when international investment and financing operations are booming. In short, diversity of accounting practices can strongly affect the decisions of regulators, companies, and users.

Effects of Diversity on Market Regulation

Market regulators' decisions involve investors and companies, as well as market operations. Accounting diversity plays a major role in all transactions.

Technological advances in communications and computer programs have accelerated stock movements. Hence, capital markets have joined in a more competitive game because today's companies and diversified investors are raising funds abroad.

Within this context, capital markets complete over requirements for setting a certain level of information.¹ Thus, it seems logical that the prerequisites for companies seeking to be listed on a stock exchange would disclose a great volume of information conforming to the accounting practices of that particular country. This presents a major obstacle for these companies since they must bear the costs derived from these policies.²

In this case, the same accounting diversity that led regulators to establish those policies—that is, to increase comparability among statements, regardless of the company's country of origin—would cause competitive disadvantages for that market vis-à-vis those markets concerned less about investor protection and follow more flexible policies regarding the information requested from foreign-based companies wishing to be listed. Such markets even reach a degree of acknowledgment and cross-border acceptance of accounting reports prepared according to domestic principles.

A major dilemma for market regulators with regard to the disclosure of information by foreign companies is whether to maintain a strict position focused on investor

1. Freund (1988) points out that capital markets tend to deregulate to become more competitive because both investors and companies tend to avoid strict regulations and excessive red tape.

2. Cheung and Lee (1995) note that the decision to quote in a market with strict information requirements implies expecting potential benefits derived from a higher market value of company stock—linked to more and better data available to investors—which eventually offsets the costs of complying with such requirements.

protection or adopt a more flexible approach to preserve international competitiveness. Cairns (1994), Hoarau (1995), and Haller (1995), suggest mutual recognition through an international standard (see Amir, Harris, and Venuti 1993; Rees 1995; Chan and Seow 1996). Taking the more flexible approach means that company A located in country X accepts the accounting statements from company B located in country Y, which are prepared according to international standards and the requirements of country Y, and vice versa. In this way, the inconveniences a company faces in needing to adjust statements to the countries where it intends to quote are reduced and comparability advantages are achieved. In the opinion of these researchers, such mutual recognition ensures greater participation by domestic regulators in defining international standards, which should not alter or affect local standards.

Currently, IASB standards are considered the most appropriate for achieving international accounting harmonization; they are accepted for many capital markets. For example, by 2005, companies listed in the United States will be required to prepare their consolidated accounts based on these standards. Yet the International Organization of Securities Commissions (IOSCO) is also contributing by endorsing IASB standards. Thus, it is possible that the U.S. Securities and Exchange Commission may accept IASB standards in the future or convergence of the main standards (e.g., U.S. and IASB) is achieved.

Repercussions of Diversity for Companies

As entities that prepare and disclose information to report their position and communicate with interested users, companies are among the economic agents most affected by diversity of accounting principles at the international level. This becomes evident when one examines funding, development of competitive strategies, company valuation, and corporate management.

Funding. It is difficult to attract foreign investors because, if they are unfamiliar with the accounting principles of the country where the company is located, two unwanted situations may occur. The investor conducts a comparative analysis with other companies that leads to wrong conclusions, causing him or her to invest in another company. Or, confronted with information that can be analyzed and construed, the investor may decide to invest in domestic markets. Either case has negative consequences that prevent the firm from achieving its goal of attracting foreign capital. A similar problem arises when a company tries to acquire foreign financing.

Development of Competitive Strategies. Multiple accounting principles may also negatively affect a company's competitive strategies.³ Those responsible for developing strategies must assess their competitors' performance, a hard task even in a local scenario. The difficulty increases when foreign rivals are involved because strategy designers may be unaware of other firms' accounting rules. This could prevent a firm from accurately assessing its competitors' performance records, thereby resulting in a plan for a new strategy that could eventually generate competitive disadvantages for the company. However, the firm might also take advantage of these multiple accounting options and develop a suitable strategy.

Company Valuation. Accounting regulations may give rise to different company valuations, owing to the wide range of existing criteria. In many cases, taxes payable by the company on gross profits are determined on accounting benefits, which include income and expenditure items. Depending on how they are treated, they will influence results, either upward or downward, as in the case of amortization practices. Because taxes imply a cash outflow, this will be affected by accounting diversity. Therefore, if the market reacts to disclosed earnings or cash-flow statements, company valuation may be directly affected.

Conversely, differences in accounting criteria directly influence the amounts itemized on disclosed accounting statements that shareholders, financial analysts, and other users check before making decisions and recommendations. Disclosure of external information may directly influence estimates of a company's worth because they either affect the expected value of key variables used to prepare an assessment, or foster uncertainties and reduce data reliability because of the accounting diversity always present in the valuation process.

Corporate Management. Accounting regulations also influence decision variables used in corporate management and assessment-related aspects, such as compensation. Management decisions are affected, which, in turn, affect the company's performance, treasury movements, and other variables considered at the time of examining the firm's situation. Consequently, this situation has a new effect on the company because of accounting diversity.

3. In their study on the effects of accounting differences on corporate competitiveness between American and foreign corporations, Wells, Thompson, and Phelps (1995) found that certain aspects had a negative effect, while others had a positive one. Likewise, Comiskey and Mulford (1988) demonstrated the effects of applying certain accounting methods to the strategies a company adopted at the time of analyzing the impact of various accounting criteria on investments in other companies to determine whether to participate.

Effects of Accounting Diversity on Information Users

Several empirical studies have demonstrated how information needs, and therefore information sources within the same group of users, vary by country. Similarly, analytical methods vary at the international level (see, for example, Arnold, Moizer, and Noreen, 1984; Olbert, 1994; Capstaff, Paudyal, and Rees, 1995).

Any outsider wanting to assess a company's financial position needs to analyze, interpret, and understand accounting statements prepared and disclosed by that company. These statements usually originate in companies operating in business environments that differ from those of the user, and statements have been prepared under accounting regulations and practices different from those observed in the analyst's country. According to some researchers, application of accounting principles departing from a company's environment generates financial and economic indicators that are statistically different (see, for example, Lainez and Callao, 2000 and Whittington, 2000). This means that comparing indicators among companies from different countries may be too risky.

Even if applying other mechanisms to minimize the effects of diversity in accounting criteria and allow comparability improves decision processes, caution is required in judging the state of a company when only a few indicators are considered. It should be remembered that sizable differences in economic, social, and cultural environments in which the company operates may lie behind these indicators. In addition, it may be that the values assumed by the indicators cannot be effectively used to evaluate the corporate position or make decisions.⁴ Finally, because of accounting diversity, users examining a foreign corporation's situation should question whether it is more useful and appropriate to check the firm's original accounting data or some type of reconciliation based on them.

International Harmonization: Needs and Efforts

Because the inconveniences resulting from diverse accounting practices are mainly related to degree of comparability of financial statements, it is necessary to establish a mechanism to achieve sufficient comparability—that is, a progressive reduction in the variety of available accounting practices that corporations use to identify their economic and financial operations and a corresponding increase in comparability of in-

4. With regard to the importance of environment in understanding ratios for evaluating the company's performance or financial position, see Choi et al. (1983), Aoki (1992), and Willmott et al. (1992).

ternational accounting information. In this way, more companies facing similar circumstances will apply the same method to account for economic events or furnish additional information, allowing users to make any relevant adjustment.

There are many reasons for developing this process, given the potential benefits of having accounting information prepared and disclosed through homogeneous principles and practices. Among the most important are:

- The process would enable investors and analysts to understand accounting financial statements of the foreign corporations in which they wish to invest.
- The process would eliminate a major obstacle to smoother circulation of international investment and financing.
- Companies seeking new markets would not face higher costs to prepare and adjust accounting statements to practices accepted in a foreign country.
- For multinational companies, the positive effects would be especially enhanced by simplifying the consolidation of accounting statements of subsidiaries in various countries. Likewise, the training of managing staff in subsidiaries would become more homogeneous, which would improve geographic mobility.
- Multinational auditing companies would benefit from the simplification of tasks performed in countries where they operate.
- The measurement of taxable corporate profits payable by foreign companies would be simplified through a uniform set of standards to identify income and outlays at the international level, thereby facilitating the work of national tax authorities.
- Banking and related entities could provide a higher level of financing to foreign companies if corporate risk assessment and economic valuation depended on homogeneous standards for preparing international-level accounting statements.
- Appraisal of a company's competitiveness in international markets would be enhanced by the ease of identifying its corporate strategic position within a sector.
- Developing countries that lack a full-fledged accounting system could benefit from a homogeneous international system.

Along with multinational companies' efforts to offset difficulties in analyzing and interpreting accounting statements at a global level, since the late 1950s, an ongoing debate has centered on the need for and feasibility of setting international accounting standards. Such standards would consist of uniform or flexible criteria—either public

or professional—that reflect principles and regulations, as well as serve as a guide for preparing and disclosing financial information in different countries (see Rivera, 1989; Laínez, 1993; Nobes, 1989, 1990; Van der Tas, 1995; García Benau, 1995; García Benau and Garrido, 1995; Rahman, Perera, and Ganeshanandam, 1996; Scheweikart, Gray, and Salter, 1996; Cairns, 1994; Flower, 1997; Van Hulle, 1997; Hegarty, 1997; García Benau and Gandía, 1998; Harding, 2000; and Zorio, 2001).

Worldwide Harmonization Entities

Despite the inherent difficulties, accounting standards harmonization is not only a goal; it is also a series of actions put in motion by several international agencies. The sections below describe the tasks performed by the principal international institutions that have been working on standards or classifying reports according to scope (global or regional) and character (public or private professional).

Public Entities

Worldwide accounting harmonization efforts by public entities originated mainly in the United Nations (UN) and the Organization for Economic Cooperation and Development (OECD). The UN and its Special Intergovernmental Experts Task Force on International Accounting Standards and Reporting publish occasional reports on accounting issues associated with inflationary periods, pension-plan costs, joint partnerships, and (more recently) accounting developments in several countries. The Task Force has also addressed such specific problems as privatization, subsidies and other public assistance, leases, new financial instruments, and environmental accounting.

The OECD, through its own Task Force on Accounting Standards, has actively participated in providing technical assistance and advice to many countries considering accounting reforms, mainly in Central and Eastern Europe. Issues recently discussed are those related to environmental accounting and auditing, application of the “prudent man rule” among member countries, and financial instruments accounting.

Private Professional Entities

At the global level, two private organizations have convened professionals from various countries to achieve accounting harmonization in financial-information preparation, revision, and auditing: the International Federation of Accounting Councils (IFAC)

and the International Accounting Standards Board (IASB). IFAC's main objective is to achieve auditing harmonization with regard to technical, ethical, and professional training issues. IFAC assembles a large group of local professional organizations (currently, more than 150 from more than 100 countries). It has issued more than 60 standards and recommendations. Increasingly, its work is acknowledged by international organizations. There is a strong relationship between IFAC and IASB; until recently, the IFAC appointed 13 of the 17 members of the IASB managing council.

Conversely, IASB has focused on harmonization, mainly by issuing and publishing—through its International Financial Reporting Standards (IFRS)—criteria and procedures to prepare or disclose corporate financial information. The first stage of its evolution was marked by the issuance of highly optional standards, which simultaneously caused severe criticism and support. The second stage was characterized by an attempt to improve comparability of accounting statements at the international level by suppressing alternative criteria contained in the standards and replacing them with those considered preferential. The third stage involved efforts resulting from IASB-IOSCO agreements. For more information on the work of the IASB, see Nair and Frank, 1980; Evans and Taylor, 1982; McKinnon and Janell, 1984; Doupnik and Taylor, 1985; Doupnik, 1987; Nobes, 1990; Purvis, Gernon, and Diamond, 1991; Adams, Weetman, and Gray, 1993; Laínez, 1993; García Benau, Laínez, and Monterrey, 1996; Jarne, 1997; Chen, Gul, and Su, 1999; Laínez, Jarne, and Callao, 1999; Zorio and Garrido, 1999; Niskanen, Kinnune, and Kasanen, 2000; Street and Bryant, 2000; Street, Nichols, and Gray, 2000; Murphy, 2000; Lorca, 2000; and Zorio, 2001, 2002.⁵

Regional Harmonizing Organizations

Regional harmonizing organizations working in the public sphere include the European Union (EU), as well as various private bodies, including the European Federation of Accountants (FEE) and the Inter-American Accounting Association (IAA).

Public Sphere

Among public organizations with a regional scope, the EU continues to make the most relevant attempts (additional efforts are being made by LAC countries within

5. Because these tasks are described in the first section, only the three stages of their evolution are examined here.

the Mercosur area). As a regional model for accounting harmonization, the EU is unique. The need to bring together various national-legislation bodies led the EU to adopt a clear synthesizing position. Yet it encountered considerable difficulties, owing to deep differences in the legal and accounting systems of its member countries. Those discrepancies implied that European harmonization proposals would not be original because several issues needed to be resolved:

- Achieving a middle ground between the extremes of extensive legal regulation in some countries and scant regulation in others.
- Finding commonality between opposing approaches, both legal and professional, to accounting standardization.
- Defining the conditions of various pressure groups accustomed to the environment in which they operate (e.g., companies, accounting professionals, auditors, and lawyers).

Evolution of European accounting harmonization can be divided into three stages: early 1970s–1990, early 1990s–1995, and late 1995–present. During the first stage, a model was forged that dominated until recently. The above-mentioned difficulties and discrepancies generated a mainly descriptive approach to European accounting harmonization, although with regulatory implications and specifications that subjected criteria and standards, set by Accounting Directives, to a “true and fair-view” concept.

From a related perspective, European regulators have faced the dilemma of choosing between flexible and strict application of accounting standards. The choice involves two legal concepts: (1) the Anglo-Saxon, common law, which gives priority to content over form and entails the “true image” of a firm’s financial position as background and (2) the Continental, civil-law system, which entails a rigid legal structure regulating in detail every aspect pertaining to preparation and disclosure of accounting information, usually through accounting plans.

Given this dichotomy, the EU opted for an eclectic solution to its accounting harmonization process. In the new approach, the “true image” is key in matters of accounting information, as a preferential—as well as subsidiary—source for standards and a guideline in other aspects. But together with this idea, the EU incorporates a new set of standards conforming to a tightly-knit, uniform body, allowing it to adapt the “true-image” concept to the second position.

Finally, the dilemma of achieving comparability in accounting information versus responding to pressure to favor a certain degree of standard flexibility (so there is a choice among alternatives) has been present throughout the accounting-harmonization process. EU regulatory bodies have decided to take the second approach; that is, allow for wide flexibility in order to move toward achieving as many coordination goals as possible so that, at the next stage, this flexibility will be progressively reduced. This approach has produced many options, meaning that member states are free to decide among several criteria, depending on events or reporting areas.

Taking all of these extremes into consideration has produced a flexible EU accounting harmonization model. Yet this flexibility has made it difficult to achieve a high degree of comparability.

By the early 1990s, doubts about progress in European accounting harmonization had led European Community authorities and researchers to analyze the degree to which the Directives instrument had succeeded and identify changes required to improve financial-information comparability. Amid discordant opinions, it was considered that the Directives had been a useful tool for change because they had introduced a European dimension into accounting theory and practice. However, the strong nature of the EU-Directive process was questioned at a time of increasingly dramatic change. The 1990s, which began in an atmosphere of uncertainty, evolved into a second stage of harmonization, which lasted until the end of 1995.

This second stage started with a will to reduce the multiple options contained in the EU Directives. However, any attempt made in that regard always found opposition in certain countries. Therefore, it was impossible to reach a satisfactory agreement; thus, accomplishments at this stage were few. The results were both stagnation and de-escalation of the convergence process.

During this stage, the role played by the existing harmonizing model was acknowledged because it had helped to improve the quality of accounting information disclosed by most European companies, thereby increasing comparability between countries. However, problems caused by the high optionality of the Directives and lack of specific accounting treatments sparked an in-depth debate on the need to resolve deficiencies. By then, European companies looking for funds in non-European markets, especially the United States, were the most affected.

The need to adjust accounting statements from European companies to conform to information requirements set forth by other capital markets, specifically the New York Stock Exchange, forced them to prepare separate reports or reconcile certain accounting aspects. This process was complicated, costly, and put them at a competitive disadvantage. The EU, aware of the potential risk that firms might opt for American accounting standards, decided to modify its harmonizing policy and amend imbalances in financial information comparability among member states, which arose from the EU accounting Directives in question.

During the transition from the second to third stage, the EU modified its harmonization strategy. It chose to give up its own model and opted for a more active role in the international accounting-harmonization process supported by IASB to make European standards comparable to those of this supranational organization.

In the LAC region, actions developed as a result of the integration process initiated by Mercosur. This effort originated in 1990 as an association between Argentina and Brazil, with a view to Latin American integration. In March 1991, Argentina, Brazil, Paraguay, and Uruguay signed the Asunción Treaty, which officially established Mercosur.

The economic integration of public projects developed through Mercosur raised the accounting profession's awareness of the need to harmonize its standards. In 1993, the Mercosur Integration Group was created, encompassing:

- Argentine Federation of Economic Sciences Professional Councils (*Federación Argentina de Consejos Profesionales en Ciencias Económicas*),
- Argentine Federation of Graduates in Economic Sciences (*Federación Argentina de Graduados en Ciencias Económicas*),
- Paraguay's Accountants Association (*Colegio de Contadores*),
- Brazil's Federal Accounting Council (*Conselho Federal de Contabilidade*),
- Brazilian Accountants Institute (*Instituto Brasileiro de Contadores*), and
- Uruguay's Economists and Accountants' Association (*Colegio de Contadores y Economistas*).

Within this group, two subcommittees were formed. One was in charge of accounting standards, while the other was responsible for auditing. In addition to regular meetings and occasional workshops, in 1994, the group prepared a comparative analysis on accounting and auditing standards enforced in the four member countries. Based on

a 1996 document prepared by the Center for Scientific and Technical Studies (*Centro de Estudios Científicos y Técnicos*), under the Argentine Federation of Economic Sciences Professional Councils, the subcommittee analyzed accounting standards in each country and compared them to IFRS in terms of valuation and disclosure. Both analyses demonstrated that difficulties in the harmonization process within Mercosur arise from the various effects of tax regulation in each country and the divergent nature and scope of national regulatory bodies in charge of setting standards for preparing and disclosing financial information.

Professional Organizations

A number of mostly private organizations have recognized the need for mechanisms to reduce differences between accounting criteria and practices in various countries within their geographic areas. Chief examples are the following five organizations.

- *Federation of European Accountants* (FEE) was created in 1986 through a merger of the European Community's Expert Accountants Study Group and the European Union of Expert Accountants, Economists, and Finance Professionals. One of its objectives is to monitor improvements and harmonization processes in the European accounting professional practice in the public and private sectors. As described by Lorca (2000), FEE includes 38 professional associations from 26 countries. This includes the current 15 EU members, plus Cyprus, Czechoslovakia,⁶ Hungary, Iceland, Israel, Malta, Monaco, Norway, Romania, Slovenia, and Switzerland. It represents more than 375,000 members, which explains its great influence, despite its professional character, on the stage of the European harmonization process.⁷
- *Inter-American Accounting Association* (IAA) was created in 1949 by the First Inter-American Accounting Conference. Its main goals are to harmonize accounting practices, terminology and training and bring together auditing professionals throughout the Americas. One of its main tasks is to issue the Generally Accepted Auditing Standards, which are submitted for approval to successive Inter-American Conferences, with a commitment from member organizations to put them into practice in their countries. IAA represents 27 organizations from 23 countries and has more than 500,000 members.

6. Afterward, Czechoslovakia split into the Czech Republic and Slovakia.

7. In Kiev (1999), the Commonwealth of Independent States (CIS) established the Regional Federation of Accountants and Auditors "Eurasia." It assembles professional associations representing 10 out of 12 CIS republics (Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kirghizstan, Moldavia, Russian Federation, Ukraine, and Uzbekistan).

- *African Accounting Council* was established in 1979 by 23 member countries of the Organization of African Unity following a comparative study on local accounting practices, with a view to develop a referential African accounting system. The Council established several country committees and organizations to accelerate accounting standardization and harmonization.
- *Confederation of Asian and Pacific Accountants* was founded in 1976 on the occasion of the Eighth Asian Conference on Accounting. It groups professional associations of more than 20 economies, ranging from Hong Kong, New Zealand, and the Philippines to the United Kingdom. Its objective is to hold periodical meetings in order to coordinate the actions of accounting professionals in the Asia and Pacific region. Currently, it handles accounting standards harmonization in these countries.
- *Accountants' Federation*, within the Association of Southeast Asian Nations, was created in 1976 by Indonesia, Malaysia, Philippines, Singapore, and Thailand. It pursues recognition and enhanced reputation for professionals, as well as reconciling differences over accounting principles and practices among member states. To achieve this goal, the Federation relies on IASB work; thus, IFRS have been in general use throughout the region. Indonesia, Malaysia, and Singapore have adopted the IFRS; Thailand applies standards based on them; and the Philippines, traditionally under U.S. influence, has its own set of standards.

International Accounting Standards in LAC and Europe

This section summarizes efforts by selected countries in LAC, as well as Europe, to adopt international accounting and auditing standards.

Argentina

A basic feature of Argentina's accounting model is the relevance that regulators give to professionals. They are grouped into powerful associations, councils, and institutions. This fact, among others—such as outside influences—reflects the strong need to preserve high-quality information in a volatile monetary environment.

Indeed, one peculiarity of the Argentine accounting system is the economic environment in which it has been operating, particularly high inflation rates. This problem

exceeded the scope of business legislation, causing professionals to implement actions to restrict, to the extent possible, distortions the situation caused companies in preparing their accounting statements. However, by the early 1990s, the Stabilization Plan and the pegging of the peso to the U.S. dollar lowered inflation to 0 percent, or even negative rates.

Nevertheless, at the beginning of 2002, a new economic scenario emerged after the peso-dollar peg was abandoned. This required professional organizations to devise new accounting tools to explicitly address such issues as inflation or exchange rate differences resulting from items in foreign currency.

However, Argentina has not been isolated from the international accounting-harmonization process. The country adopted IASB standards as references in accounting-regulation matters and IFAC standards in auditing matters. New technical resolutions were passed on accounting matters that involved clear harmonization vis-à-vis IFRS. With regard to the accounting profession, particularly auditing development, no major differences can be found with respect to IFAC rules and regulations affecting techniques and procedures. With regard to ethical standards or professional training, Argentine regulations are in line with international parameters.

Clearly, Argentina has experienced a process of adjusting to international standards. The specific characteristics of the country and its environment should be considered for appropriate application of regulations and resolution of any conflicts within the framework of the Argentine Federation of Economic Sciences Professional Councils.

Brazil

Brazil's accounting experience is not extensive, because, until the mid 1970s, the main objectives of an accounting information system had not been specified. For that reason, valuation and information standards developed informally, with a clear bias toward fiscal, rather than accounting, criteria.

Over the past two decades, the Brazilian accounting model has undergone a strengthening process, coinciding with the progressive development of the capital market and transparency. Though IFRS have not yet been fully adapted, most Brazilian standards are in line with international practice. Currently, professional and government

organizations are pursuing establishment of a task force to begin the formal process of adapting Brazilian standards to international ones.

The country's current structure of accounting regulations results in poorly developed descriptive and technical components because the regulatory approach is left to technical interpretations, which are few. This fact somewhat clashes with the IFRS approach, which involves relevant descriptive components. Likewise, the global adjustment of international auditing standards will require a comprehensive revision of Brazilian standards. Finally, the approval of international standards in Brazil will require an evaluation, considering the country's peculiar circumstances of how to adjust them for application in the Brazilian environment.

Chile

In Chile, the most important organization representing the accounting trade is the Accountants' Association (*Colegio de Contadores de Chile*), which is in charge of issuing accounting standards. Nevertheless, regulatory bodies are responsible for issuing accounting standards within their areas. For example, the Securities and Insurance Superintendency (*Superintendencia de Valores y Seguros*) is in charge of stock-exchange capital markets.

The Accountants' Association, through its respective committee, has issued 70 standards, embodied in the so-called Technical Bulletins. Over the years, such rulings have been influenced by several factors. Thus, Chilean accounting regulations have clearly evolved alongside the country's economic development, underscoring the need to advance the international-harmonization process.

Until the mid-1990s, Chilean regulations followed the standards of the U.S. Financial Accounting Standards Board because most economic activities were with the United States. During 1995–1997, a rapprochement of professional associations and regulators to IASB standards occurred. Since then, local standards have been set using these standards.

However, much work remains to accomplish harmonization. Stock-market regulators consider harmonization a key element since a basic tenet is that decision makers be fully informed in order to act efficiently. For companies, accounting harmonization

facilitates internationalization. For investors, it makes analysis and interpretation of accounting information easier.

On the road to harmonization, Chile expects to lessen differences between its standards and IASB, starting with those considered most relevant. It should be noted that, since 1997, under a Chilean regulation, international standards are considered valid if a local standard is lacking.

Peru

In Peru, the General Corporations Act (*Ley General de Sociedades*) establishes that company financial statements should be prepared according to relevant legal provisions and generally accepted accounting practices. According to the National Accounting Office (*Contaduría Pública de la Nación*) and its executive branch, the National Accounting System (*Sistema Nacional de Contabilidad*), both within the Economy and Finance Ministry, these principles include:

- IASB standards, made official through resolutions issued by the Accounting Regulatory Council (*Consejo Normativo de Contabilidad*) and
- Regulations issued by controlling and supervisory organizations (provided that they fall within the IFRS theoretical framework).

Whenever an event or aspect is not contemplated in IASB standards, the American standards (i.e., U.S. Generally Accepted Accounting Principles or U.S. GAAP), are applicable.

Peruvian accounting is currently governed by IASB standards; they have been fully adopted and have become the country's official accounting standards. The National Accounting Board has approved IAS 1 through 41.

Similarly, with regard to auditing regulations, the Federation of Public Accountants' Associations (*Federación de Colegios de Contadores Públicos*), institution that regulates independent accountants' practices, has recommended the adoption of auditing standards that were issued by the International Auditing Practices Committee (IAPC) (the Federation has made them official). At present, the standards in force are those IAPC published in the *IFAC Handbook 1998 Technical Pronouncements*. Clearly, Peru has decided to look to international pronouncements to regulate accounting and auditing

matters, leaving the door open to U.S. GAAP only when international standards do not contemplate a specific accounting procedure (i.e., exception).

Jamaica

The case of Jamaica demonstrates that accounting models and the changes they undergo result directly from the environmental influences in which they operate. The country's most recent amendments have resulted from emerging situations in the accounting environment.

The financial crisis of the late 1990s was a key factor behind changes in the Jamaican regulatory model. This crisis revealed that the framework of accounting regulations was not well adapted to the economic and financial environment. Deficiencies in the structure of corporate and accounting regulations played a key role.

Although this crisis especially affected financial and insurance entities, bringing about changes in that area, there was also a restructuring of the general legislation, including a new Companies Act. Based on aspects specifically related to the Jamaican accounting model and its standing regarding the international harmonization process, the most relevant fact is that Jamaica was to have adopted IFRS by July 1, 2002, as well as international standards on auditing practices (ISA).

It is becoming more common for Caribbean countries in general to adopt IASB guidelines as national accounting standards. In Jamaica, this trend was especially relevant because the country depends highly on foreign investment. There is no doubt, then, that the adoption of international standards generates special and significant benefits, despite major changes that will modify the criteria for preparing and disclosing accounting information.

Unlike what has happened with accounting standards, adoption of international auditing standards has not significantly affected current practice because most of these standards had already been introduced by international auditing companies or through local rulings. Therefore, it is clear that Jamaica underwent an adaptation and improvement process in its business regulatory framework. One key factor is the adoption of international standards, for both accounting and auditing matters, which will ensure higher-quality financial information.

Europe

The new approach adopted in the process of European accounting harmonization is reflected in the 1995 EC communication, entitled *Accounting Harmonization: A New Strategy vis-à-vis International Harmonization*. In this document, the Commission stated its views on the best ways to resolve issues raised in the common harmonization process; its perspective was based on 20 years of experience with a model that proved inadequate for tackling problems of information comparability within the European environment. The new strategy adopted by the European Commission (EC) takes, as a reference, the IASB standards.

After several comparability studies between Directives and IFRS, the EC issued a new communication in June 2000 entitled *EU Strategy in Financial Matters: The Way to Go*, wherein the European position is consolidated as outlined in 1995. This communication considers it critical to provide an internationally accepted, financial information framework for EU companies listed on stock markets, and it endorses the IASB approach (over the U.S. GAAP). Likewise, 2005 is established as a deadline for EU-listed companies to prepare their consolidated annual accounts pursuant to IFRS.

Regarding unlisted companies and individual accounts, the EC states that all member states will decide whether IFRS application should be extended to them. Still, the Commission indicates that it would be desirable to foster use of such standards.

In February 2001, the EC submitted a proposal to the European Parliament and European Council regarding the IFRS application. In 2002, this regulation was approved by the European Parliament and ratified by the Council.

Currently, IFRS are being adopted in the EU, as well as at the local level, with the 2005 deadline in mind. In Spain, the *White Book of Accounting*, published in July 2002, analyzes the evolution of the regulatory accounting model in use, and sets the basis for a reform that would allow Spanish corporations to adopt international standards (see chapter 4).

Obstacles to International Accounting Standards Adaptation

Obviously, harmonization faces a number of obstacles on the path to attainment, especially because accounting systems are a product of their environment. The process

of accepting IASB standards in various countries raises a number of issues that must be resolved. First, the existence of several options within IFRS may lead to a merely formal harmonization, which may not be reflected in fact. The selection of applicable criteria by corporations in each country would be key to accomplishing the harmonization of accounting information prepared and disclosed by companies, which should be the ultimate goal.

A second issue involves selective or extensive application of international standards. Although attaining accounting harmonization may be considered an objective of general interest, a certain type of corporation may regard this objective as more desirable and necessary than will others—the so-called global players or corporations that do business and seek financing beyond national boundaries. This is the type of firm that is experiencing problems with lack of homogeneity in accounting information on one hand, and comparability on the other. On the contrary, small- and medium-sized companies, especially those not involved in international operations, may view implementation of a new accounting model as a cost without a benefit.

Within this context, there are examples, such as the EU experience, of opting to require application of IFRS for companies listed in stock markets and their consolidated accounts, with a 2005 deadline. Each member state must define levels of compliance for other types of companies.

Third, the role of national regulatory entities must be redefined within a framework whereby accounting standards are developed by an organization—the IASB—with assistance from national entities, whose decision-making occurs in a more limited environment.

Fourth, capital markets' level of acceptance of IFRS is critical since most problems created by comparability of lack of information are reflected in those markets. One should recall the recommendations IOSCO issued in 2000 to domestic stock and securities commissions, regarding the validity of adopting IAS criteria for meeting their information requirements. Despite the markets' increasing acceptance of international standards,⁸ one should wait a reasonable period of time before evaluating their effect.

Fifth, historically, the position of the United States in relation to international standards has been critical. Still, a clear degree of "rapprochement" has recently been detected and a process of convergency of U.S. and international standards is now underway

8. More information can be found at www.iasb.org.

(see Masci and Sotomayor in Chapter 2). Accordingly, one must not forget that American stock exchanges are the most attractive markets when it comes to seeking international financing; at the same time, they are the toughest regarding information requirements, especially for foreign companies. The recent IASB reform has led to more professionalism and collaboration with domestic organizations and stock markets. That may be a catalyst for a favorable pronouncement from the Securities and Exchange Commission, with respect to IFRS acceptance.

Sixth, the work of regional harmonizing organizations, such as Mercosur and the EU, may fade as international standards become more generally accepted. In this case, adequate coordination among agencies pursuing harmonization will be imperative so that their roles can be clearly defined.

Seventh, the validity of international standards has been questioned in various environments, especially those whose accounting philosophies lack the Anglo-Saxon, common-law approach, which forms the basis for international standards, or those with low economic development (see Samuels and Oliga, 1982; Belkaoui, 1985; Hove, 1986; and Hoarau, 1995).

Clearly, one key aspect for successful acceptance of IFRS is their validity beyond significant differences in their application in the various countries. This validity is reflected in all factors that may influence creation of an accounting system, but are not part of it. These include the legal system, level of economic development, and cultural aspects.⁹

The main components of the accounting environment can be summarized as follows:¹⁰

- *Legal system.* The influence of the legal system on the accounting environment is marked by traditional differentiation between two models: common law, whereby basic regulations are dictated by the accounting profession, rather than the law, and Roman or civil law, whereby regulations are developed mainly in trade, business, and corporate laws and accounting plans.
- *Main provider of corporate financing.* A corporate financing model concentrated on a certain core group will, to a great extent, handle information in order to satisfy the needs of the provider.

9. Within this context, Nobes (1989) links differences between accounting systems and their specific legal and social environments with difficulties in supporting accounting harmonization. Obstacles can also be found in accounting nationalism, language differences, and levels of professional development.

10. Jarne (1997) offers a synthesis of factors that shape the accounting environment and work developed during the past three decades.

- *Accounting nationalism.* In the modern world, nationalist trends are commonplace. They cover values inherent in a country or area, including accounting traditions.
- *Corporate organization.* The structure of business organizations, particularly various forms of ownership, also have a significant influence on the development of accounting models. Separation of ownership and management created the need for more accounting information to be sent abroad. Likewise, since company size varies—the interests of large or multinational corporations (they usually have several product lines and foreign investments) will differ from those of small- and medium-sized companies—the accounting system should be able to respond to specific needs.
- *Level of stock-market development.* The degree of market sophistication will create a demand for accounting information that is useful to individual investors' decision-making.
- *Cultural factors.* Because cultural factors and accounting-system characteristics are linked, it is possible to explain, for example, differences between Anglo-American and Continental-European accounting systems in terms of their cultural environments.
- *Fiscal influence.* Fiscal factors' influence on accounting matters involves the degree to which tax regulations determine accounting valuation practices, especially those related to assessment of income and expenses.
- *Main users of accounting information.* The presence of various users allows them to push for information prepared and disclosed by companies in a way that satisfies their needs.
- *Accounting profession's level of development.* A highly developed practice will cause accounting professionals and their associations to exert a strong influence on a country's standardization process. For this reason, a key factor of these professionals is their degree of sophistication, not merely their practice of the profession.

The relationship between accounting systems and their environment has been analyzed by many researchers. These include Fantl (1971), Mueller (1971), Choi (1974), Frank (1979), Nair and Frank (1980), Belkaoui (1985), Amenkhienan (1986), Goodrich (1986), Gray (1988), Belkaoui and Picur (1991), Salter (1991), Salter and Doupnik (1992), Nobes and Parker (1991a), and Laínez and Jarne (1999).

Finally, the process of international harmonization faces sizable obstacles on its way to becoming effective. These are mainly related to existing differences in other social, economic, legal, and cultural factors. Country peculiarities may justify the persistence of accounting differences; however, their elimination is a difficult task.

Conclusion: The Future of the International Process of Harmonization

As stated above, a major challenge in achieving accounting harmonization is the presence of substantially different environments at the international level. This obstacle is difficult to overcome because it would be absurd to undertake the homogenization of the economic, social, political, and cultural structures that predominate at local levels.

Therefore, to achieve eventually comparable accounting information at the international level, policymakers and practitioners must acknowledge such environmental diversity. In light of the harmonization methods addressed in this chapter, the first consideration for the adoption of IASB standards is that this situation must be considered and interpolated in any process.

The new IASB structure includes professionals associated with 7 of the 14 national regulatory bodies in the member countries.¹¹ This can help in considering existing local idiosyncrasies at the time treatments for resolving problems are evaluated for appropriateness.

In this context, another useful action would be for national or regional regulators (e.g., EU) to assess the validity of criteria supported by IASB standards in relation to each area's specific circumstances, acting as a filter for the effective application of IFRS. Nevertheless, such a course of action may lead to a piecemeal adjustment of international standards, thereby critically reducing harmonization levels.

Even when it can constitute an important obstacle, heterogeneous environments should not impede advances in the international accounting-harmonization process. Accordingly, IASB has opted for quality, an interesting course of action. Perhaps it will be the key to the final global acceptance of international standards.

In the new articles of the IASB Constitution, redefined objectives incorporate the quality concept, which refers to both accounting standards and information resulting from their application. They state that the Board is committed to:

11. Currently, there are members linked with regulatory entities from Australia, Canada, France, Germany, Japan, New Zealand, United Kingdom, and United States.

- Developing a single set of high-quality, understandable, and enforceable global accounting standards, in the public interest, that require high-quality, transparent, and comparable information in general-purpose financial statements and other financial reporting to help participants in world capital markets and other users make economic decisions;
- Promoting the use and rigorous application of those standards; and
- Fostering convergence of national accounting standards and IFRS toward high-quality solutions.

The achievement of these objectives will no doubt be an important step toward the general use of IFRS and the convergence with U.S. standards. The rigor of financial standards is a pillar of capital markets as Arthur Levitt, former president of the Securities and Exchange Commission, stated “The success of capital markets depends entirely on the quality of their accounting and financial information disclosure systems. If supported by high-quality standards, they build trust among investors” (Levitt, 1998).

Clear and uniform accounting practices are among the other aspects to be considered,¹² being one of the most relevant issues for a high-quality regulatory framework. In a first stage, the harmonization process was based on maintaining a high level of flexibility to promote at least a harmonizing culture, even though accomplishments were not significant.

The second stage, in the early 1990s, which featured the Comparability Project developed by IASB, reduced optionality in accounting practices to achieve greater comparability and meet the needs of a variety of users for accounting information in the international environment. Today and in the future, efforts must be focused on reducing the optionality still present in IASB standards, endorsing a single accounting treatment for various areas, and therefore eliminating one of the two treatments—preferred and allowed—that currently co-exist in most IFRS.

Another key aspect for international-standards implementation in various countries is its compliance control. In this sense, auditing tasks and the work of national regulatory entities become especially relevant. With regard to auditing—and despite recent problems affecting that function—it is obviously one of the most important guarantees for effective compliance with accounting regulations in general and international standards in particular.

12. Examples include relevance, trustworthiness, and cost-benefit analysis.

Likewise, international regulatory entities, besides generating the legal and procedural tools needed to integrate IFRS into their regulatory schemes, must be in charge of their appropriate application. At the same time, other issues related to the above-mentioned problems must be resolved; these include scope of application of international standards, their acceptance in the United States, and their validity in stock markets.

All of these aspects underscore the need for caution in evaluating the results of the harmonization process and adopting the IFRS. Nevertheless, one must be optimistic about emerging perspectives on accounting information in the international context.

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