

REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC)

Mexico

ACCOUNTING AND AUDITING

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Executive Summary

The last decade has witnessed the sustained efforts by Mexico for the convergence of its generally accepted accounting principles (GAAP) toward International Accounting Standards (IAS). Since 1995, Mexican GAAP have required the subsidiary use of IAS, such as in those areas where no national standards existed. Subsequently, several pronouncements have been issued in areas not previously covered by Mexican GAAP. With the recent establishment of an independent national accounting standardsetter, further steps should be initiated toward enhanced alignment with International Financial Reporting Standards.

Mexican generally accepted auditing standards (GAAS) are well developed, although steps are needed to further harmonize them with International Standards on Auditing (ISA). A strengthening of the code of ethics—consistent with the recent proposals of the International Federation of Accountants—is also needed, which has led to the Mexican Institute of Accountants recently taking steps toward achieving that goal.

The review of accounting and auditing standards and practices in Mexico, which forms the basis of this report, placed specific focus on the strengths and weaknesses of the institutional framework that supports the corporate financial reporting system in the country. In that context, specific emphasis was placed on the quality and consistency of academic curricula for public accountants, as well as on existing arrangements for the licensing of auditors.

This report offers several policy recommendations aimed at improving the accounting and auditing regulatory framework. An important aspect is the strengthening of enforcement mechanisms for ensuring compliance with accounting and auditing requirements and auditors' professional code of ethics; in this context, a recommendation has been made for the establishment of an independent oversight body for the audit profession.

This report was prepared by a staff team from the World Bank on the basis of the findings from a diagnostic review carried out in Mexico through October 2003. The staff team comprised M. Zubaidur Rahman (OPCFM), Luis Schwarz and Henri Fortin (LCOAA). The review was conducted through a participatory process involving various stakeholders and led by the country authorities.

I. INTRODUCTION

1. The review of accounting and auditing practices in Mexico is part of the World Bank and the International Monetary Fund (IMF) joint initiative on Reports on the Observance of Standards and Codes (ROSC). The review focused on the strengths and weaknesses of the accounting and auditing environment that influence the quality of corporate financial reporting. It used the International Accounting Standards (IAS)¹ and the International Standards on Auditing (ISA) as benchmarks, and involved a study of both mandatory requirements and actual practices.

2. Particularly since the signing in 1993 of the North American Free Trade Agreement (NAFTA), Mexico's economy has benefited from globalization. However, with the emergence at an international level of new competitors, such as China, one of the challenges facing Mexico's export-oriented, industrial sector is its ability to access financing. To that extent, the deepening of its capital markets and a further enhancement of transparency in the corporate sector play important roles in Mexico's economic development. This is particularly true for small and medium enterprises (SMEs), which need further formalization and integration in order to be able to compete at international level.

3. Historically, Mexico's accounting and auditing practices have been influenced by the United States' generally accepted accounting principles (GAAP) and generally accepted auditing standards (GAAS). The main reason for this trend has been the importance of foreign direct investment from the United States, as well as a trend among large Mexican publicly traded corporations to seek listing in the world's largest stock exchanges. The pace of such trends has accelerated since NAFTA. However, acknowledging that the rules issued by the Financial Accounting Standards Board in the United States did not always meet the needs of Mexican stakeholders and users of financial statements, the national standardsetters have also looked for "principles-based" IAS as a reference for upgrading Mexican GAAP.

II. INSTITUTIONAL FRAMEWORK

A. Statutory Framework

4. **The accounting and financial reporting requirements are prescribed under various legal arrangements.** The General Law for Commercial Enterprises (*Ley General de Sociedades Mercantiles* or LGSM) contains only general rules on the form of the financial information provided to shareholders. The Securities Market Law (*Ley de Mercado de Valores* or LMV) requires listed companies to prepare consolidated financial statements in accordance with the accounting standards approved by the National

¹ Within this report, IAS is used to mean all standards and related interpretations issued by the former International Accounting Standards Committee (IASC); and the International Financial Reporting Standards (IFRS) issued by the successor to IASC, the International Accounting Standards Board (IASB), and related official interpretations.

Banking and Securities Commission (*Comisión Nacional Bancaria y de Valores* or CNBV). In turn, the CNBV's *Circular Única de Emisoras* of 2003 recognizes the accounting standards issued by the Mexican Institute of Public Accountants (*Instituto Mexicano de Contadores Públicos* or IMCP), commonly referred to as "Mexican GAAP." Moreover, in various regulated industries, such as banking, brokerage firms, insurance, and pension fund administration, Mexican law empowers the respective regulatory agencies with the responsibility of setting accounting standards for both regulatory and general purposes. For instance, the CNBV has issued various circulars—recently nos. 1448 and 1488—setting out detailed valuation and recognition methods, as well as presentation and disclosure requirements to be applied by banks. Similarly, insurance companies are required to apply the accounting rules set out by the National Insurance and Surety Commission (*Comisión Nacional de Seguros y Fianzas* or CNSF) in several circulars (nos. S-16.1.3, S-16.1.5, S-17.1, and S-18.3).² As a consequence of the aforementioned legal arrangements, general-purpose financial statements of banks or insurance companies do not conform to Mexican GAAP in certain areas specific to the respective regulated activities or not explicitly covered by Mexican GAAP.³ Accordingly external auditors systematically include a paragraph in their report on the financial statements of banks or insurance companies emphasizing on the difference between accounting standards applied and Mexican GAAP.

5. There are additional financial reporting requirements for listed companies. Under the CNBV's *Circular Única*, listed companies must provide CNBV with audited annual financial statements prepared in accordance with Mexican GAAP no later than three working days after approval by the annual general shareholders' meeting. Unaudited quarterly financial statement must be filed within 20 (for first, second and third quarters) or 40 (for the last quarter) subsequent working days. Also, by June 30 of the following year, listed companies must provide an annual report in a CNBV-prescribed format to the securities regulator and to the Mexican Stock Exchange for communication to the public. This standardized report, which is published on the CNBV Website, generally provides more detailed information than the company's annual report.

6. In addition to domestic reporting requirements, approximately 40 Mexican listed companies are also registrants in the United States. These listed companies are therefore subject to the U.S. Securities and Exchange Commission (SEC) reporting requirements. When filing their Mexican GAAP-based financial statements with the SEC, these registrants are also required to reconcile Mexican GAAP to U.S. GAAP. The ROSC review noted one Mexican registrant filing IAS-based financial statements with the SEC and also including reconciliation to U.S. GAAP.

² Another separate, regulated activity is that of pension fund administrators where the self-regulated agency (CONSAR) also issues sector-specific accounting rules.

³ These areas might include consolidation of non-banking subsidiaries, recognition of certain transactions directly through equity, valuation of loan loss provisions, insurance liabilities, presentation of the financial statements, treatment of acquisition costs for insurance contracts, or valuation of property.

7. **Audit of general-purpose financial statements is mandatory for all entities subject to the supervision of a regulatory agency.**⁴ Among public-interest economic entities, auditors are appointed and terminated by the board of directors; the shareholders do not play any role in this regard. In order to be appointed as auditors of a company within any of the aforementioned regulated activities, public accountants must be registered with the corresponding supervisory agency. In the case of the CNBV, registration requires that the public accountant be certified by the most representative body in terms of number of members in the accounting profession.⁵ In the case of the CNSF, the regulator requires professional experience in the regulated field, and registration must be renewed periodically; moreover, the Law on Insurance Companies requires external auditors to be certified by the relevant professional body for audits of financial statements issued after January 1, 2004. The agencies have legal power to dismiss or impose other administrative sanctions to auditors of entities under their respective supervision for violation of applicable accounting, auditing, and reporting rules and standards. To date, there is no known case of exercising this power. Specifically for insurance companies, there is an additional requirement for an external actuarial audit to be performed by an independent, licensed actuary registered with the CNSF upon which external auditors rely for drawing their conclusions with respect to technical provisions on insurance contracts.

8. **Under federal tax law, enterprises over a certain size⁶ must file their annual financial statements with the federal tax authorities together with an independent auditor's report (*dictamen fiscal*).** Such tax-purpose audit requirement is separate from those applicable to listed companies, banks, insurance and other regulated companies. The licensed professional public accountants (*contador público*) who intend to carry out tax-purpose audits need to register with the *Administración General de Auditoría Fiscal Federal*, a division of Mexico's Internal Revenue Department. Any practitioner affiliated with a colegio of public accountants is eligible for inclusion in the list of qualified auditors maintained by the taxation authorities. If the taxation authorities are not satisfied with the performance of any of the auditors, their names may be struck from the list. Also, the taxation authorities have power to impose civil and criminal penalties against those auditors who provide misleading certification with regard to the accuracy of taxable profits. In practice, such tax-purpose reporting requirements tend to exert influence over the accounting methods followed by small and medium entities, while public-interest entities seem to better distinguish tax accounting rules from GAAP. The use by listed companies of deferred taxation accounting, which was noticed as part the ROSC review of financial statements, tends to confirm the existence of such proper separation.

9. **The company law requires that shareholders appoint a *comisario*.** As per requirement of the LGSM, a *comisario* is appointed at the annual general meeting of

⁴ CNBV for listed companies, brokerage firms and banks; CNSF for insurance companies and guarantee issuers; and CONSAR for pension funds administrators (*afores*).

⁵ Currently the IMCP. Refer to paragraph 18 on the issue of certification.

⁶ As measured by the following indicators (for 2003): annual gross revenue in excess of 27.5 million Mexican Pesos; total assets in excess of 55 million Mexican Pesos or at least 300 employees who worked every month during the previous year.

shareholders and is given responsibility to protect shareholder interests. This individual, for whom no professional title of any kind is required, attends board meetings without voting right, is authorized to call a shareholders' meeting, and has full access to company information. At each annual general meeting, the comisario is required to deliver a report with respect to the accuracy, adequacy, and rationality of financial and other information presented by the board of directors, including an opinion on whether appropriate accounting policies were followed in preparing the financial statements. Within publicly traded companies, minority shareholders who collectively hold more than 10 percent of the outstanding stock have the right to appoint a second comisario. Comisarios are subject by law to personal criminal and civil liability for violation of prescribed duties, though lawsuits against them have been relatively infrequent. Nonetheless, Mexican practitioners usually view the risk attached to the mandate of comisario as greater than that borne by external auditors. For that reason, to be able to adequately fulfill his or her duties with respect to rendering an opinion on the financial statements, the comisario is generally a partner of the same accounting firm that conducts the external audit, but usually not the same individual who acts as signing audit partner, as recommended in the code of best practices issued by the CNBV. As a result, within publicly traded companies and other regulated entities where external audit is mandatory, the comisario appears in effect to often act more as a quality controller of the independent auditor's work, rather than to effectively exercise separate oversight of the fairness and accuracy of financial statements.

10. **The top management, board of directors, and comisario of an enterprise are susceptible to civil liabilities for material misrepresentations in the financial statements.** Applicable business law prescribes civil penalties for negligence, transgressions, and fraudulent acts committed by top management, the board of directors, auditors and the comisario. The CNBV and the CNSF, under administrative authority granted by the law, can impose sanctions on the responsible management, board of directors, and comisarios for violations of the accounting, reporting, and auditing requirements in preparing and presenting the financial statements of the entities supervised by these two regulators.

11. **There is a legal requirement for publication of financial statements.** Once the financial statements of a company receives approval at the annual general meeting of shareholders, a complete set of these financial statements including the comisario's report is required to be published within 15 days in the official gazette of the city where the company is located. Listed companies, banks, and similar financial institutions should also publish a set of consolidated financial statements. The CNBV and the CNSF require their regulated entities to file annual audited financial statements and quarterly unaudited financial statements within specific time limits.

B. The Profession

12. **The IMCP is the prominent self-regulated institution overseeing the accountancy profession in Mexico.** Under article 5 of the Mexican Constitution, professional associations have been established to regulate their respective fields of

activity. Within that framework, colegios (societies of public accountants) have been established throughout the country.⁷ Those colegios in turn have delegated their regulatory capacity to the IMCP, which represents approximately 85 percent of affiliated public accountants in the country. In the recent past, other institutions, such as the *Federacion de Colegios de Contaduría Pública de México* or the *Federación Nacional de la Asociación Mexicana de Colegios de Contadores Públicos*, have been created as a result of a split from the IMCP.

13. **The IMCP is authorized to issue accounting and auditing standards, and a code of ethics for practicing accountants—including auditors.** The IMCP is also empowered to conduct investigations in response to complaints against its members and impose sanctions (through the Honorary/Disciplinary Committee); oversee professional conduct of its members; and establish continuing professional education requirements. The IMCP was one of the founding members of both the International Accounting Standards Committee in 1973—of which it remained an active member until that institution was succeeded by the IASB in 2001—and the International Federation of Accountants (IFAC) in 1977.

14. **Professional indemnity insurance for auditors is not required by law.** Some practicing auditors who work for affiliates of international firms in Mexico are covered by professional indemnity insurance arranged through the international network.⁸ There is no legal provision in the country specifying statutory auditor’s liability (contractual, civil, and/or criminal) for unlawful conduct in the course of discharging professional responsibilities. This has created an environment of unconcern toward risks of malpractice suits by auditors who, as customary in Mexico, do not have professional indemnity insurance. Up to now, there have not been any known cases of lawsuits against auditors. This can be partly explained by the fact that, under Mexican law, claimants in such cases would have to demonstrate not only the damages suffered by them as a result of misstatements in audited financial statements, but also gross professional negligence or willful misconduct on the part of auditors.

15. **IMCP’s Code of Ethics is currently being reviewed toward alignment with IFAC’s Code.**⁹ The Code of Ethics for professional accountants in Mexico was issued in 1925 and revised several times up until October 2001. It focuses on principles to be followed by practicing accountants and does not contain implementation guidelines similar to IFAC’s guidelines. An exposure draft, which was circulated to the profession in July 2003, proposes expanding the standards applicable to independent auditors regarding conflicts of interest. The first three pages of the Code of Ethics establish 12 “postulates” governing the scope of the Code and the fundamental principles of the public accountant’s professional behavior and conduct. Although “responsibility toward the society” is emphasized through postulates II to V, the notion of public interest is not

⁷ There are currently 61 colegios federated under IMCP.

⁸ The international network affiliates audit almost all listed companies in Mexico.

⁹ An exposure draft for a revised Code of Ethics for Professional Accountants has been recently distributed for comments by IFAC. It plans for, among other changes, the adoption of a framework and principles-based approach, and provides additional guidance for implementation of the principles.

promoted as a distinguishing mark of the accountancy profession. Also, postulate VIII, which states “loyalty owed [by the public accountant] to the one who pays for his/her services,” is ambiguous to some practitioners to the extent that it appears to contain some degree of client advocacy, and therefore requires clarification. The Executive Board of the IMCP, which was designated for the period 2003-2004, has indicated that it intends to fully review the current Code of Ethics in the near future to align it with IFAC’s.

16. **The four largest internationally affiliated accounting firms dominate the audit market.** The majority of the listed companies, banks, and insurance companies are audited by the local affiliates of the four largest international firm networks (“Big-4”). There are some 200 companies listed on the Mexican Stock Exchange of which about 80 percent are audited by the Big-4, and the remaining companies are audited by about 10 accounting firms that are associated with the second-tier international accounting firm networks. The other small accounting firms mostly perform bookkeeping services and tax-compliance audits.

17. **There is a need to further enhance the level of the accountancy profession in Mexico.** The number of public accountants is estimated at 200,000, with the majority working in business or government. A license of public accountancy is awarded to students who have fulfilled an academic curriculum corresponding to that of a bachelor’s degree from one of the several universities supporting such curriculum. It does not require any professional examination or practical experience other than what may have been required by certain universities. Although no official record is kept, there are an estimated 25,000 practicing public accountants in Mexico, most of whom are affiliated with IMCP. Since IMCP recently introduced certification requirement of auditors of public-interest entities, it is widely viewed as a major step forward for the profession as a whole.

C. Professional Education and Training

18. **Under the traditional licensing arrangement, professional qualification examinations are not required for registering as a public accountant.** The General Director of Professions of the Ministry of Education issues the public accountancy license to applicants who have received a bachelor’s degree with an accounting concentration from a recognized university. Then, after registration with a colegio, the graduates may qualify for inclusion on the list of registered auditors maintained by the taxation authorities, which entitles them to issue audit reports for tax purposes.

19. **Recognizing the shortcomings of the traditional arrangement for licensing public accountants, the IMCP has introduced the certification as an upgraded title of professional qualification.** According to legal requirements in Mexico, obtaining the public accountant’s license under the traditional arrangement is the only prerequisite for starting a public accounting and auditing practice. Under the new arrangement initiated in 1999, the IMCP organizes qualification examinations for those public accountants who intend to obtain the title of *contador publico certificado* (CPC).¹⁰ The new arrangement,

¹⁰ The CPC is considered equivalent to the certified public accountant in the United States.

which is voluntary, is comparable to other international licensing requirements; the Mexican licensee can practice accountancy in the United States and Canada, subject to passing examinations on national legislation and standards, in accordance with provisions of the Professional Mutual Recognition Agreement signed on September 27, 2002. As of this Agreement date, the CPC membership included approximately 6,000 founding members in good standing. The Agreement stated that the founding members had the professional experience and the educational attainments, both pre- and post-certification, as recognized under the terms and conditions of the Professional Mutual Recognition Agreement.¹¹ One issue of concern remains however: the certification of public accountants in Mexico can be awarded by organizations other than the IMCP, with less stringent requirements,¹² although only the IMCP's certification is accepted by the CNBV and the CNSF.

20. There is need for improving the system of professional examination organized by the IMCP. The system of professional examination, which the IMCP has been administering since July 1999 and which has been recognized by IMCP counterpart organizations within NAFTA, needs updating in line with international good practices. The curriculum of professional examination should include international components and increase focus on information technology and professional ethics. The content coverage of examination questions needs to be rationalized for testing critical-thinking ability of the candidates. Overall assessment procedures need to be changed to ensure that a candidate demonstrates competency in all parts of the examination—at present it is possible to succeed overall with failing grades in one or more parts, which average out with higher grades in other parts.

21. The academic accounting curriculum needs reforming in line with facilitating the implementation of international standards. Although arrangements exist in the country for quality higher education in accounting, bachelor-level curriculum needs to include topics covering practical application of IAS issued by the International Accounting Standards Board and ISA issued by the International Federation of Accountants. Moreover, particular emphasis needs to be given on teaching business ethics as a separate subject in business schools and equivalent higher educational institutions.

22. Arrangements are needed to require practical experience as a prerequisite for awarding practice certification to the new professional accountant. Prior to obtaining the professional qualification as a licensed public accountant under current procedures in Mexico, a candidate must wait for three years but is not required to gain practical work experience. In order to raise the quality level of auditors, IMCP should adopt the IFAC International Educational Guideline No. 9 that requires practical work experience of at least three years for fulfilling a candidate's certification qualification.

¹¹ Parties to the Agreement included the National Association of State Boards of Accountancy, the American Institute of Certified Public Accountants, the Canadian Institute of Chartered Accountants, the *Comite Mexicano para la Practica Internacional de la Contaduria*, and the IMCP.

¹² According to the IMCP, a project is currently under way at the Ministry of Education to homologate institutions that award professional certification of public accountants.

This work experience should be under direct supervision of a knowledgeable professional. The training providers must have the support and capacity to teach the practical dimensions of internationally accepted audit standards and procedures.

23. **The IMCP has set continuing professional education requirements.** In the case of public accountants under the traditional licensing arrangement, annual continuing education requirement is 55 hours for public practice and 40 hours for others. In the case of those obtaining a CPC under the new licensing arrangement, annual continuing education requirement is 65 hours. Members are encouraged to undertake professional training courses offered by the 61 colegios of public accountants. Audit firms, especially those affiliated with international networks, also organize in-house training programs, which must be approved by the colegios of public accountants in order to be considered as valid, IMCP-equivalent continuing professional education courses.

D. Setting Accounting and Auditing Standards

24. **Through its Accounting Principles Commission, IMCP has traditionally been the accounting standardsetter.** The Mexican Constitution grants legal authority to set accounting standards to the colegios and their federal umbrella, the IMCP. The drafting of an accounting standard is completed by a select group of experts from the Accounting Principles Commission¹³ and representatives of the CNBV. The first draft of the standard is issued as an exposure draft for comments by users and preparers of financial statements. The final draft, after approval by the Accounting Principles Commission, is submitted for vote by the National Executive Committee of the IMCP. An approval by two-thirds majority is required of both bodies. The approved and issued accounting standard is known as a “bulletin” and interpretations of the bulletin are known as “circulars.” As of October 2003, there were respectively 36 and 22 applicable bulletins and circulars.

25. **The CNBV has issued accounting standards in areas specific to banking activities, some of which are not considered consistent with Mexican GAAP by CINIF and the audit profession.** The CNBV accounting rules are applicable for both regulatory and general-purpose financial reporting. In addition, under section 3 of Circular 1448, CNBV is empowered to (a) issue special accounting rules when the liquidity, solvency, or stability of more than one bank can affect the market as a whole; and (b) grant special accounting treatment to individual banks that are in the process of financial or corporate restructuring. Currently, there are 10 banks that have been granted permission to follow individual accounting treatments for recording selected transactions. Such individual treatments must be disclosed in the explanatory notes to the financial statements. The reports on general-purpose financial statements of banks are prepared in accordance with GAAS under Bulletin 4020 “Financial statements that are prepared in

¹³ The National Executive Committee of the IMCP appoints the president and the secretary of the Accounting Principles Commission. Another 15 to 20 members of the Accounting Principles Commission are selected jointly by the president of the Committee and the vice president of Legislation of the IMCP; the selection of members must be ratified by the National Executive Committee. Members of the Accounting Principles Commission are experienced professional accountants.

conformity with a comprehensive basis of accounting other than GAAP¹⁴. These reports establish that financial statements have been prepared in accordance with accounting rules promulgated by the CNBV, which differ from GAAP in certain cases¹⁴.

26. The Auditing Standards and Procedures Commission of IMCP sets auditing standards. The IMCP issues auditing standards set by the Auditing Standards and Procedures Commission (*Comisión de Normas y Procedimientos de Auditoría* or CONPA). The chairperson and other members of this commission are appointed in the same way as the Accounting Principles Commission. The auditing standardsetting procedures are also the same as the due process for accounting standardsetting described above. The issued auditing standards are also known as bulletins. As of March 2003, there were 64 bulletins issued by the IMCP.

27. In an effort to further consolidate the corporate financial reporting principles in Mexico, an independent standardsetting body has been established. The Mexican Board for Research and Development of Standards for Financial Information (*Consejo Mexicano para la Investigación y Desarrollo de Normas de Información Financiera* or CINIF) was established on August 21, 2001, as an independent nonprofit entity for the purpose of conducting research and related activities toward setting national accounting standards in Mexico, and to develop and issue Mexican financial reporting standards consistent with IAS. The CINIF will replace the IMCP as promulgator of national accounting standards. Representatives of 12 regulatory and self-regulatory organizations signed the founding document of CINIF; the President of Mexico signed the document as a witness of honor. A Board of Directors elected by a Nominations Committee will govern the CINIF.¹⁵ Within CINIF, *Centro de Investigación y Desarrollo*, or CID, is the division in charge of the development of accounting standards. Its staff is composed of full and part-time members, with acknowledged background and expertise in the accounting field, appointed for renewable five-year terms.

E. Compliance with Accounting and Auditing Standards

28. The CNBV and the CNSF have put in place a system of monitoring compliance with accounting and auditing requirements. The CNBV conducts reviews of financial statements of listed companies and other participants in the securities markets, which include brokerage firms and investment funds, as well as banks, aimed at determining compliance with applicable accounting and disclosure requirements. The CNBV has also recently begun visiting audit firms, selected on a random basis, to perform reviews of audit work and ensure compliance with applicable standards. For violations of accounting and auditing requirements, the CNBV is authorized under the Securities Exchange Law to impose administrative sanctions, including fines, suspension,

¹⁴ The main differences are presented in the explanatory notes to the financial statements and relate to issues discussed in footnote 3 above.

¹⁵ The Board of Directors includes four practitioners from highly recognized accounting firms; three executives from the Mexican Institute of Financial Executives; members of the National Association of Accounting Schools, the CNBV, and the IMCP; and two eminent persons drawn from the public and private sectors

and disbarment of advisers, directors, management, comisarios, and external auditors. The regulator is also empowered to assist the judiciary in the prosecution of violators of the legal requirements. At present there is no public record of sanctions for violations with respect to the accounting, reporting, and auditing requirements. The banking and financial institutions supervision arm of the CNBV and the CNSF also perform periodic review of financial statements of banks and insurance or surety companies, respectively.

29. **The enactment of the Securities Market Law (LMV) of 2001 and of the CNBV's *Circular Única* provides the basis for enforcement of the accounting and auditing requirements in listed companies.** Before the LMV was enacted, audit requirements were only dealt with at the level of secondary legislation (circulars), thereby limiting the CNBV's ability to exercise sanctions on auditors. Moreover, the *Circular Única* issued in March 2003 consolidates all such requirements and sets out detailed independence rules for external auditors, including a concentration of revenues of no more than 10 percent from one client, a list of nine activities incompatible with the position of external auditor, and compulsory signing-partner rotation every 5 years. Furthermore, the *Circular Única* requires the audit firms of registered external auditors to maintain a quality assurance program to ensure compliance with the CNBV's regulations.

30. **In addition to their internal review or inspection mechanisms, the statutory regulatory bodies rely on auditors for ensuring compliance with the applicable accounting and disclosure requirements.** On top of their own review and inspection procedures, the CNBV and the CNSF rely on regulated entities' external auditors for finding infractions in the financial statements, consistent with the provisions set out in the respective circulars.

31. **The CNBV, CNSF, and the IMCP are empowered to take disciplinary actions for enforcing the code of auditor's professional ethics and auditing standards.** The CNBV and CNSF may impose the following disciplinary penalties against errant auditors: monetary penalties, admonishment, reprimand, or dismissal. In cases of fraud, the regulators can initiate judicial proceedings for criminal actions. These enforcement actions against errant auditors have not been effectively implemented. The state societies of public accountants and the IMCP have the authority under Article 5 of the Constitution to initiate investigations by the Honor Committee of any complaints against licensed public accountants and report findings to the Secretary of Public Education. The Honor Committee is not proactive when monitoring and enforcing compliance with the applicable auditing standards and professional code of ethics. This Committee reviews and investigates complaints against auditors for violation of auditing standards and independence rules with respect to the audit of any regulated company, and imposes sanctions, although presently no public record exists of such sanctions against auditors.

32. **Arrangements need to be made for increasing accountability of the auditors.** Under current regulation, an individual public accountant, who is typically the partner-in-charge of the audit engagement, must sign an audit report on financial statements. Any professional liability for a bad audit rests with that signature authority, not with the audit

firm. Of course, the quality of the audit largely depends on the firm's internal management policies and procedures that the individual auditor must follow. CNBV is studying certain proposals for changes in the LMV that would allow more effective sanctions against an individual auditor and/or audit firms for failure to comply with their sworn duties.

III. ACCOUNTING STANDARDS AS DESIGNED AND AS PRACTICED

33. **In an effort to reduce the gap between Mexican GAAP and IAS, the IMCP's Accounting Principles Commission issued a bulletin in 1994 mandating the use of IAS on a subsidiary basis within Mexican GAAP.** Bulletin A-8, which went into effect on January 1, 1995, requires IAS to be followed when no corresponding Mexican standard(s) exist. Furthermore, various circulars (Nos. 41, 45, and 49) were issued subsequently to clarify the timing and extent of such "subsidiary use" of IAS. Nonetheless, since the effective introduction of Bulletin A-8, the IMCP with the support of Mexican authorities has sought to further develop the set of national accounting standards, thereby reducing the scope of Bulletin A-8. Throughout the process of issuing new pronouncements on financial reporting, the IMCP has used IAS as a benchmark, but has also incorporated certain provisions of U.S. GAAP in view of accommodating the needs of its many Mexican corporations listed in U.S. stock exchanges. Mexican authorities and accounting practitioners view such upgrading and expanding of the national standards as a means to ensure that Mexican GAAP better reflects specific features of the Mexican economy. This particularly reflects inflation for which—Mexican stakeholders believe—Bulletin B-10 provides a more adequate treatment than its IAS or U.S. GAAP counterparts.

34. **National accounting standards embodied in Mexican GAAP have been significantly expanded and aligned with IAS in the recent years.** A 2001 survey, which was conducted by the IMCP for the World Bank, compared 164 requirements under IAS with those under Mexican-counterpart pronouncements and showed 24 percent of noncomparable or nonexistent requirements. Since then, however, several bulletins have been issued or revised by the IMCP's Accounting Principles Commission, covering segment information (B-5); financial instruments (C-2); intangibles (C-8); liabilities, provisions, contingent assets, and liabilities (C-9); impairment of assets (C-15); construction contracts (D-7); and agriculture (E-1). As a result of those changes, differences between IAS and corresponding Mexican GAAP pronouncements officially issued to date by the IMCP have been significantly reduced and mainly relate to the following items:

- ***Inflation adjustment.*** Bulletin B-10 requires that nonmonetary items of the financial statements be restated for the effects of inflation, irrespective of the level of inflation; whereas IAS 29, *Financial Reporting in Hyperinflationary Economies*, sets certain conditions for such restatement, which do not appear to be met mainly as a result of the decrease of inflation observed in Mexico over recent years. Mexican stakeholders strongly expressed the view that, even though price levels have been stabilized in the recent period, it is still more beneficial to the business community to maintain the practice of

restating the effects of inflation in the country.

- **Statement of cash flows.** Bulletin B-12 provides for the presentation of a statement of changes in financial position instead of the cash flow statement required in IAS 7. The main differences relate to the inclusion of gains or losses on current monetary position or unrealized exchange gains or losses among operating activities. Also, IAS 7 sets out more disclosure requirements.
- **Investments in associates.** Under Mexican GAAP, it is presumed that an investor has significant influence over an investee if the investor holds 10 percent or more of the voting power. IAS uses a 20 percent threshold.
- **Impairment of assets.** Bulletin C-15 does not use the concept of recoverable amount in the same way as IAS for calculating impairment loss on long-term assets to be disposed.¹⁶
- **Financial instruments: Recognition and measurement.** Mexican GAAP does not provide specific rules relating to hedge effectiveness, so hedge accounting is permitted more widely than under IAS. Also, there are no rules under Bulletin C-2 relating to changes of classification of financial assets,¹⁷ transfer of receivables, etc.
- **Employee benefits.** There are certain differences insofar as Bulletin D-3 requires the recognition of a minimum additional liability and does not provide for specific methods of recognition of plan assets or faster recognition of actuarial gains/losses.
- **General.** The level and type of disclosure required by IMCP accounting pronouncements differ in several areas with those of IAS.

35. **Further steps are being considered by CINIF to enhance convergence toward IAS in the near future.** The newly established national standardsetter is currently considering—as a priority undertaking—a comprehensive and thorough comparison of Mexican GAAP with IAS and U.S. GAAP and an analysis of the reasons for existing differences. This approach is consistent with CINIF’s stated objective for promoting harmonization with international standards and promoting the use of high-quality accounting principles.

36. **The ROSC review of 25 sample sets of financial statements of companies listed in Mexico did not reveal major apparent shortcomings in compliance with applicable accounting standards.** However, the review showed that the level of disclosure did not fully conform to Mexican GAAP prevailing at the time, mainly in the following areas:

- **Disclosure of accounting policies.** In certain cases, disclosure was missing on policies for revenue recognition, useful lives of property, or financial

¹⁶ An exposure draft currently under discussion contains changes to IAS 36, *Impairment of Assets*, which would eliminate this difference.

¹⁷ An exposure draft being circulated to amend Bulletin C-2 would eliminate this difference.

instruments.

- **Related party disclosures.** Information on related party relationship and transactions was in some cases incomplete, especially with respect to the pricing policies and other information necessary to understand such transactions.
- **Segment information.** In several instances, the information required by IAS 14 was incomplete as to geographical areas, elements of the balance sheet, and reconciliation with primary financial statements.¹⁸
- **Employee benefits.** Several companies did not provide required information describing defined benefit plans, actuarial assumptions, or expenses recognized during the year.
- **Income taxes.** Some companies omitted certain disclosures, mainly the reconciliation between effective and statutory tax rates.

IV. AUDITING STANDARDS AS DESIGNED AND AS PRACTICED

37. **Mexican GAAS are embodied in the “Audit Standards and Procedures” issued by the IMCP.** Most existing Mexican auditing standards have been historically developed on the basis of U.S. GAAS, though without an equivalent level of detailed implementation guidance. IMCP Audit Standards and Procedures consist of:

- Two “general provisions” setting out a framework for Mexican GAAS (series 1000);
- A standard on “personal norms” (series 2000);
- 13 “execution standards” that address fundamental concepts involving the performance of an audit (series 3000);
- 17 “reporting standards” that cover various types of assurance engagements (series 4000);
- 27 “audit practices” that deal with certain general procedures performed as part of an audit,¹⁹ as well as with certain specific components of the financial statements (series 5000);
- 4 other bulletins dealing with “other pronouncements of the commission” (series 6000) and attestation services (series 7000).

¹⁸ The CNBV indicated that, in October 2002, it conducted a review of financial statements of listed companies for the year 2001, which revealed several cases of non-compliance with IAS 14 *Segment Reporting* and that, as a result, 55 listed companies were required to modify their financial statements and nine companies were sanctioned. The CNBV also indicated that a review was conducted in 2003 as a result of which 14 listed companies were reprimanded for non-compliance with Mexican GAAP. The CNBV indicated that it considers all listed companies have made adequate disclosures of segment information in their 2002 audited financial statements.

¹⁹ Including sampling (Bulletin 5020) and impact of electronic data processing on internal controls (Bulletin 5080).

38. **Mexican GAAS, although less developed in certain aspects, are broadly comparable to ISA.** IMCP Audit Standards and Procedures Commission (CONPA) has introduced new standards, or revised existing ones, on such matters as quality control (Bulletin 3020), study and evaluation of internal control (Bulletin 3050), reporting on comparative financial statements (Bulletin 4170), methodology for the study and evaluation of internal controls (Bulletin 5030), and audit procedures for the study and evaluation of the internal audit function (Bulletin 5040 revised). Nonetheless, several aspects appear less developed within Mexican GAAS than within ISA, as the following detail:

- ***Fraud and error.*** While Mexican GAAS do address the issue of detecting fraud or error and communicating to management, ISA provide more elaborate guidance on how the auditor should consider, from the outset of the audit process, factors that could lead to irregularities or errors in the financial statements. Also, ISA appear more up-to-date with the recent development of corporate governance practices, and better reflect the important role played by audit committees and other bodies charged with governance of corporate entities.²⁰
- ***Knowledge of the business.*** Although the issue of knowledge of business is dealt with in several Audit Standards and Procedures, none addresses it as specifically as ISA do; and the requirement for auditors to ensure that less experienced professionals obtain adequate knowledge of business transactions is not explicitly set forth.
- ***Audit evidence.*** Mexican GAAS specifically address the issue of audit evidence mainly through Bulletin 3060—that defines the fundamental underlying assertions attached to the financial information and through which the audit evidence should be obtained—and to a lesser extent through Bulletins 3040 and 3050. But, contrary to ISA 500 little guidance is provided on the quantity and quality of audit evidence to be obtained.
- ***Corporate governance.*** There is no Mexican standard covering communications of audit matters with individuals trusted with governance.

V. PERCEPTION OF THE QUALITY OF FINANCIAL REPORTING

39. **Users of financial statement acknowledge the significant improvements achieved in the quality of the financial reporting, though a consensus exists as to the need for further alignment with international standards.** Most financial statement users who were interviewed in connection with the ROSC review²¹ agreed that the quality

²⁰ A new Bulletin 3070, dealing with “Considerations to be given to fraud as part of an audit of financial statements”, is currently being circulated as an exposure draft among IMCP members.

²¹ These findings were part of the due diligence exercise carried out by World Bank staff in connection with the ROSC accounting and auditing review in Mexico. Interviews were conducted with various stakeholders, including CNBV, CNSF, Bank of Mexico, Mexico Stock Exchange, foreign banks, international rating agencies, IMCP, CINIF, and experienced audit practitioners.

of corporate financial reporting has improved in the recent past. However, various users agreed that full adoption of IAS—following a convergence process as envisaged in paragraph 42 hereafter—and further strengthening of the enforcement mechanisms would contribute to bolstering the quality of financial reporting in Mexico.

VI. POLICY RECOMMENDATIONS

40. In the course of several meetings and working sessions in Mexico City up until in November 2003, World Bank staff had several discussions with and received feedback from a group of designated national experts and stakeholders on the current issues and prospects of corporate financial reporting in Mexico. The discussions focused on the findings of the ROSC accounting and auditing review and on proposed policy recommendations. The recommendations will form the basis for designing and implementing a Country Action Plan, as agreed upon, for the continuing improvement of accounting and auditing in Mexico. The policy recommendations are summarized in this section.

41. **Provide legal backing for the use of IAS by public-interest entities and implement the corresponding requirements over a reasonable transition period.** Public-interest entities include banks, insurance companies, investment funds, other nonbanking financial institutions, companies that offer shares and/or bonds for public subscription, and other large-size enterprises under a legal definition. Since the recent acknowledgment by Financial Accounting Standards Board in the United States of the benefits of “principles-based” standards, there is widespread consensus of the need for accelerated convergence between IAS and U.S. GAAP, and sustained efforts are currently under way to that effect. There is a growing complexity of issues to be considered with regard to accounting standards. The best solution for Mexico in the long term appears to be the importance placed on the resources and contributions entrusted to IASB by its members and stakeholders at an international level and the stronger acknowledgment for needed common principles at worldwide level, ultimately establishing legal backing for the full adoption of IAS following the convergence process as envisaged in paragraph 42 hereafter.²² Such evolution would also be consistent with Mexico’s growing economic integration with other regions of the world.²³

42. **In view of the transition toward IAS, set a clear agenda for the recently established accounting standardsetter.** The Board of Partners (*Asamblea de Asociados*) of CINIF, which comprises all Mexican stakeholders in corporate financial reporting, should endorse the following priorities for the short and medium terms:

- Complete convergence of Mexican standards with IAS or other high-quality

²² The case of the European Union, which has mandated the use of IAS for all publicly traded companies as of January 1, 2005, provides an example of how to undertake such transition to IAS.

²³ Such objective is also consistent with the recommendation of the White Paper on Corporate Governance in Latin America recently issued by OECD, which states that “standardsetters for publicly traded companies should with all deliberate speed bring national accounting standards into full compliance with International Financial Reporting Standards (IFRS).”

standards, using IAS as the primary benchmark for measuring the quality of accounting standards for such guidance provided on recognition, measurement or presentation, level of disclosure, etc. The priority can benefit from CINIF's planned project for a comprehensive evaluation of differences between IMCP pronouncements, IAS, and U.S. GAAP. Moreover, this efforts for greater convergence would be facilitated by the fact that the official translation of IFRS into Spanish—which is currently used under the “subsidiary use” provision of Bulletin A-8—has been prepared by the IMCP. Also, such efforts could be coordinated with the Inter-American Association of Accountants, or within other fora of Spanish-speaking countries and stakeholders in which representatives Mexican of institutions play an active role.

- Adapt existing or soon-to-be-issued standards for small and medium enterprises with a reporting framework more suitable to their special needs than currently required by existing Mexican GAAP. This process should follow the steps of IASB's project, *Accounting Standards for Small and Medium Entities*, initiated in 2002.
- Develop a specific capacity for interpretations of Mexican GAAP, consistent with the pronouncements of the International Financial Reporting Interpretations Committee (of IASB).
- In close cooperation with the CNBV and the CNSF, undertake the harmonization of accounting standards for general purposes with the rules set-out by the regulatory agencies, in such a way that would allow to eliminate the external audit reports' related emphasis paragraph, and general-purpose financial statements of banks and insurance companies to be presented under GAAP. Under such arrangement, Mexican banks and other regulated entities would fulfill their regulatory obligations and the needs of their shareholders in terms of financial information.

43. **Strengthen enforcement mechanisms.** High-quality corporate financial reporting depends on proper enforcement of the established standards. Under the laws covering commercial activities in Mexico, there is no provision for civil or criminal penalties to deter fraudulent or erroneous financial reporting by a board of directors and attest misleading financial information by auditors. Regulatory bodies need to strengthen capacity to conduct in-depth analysis of corporate financial statements in order to monitor compliance with the standards. The enforcement departments of CNBV and CNSF have in place monitoring mechanisms; however, experience shows that effective sanctions for infractions may be difficult to impose within the Mexican legal framework. Recently, the CNBV has started a program to visit audit firms for reviewing their work papers. There is a need to improve institutional capacity and ability to effectively exercise administrative sanction in order to fully achieve the objectives of this program. Moreover, the role of the comisario, which was designed several decades ago before external audit or corporate governance requirements existed, needs to be clarified, including relationship with the independent auditors. To that effect, consideration should be given to the possibility of requiring that independent auditors fulfill the mandate of comisario within publicly

traded companies. Regarding non-listed companies, the comisario appointed by the majority shareholder(s) should be required to be a licensed public accountant.²⁴

44. **Establish an organization for independent oversight of the auditing profession.** According to current legislation, the IMCP is responsible for regulating the profession of public accountants. Acknowledging the distinctive responsibilities of the independent auditor toward shareholders, regulators, and the public in general, specific independent oversight of the auditing profession should be introduced, consistent with the trend recently observed in several countries.²⁵ The CNBV and the CNSF have legal authority to oversee the audit quality of the entities under their supervision. Moreover, the Mexican federal taxation authority has power to take steps toward ensuring high-quality audits for tax purposes. It therefore would be possible to establish an independent oversight body for the auditing profession without enactment of a new law. The IMCP, CNBV, CNSF, federal taxation authority, and other public-interest representatives should jointly sponsor the formation of a “Joint Council on Auditors” with delegated power to monitor and enforce auditing standards and professional code of ethics. This would allow regulators to focus their resources on their own enforcement activities and to draw synergies in the monitoring of auditors. As a matter of example and subject to formal exchanges of view and agreement between the various stakeholders on the matter, oversight by the Joint Council on Auditors could cover the following aspects among others of the audit profession:

- Requirements for eligibility of firms to audit public-interest entities or to issue tax-purpose reports, in order to enhance audit quality and increase auditors’ accountability.
- Monitoring of practicing auditors through: (a) inspections of audit firms to ensure compliance with Mexican GAAS and other applicable auditing requirements and professional code of ethics; (b) preventive measures for ensuring that the audit firms establish robust quality assurance arrangements,²⁶ and (c) investigations and disciplinary proceedings and, where applicable, imposition of appropriate sanctions against the violators of auditing requirements including auditor’s code of ethics.
- Institutional relations with all key stakeholder groups, including the accountancy profession—especially the Ethics and Auditing Standards and Practices Commissions of the IMCP, the investor community, academia,

²⁴ Such requirement would not apply to the second comisario appointed by minority shareholders representing 10 percent or more of shares of a company, as otherwise it could limit the ability of such minority shareholders to appoint the individual whom they would consider best fit to defend their interests.

²⁵ Examples include the Canadian Public Accountability Board in Canada, *Haut Conseil du Commissariat aux Comptes* in France, Irish Auditing and Accounting Supervisory Authority in Ireland, and Public Company Accounting Oversight Board in the United States. Also, at the international level, IFAC is currently working with several multilateral institutions on establishing a Public Interest Oversight Board to “ensure that the standardsetting and compliance activities of IFAC are conducted in a manner which is consistent with the public interest, in order that the public can have confidence in financial reporting.”

²⁶ In that respect, the IMCP’s current project for monitoring quality control by audit firms could be given consideration by the Joint Council on Auditors in designing its regulation on the matter.

professional bodies, relevant government agencies, and CINIF; also, from an international perspective, ties with sister organizations in other countries, in order to define mutually beneficial cooperation arrangements as needed.

45. **Extend the requirements of certification for public accountants acting as independent auditors.** The traditional system of awarding public accountant designation without any qualification examination has proven to be inadequate for the needs of users of audited financial statements in Mexico, leading to the introduction of the certification in 1999²⁷. Those efforts toward a stronger and better-acknowledged audit profession should be further pursued by extending the applicability of the certification requirement to the issuance of all regulatory or tax-purpose audits, and possibly to any audit of financial statements.

46. **The IMCP should pursue the implementation of fully ISA-comparable auditing standards.** Mexico's involvement in global economic activities increases the need for further alignment of Mexican GAAS with ISA. In that perspective, the IMCP's Auditing Standards and Procedures Commission (CONPA) should take the following steps: (a) consider implementing any new standards issued by IFAC's International Auditing and Assurance Standards Board (IAASB), as well as those already in force with no equivalent among Mexican GAAS, (b) whenever possible translate those for official adoption by the IMCP, with modifications only to the extent required by the local environment; and (c) emphasize the application of Mexican GAAS in the development and dissemination of guidelines and audit practice manuals.

47. **Arrangements should be made for the full adoption of IFAC's Code of Ethics for Professional Accountants and for development of guidelines on its implementation in the Mexican context.** The IMCP's Code of Ethics should be updated to address in detail issues of auditor's conflict of interest and independence impairment, mainly by translating and adopting the provisions contained in IFAC's Code of Ethics for Professional Accountants, with modifications to meet Mexican legal requirements, as may be necessary. Specifically, the concept of public interest should be more emphasized, and Postulate VIII should be reworded so as to avoid possible misinterpretations of "loyalty to the client."

48. **Strengthen professional education and training.** Arrange training programs for improving the expertise of professional accountants on practical application of IAS, ISA, and other international best practices for conducting audit activities. Also, strengthen arrangements for improving the requirements for continuing professional education and for ensuring compliance with those requirements

49. **Harmonize and strengthen the academic curriculum in accounting and auditing.** Accounting and auditing curricula should be harmonized and updated, in such a way that all future candidates for the license of auditor would have sufficient and consistent academic background. Such curricula should contain practical-oriented

²⁷ As mentioned above, such certification is required by the CNBV for the audits of financial statements within entities under its purview.

teaching at the undergraduate level in universities and higher educational institution, and should cover the ethical dimension of the accountancy profession.

ABBREVIATIONS AND ACRONYMS

CID	<i>Centro de Investigación y Desarrollo</i>
CINIF	<i>Consejo Mexicano para la Investigación y Desarrollo de Normas de Información Financiera</i>
CNBV	<i>Comisión Nacional Bancaria y de Valores</i> (National Banking and Securities Commission)
CNSF	<i>Comisión Nacional de Seguros y Fianzas</i> (National Insurance and Surety Commission)
CONPA	<i>Comisión de Normas y Procedimientos de Auditoría</i> (Auditing Standards and Procedures Commission)
CPC	<i>contador publico certificado</i>
GAAP	generally accepted accounting principles
GAAS	generally accepted auditing standards
IAASB	International Auditing and Assurance Standards Board
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
IMCP	<i>Instituto Mexicano de Contadores Públicos</i> (Mexican Institute of Public Accountants)
IMF	International Monetary Fund
ISA	International Standards on Auditing
LGSM	<i>Ley General de Sociedades Mercantiles</i> (General Law for Commercial Enterprises)
LMV	<i>Ley de Mercado de Valores</i> (Securities Market Law)
NAFTA	North American Free Trade Agreement
ROSC	Reports on the Observance of Standards and Codes
SEC	Securities and Exchange Commission
SME	Small and Medium Enterprises