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Valuation and mergers and acquisition in Latin America:
Accounting rules and the functioning of capital markets

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Introduction and summary

The globalisation 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&A) have grown enormously over the last 20 years, both domestically and internationally, in response to many factors: technological changes; increased liberalisation, particularly of foreign exchange controls; direct investments; privatisation of public companies; regulation of activities in the public utility sectors; and international competition.

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 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 harmonisation 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 realise their investments, make valuation possible and reduce the cost of capital. Under these circumstances, harmonisation 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 generally accepted accounting principles in the United States (US GAAP) and/or International Accounting Standards (IAS). 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) held a joint meeting at the FASB's headquarters in Norwalk, Connecticut.

The Boards of the organisations 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 article reviews the status of business and assets valuation as well as that of M&A 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 harmonisation 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 US GAAP and IAS, the following discussion provides some insights into the key considerations in evaluating and comparing local GAAP with US GAAP or IAS, 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 article also illustrates that the implementation of accounting standards according to international norms serves the objective of promoting transparency, disclosure, and harmonisation; 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

Foreign direct investments (FDI) inflows and mergers and acquisitions (M&A) by group of countries, 1991-2001 (USDm)

Country/Group	1991	1995	1998	1999	2000	2001
TOTAL WORLD FDI	160,199	330,516	694,457	1,088,263	1,491,934	735,146
Developed countries	113,099	203,311	484,239	837,761	1,227,476	503,144
Western Europe	80,112	118,265	274,739	507,222	832,067	336,210
EuropeanUnion	77,735	114,439	262,216	487,898	808,519	322,954
Other Western Europe	2,377	3,827	12,523	19,324	23,549	13,256
North America	25,680	68,027	197,243	307,811	367,529	1,518,900
Other developed countries	7,307	17,019	12,257	22,728	27,880	15,034
Developing countries	44,396	112,537	187,611	225,140	237,894	204,801
Africa	3,307	5,743	9,021	12,821	8,694	17,165
Latin America and the Caribbean	16,713	30,866	82,203	109,311	95,405	85,373
Asia and the Pacific	24,376	75,928	96,387	103,008	133,795	102,264
Asia	24,272	75,217	96,109	102,779	133,707	102,066
West Asia	2,230	3	6,705	324	688	4,133
Central Asia	20	1,484	3,152	2,466	1,895	3,569
South, East and South-East Asia	22,022	73,729	86,252	99,990	131,123	94,365
The Pacific	104	711	277	229	88	198
Central and Eastern Europe	2,705	14,668	22,608	25,363	26,563	27,200
TOTAL WORLD M&A	80,713	186,593	531,648	766,044	1,143,816	593,960
of which Latin America and the Caribbean	387	3,951	12,640	44,767	18,614	27,380

Source: Unctad, Foreign Direct Investment database: http://www.unctad.org/

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 harmonisation and their impact on valuation; describe the valuation of target companies and analyse the quality of earnings; examine the main differences between Local GAAP and US GAAP or IAS standards. 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 (FDI) 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 imply 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 as globalisation has advanced, countries have continued to liberalise their economies in various forms. The abolishment of foreign exchange controls, privatisation 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 in the last decade, and particularly in the late 1990s, continues to be cross-border M&A 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&A rose from about USD80bn in the early 1990s to more than USD1tr in 2000 and to decline to USD593 in 2001. In the United States, Mergerstat Review reported 9,566 deals valued at USD1,325.7bn in 2000 compared with 2,074 valued at USD108.2bn in 1990. Among the emerging economies, Latin America and the Caribbean have a share of cross-border M&A that fluctuates between 2 and 5%, with Brazil and Argentina being the main sellers The decline of M&As inflows in the last few years is parallel with the decrease of the FDI flows and is due to the adverse international economic situation together with the attraction that other areas, e.g. China, exercise on FDI. M&A activities in the Latin American and Caribbean region is primarily related to privatisation and is 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&A on the world economies.

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

- 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 amortised 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 recognised 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.

M&A: Comparisons of reporting practices in selected countries and International Accounting Standards

Country	Purchase	Pooling	Goodwill accounting: Capitalise/ Amortisation	Goodwill accounting: 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
IASC Standards	Yes	Yes	20 years	Yes
European Union	Yes	Yes	Yes	Yes

Source: Kenneth R Ferris and Barbara S Pecherot Petitt, *Valuation: Avoiding the Winner's Course*, Financial Times Prentice Hall, 2002

FDI and M&A 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.

One concern of the host country is that FDI, and consequently M&A, activities do not add to productive capacity, as for example, a green-field project would. This school of thought states that FDI and M&A 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 (such as Research and Development – R&D), all of which can be transferred abroad. Moreover, FDI and M&A could lead to situations in which competition is restricted or reduced, or a monopoly or an excessive market power established, which is detrimental to consumers and for the economy. On the other hand, FDI and M&A could raise productivity of domestic factors, and allow for technological advances.

The literature, among others Caves (1996), Hanson (2001), and Wolf (2001), and experience point out that FDI and M&A may enhance social national welfare, depending on the magnitude of the improvement of productivity and other spillovers that FDI and/or M&A generate, versus the negative impact on the domestic industry. In other words, there is evidence that if the host country has the capability of promoting policies directed toward increasing the competitive environment, favouring capital market development as well as introducing and making effective and enforced rules of competition and antitrust, FDI and M&A facilitate a more efficient use of resources. In that context, 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 harmonisation, which not only promotes local capital market development but also the valuation of assets as well as mergers and acquisitions, and which is the specific focus of this paper.

Disclosure, transparency, and harmonisation 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 harmonisation and constitute primary factors for capital market development and permit accurate valuations of business as well as of M&A.

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 which 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, 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 utilising 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 fundamental value, which validates the other three factors. Enforcement has 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 harmonisation is particularly relevant with respect to the introduction of international accounting standards as well as to enforcement. While the discussion of harmonisation vs. regulatory competition applies to the area of accounting, harmonisation 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 is 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 analysed to determine the value of the target company. Such information is typically prepared in accordance with the local accounting standards of the country in which the target company is domiciled. 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 amortisation (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 the table below. 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.

Discount rate risk matrix

Unsystematic or subjective risk	
Market risk	• Barriers to market entry • Market size or share constraints • Strength of competition • Buyer product or service acceptance • Shifting buyer preferences
Financial risk	• Illiquidity • Unfavourable contractual obligations • Excessive debt
Management risk	• Depth of management talent • Key employee dependence • Management's past experience with product or service
Product risk	• Key supplier dependence • Obsolescence • Reliance on specific patents and licences • Lack of productive capacity • Commercial impracticality of production
Company sales risk	• Key customer dependence • Lack of product diversification • Lack of geographic sales diversification
Business environment risk	• General economic conditions • Government regulation
Base rate	
Systematic risk	• General equity risk premium • Beta coefficient for the subject industry to modify the general equity risk premium • Company size premium
Risk free	• US Treasury bond, note or US Treasury bill yield

When evaluating a potential target's financial information, investors consider (i) the country (or countries) in which the target company has operations; (ii) the target company's industry; and (iii) 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 US GAAP and IAS 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 year 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.

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 analysing 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.

Analysing the quality of earnings

One of the most important assessments that are performed on a target company is a quality of earnings analysis. A quality of earnings analysis 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 amortisation, 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 is it (business or 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 'normalised' earnings or EBITDA that should be used to properly value a target company?
- Have historical earnings been overstated? Have certain costs been deferred or capitalised 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 categorised as follows:

- Adjustments made to comply with US GAAP or IAS;
- Exclusion of the impact of inflation accounting included in historical operating results;
- Exclusion of non-cash revenue and expense items recognised under local GAAP;
- One-time, non-recurring adjustments;
- Analysis of the classification of revenue and expense items and exclusion of non-operating revenues and expenses; and,
- Errors in the application of local GAAP.

Principal differences between local GAAP and US GAAP/IAS

In this section we utilise 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 US GAAP/IAS.

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 recognising 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 US GAAP or IAS.

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 US GAAP/IAS 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

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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 US GAAP and IAS often requires capturing significantly more data than required under local GAAP. Many companies in Latin America do not utilise sophisticated accounting systems and procedures that would be capable of periodically converting financial results from local GAAP to financial results using US GAAP or IAS. For publicly traded companies in the US 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 US GAAP and IAS.

Consolidation and investment in common stock

There is considerable variability among local GAAP related to consolidated financial reporting. Under US GAAP and IAS, if the parent company controls, directly or indirectly, greater than 50% of the voting stock of the subsidiary, the parent company must prepare consolidated financial statements. The US 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% but greater than 20% of the voting stock, requires use of the equity method. Under the equity method, the parent company recognises its proportionate share of the earnings/losses of the subsidiary. In the cost method, the investment is recognised at historical cost and it is never adjusted, unless impaired. The investor recognises 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% in the subsidiary.

Local GAAP in many Latin America countries allows 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.

Non-publicly 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% or greater interest, or a 10% or greater interest if the investor also has influence in the administration of the company. The equity method is required for both 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% or greater interest in the shares of the company. An investment is considered significant if it represents at least 10% of the investors' equity, or if the investor has several investments equal to 15% of equity.

Mexico

Consolidation practices are similar to US GAAP and IAS.

Argentina

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

Venezuela

In Venezuela, if one company holds an interest of more than 50% in another company, the financial statements of the two companies must generally be consolidated. 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% 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% 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 amortisation, and substituted a framework for analysing 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 US 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 amortised over a period not to exceed forty years. Under FAS No 142, goodwill and indefinite life intangible assets are no longer amortised 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 recognised on the transaction is the difference between the sum of the net book value of tangible and intangible assets less liabilities. Goodwill is amortised over a 'reasonable' period. Similarly, in Brazil and Mexico the goodwill recognised 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 non-operating 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 programmes are sponsored and administered by the government and programmes vary from country to country. Appropriate valuation requires that investors carefully evaluate the respective country's labour 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 US 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. Labour 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 labour 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 USA. where the attraction of target companies rests with their valuable intellectual property and intangible assets (e.g., trade marks, 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 US accounting standards, intangibles can be amortised 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 the following table.

FASB intangible asset classifications

Marketing-related intangible assets
- Trade marks, trade names
- Service marks, collective marks, certification marks
- Trade dress (unique colour, 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 programmes

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

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 US 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 US 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 recognised 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.

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 recognising 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 recognised only for identifiable, non-recurring 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 utilising tax loss carry-forwards and tax credits is not recognised until it is realised, 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 US 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 US 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 capitalised 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 realisable market or present value of assets.

US 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 amortised to the operations over the remaining life of the asset.

Deferred charges

In accordance with most Latin American accounting standards, organising and pre-operating expenses may be capitalised and amortised, generally, over a period of five years, while under US 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 capitalisation of non-recurring and development costs are subjective and require matching of capitalised costs to future revenues. Most countries do not require a periodic review for impairment of capitalised 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 US 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 US GAAP and IAS.

In many Latin American countries, within the equity accounts is a 'Restatement' account. A restatement account 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% of their annual profits, until the legal reserve equals 20% 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 US 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% 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 US GAAP purposes, these expenses are generally included as a component of operating income. Additionally, most Mexican companies do not recognise 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 US GAAP, deferred profit-sharing expenses would be recognised 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, labour, legal or other significant reserves, guarantee obligations, capitalisation of overhead, and depreciation and amortisation (i.e., capitalisation 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.

US 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 realisation 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 and public policy considerations

Policy makers in emerging economy countries should realise that the introduction of an effective transparent and harmonised accounting system, particularly in the areas illustrated in this paper, would have a momentous and lasting impact on attracting FDI. It would also favour M&A while at the same time improving the economic environment, allowing proper valuation of assets, and ultimately, favouring capital markets development and lowering the cost of capital. It is clear that FASB and IASB have made a priority the convergence of accounting principles in the area of business combinations, which most likely will result 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. 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 harmonise financial reporting and introduce International accounting standards is a significant stride toward breaking down barriers.

To support Competitiveness through the Application of International Accounting and Auditing Standards, in May 2002 the Multilateral Investment Program (MIF) of the Inter-American Development Bank presented to its Donors Committee 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 moment when economies in the region were striving to improve their access to capital and financial markets. The Program will finance 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 programmes by universities, accounting bodies, and securities regulators; assistance to national or sub-regional entities to establish or strengthen peer review or certification programmes; disseminating results and best practices to increase awareness of newly adopted standards and promote programmes to improve compliance.

The projects present very similar design characteristics and a strong coordination with the Latin American and Caribbean Financial Management Group of the World Bank, which is charged with carrying out the Reports on the Observance of Standards and Codes on Accounting and Auditing (ROSC). In fact, the design of MIF projects is intended to incorporate the results of the ROSC independent reviews. In addition, the ROSCs will serve to measure the progress during the execution of the project as they establish and provide a baseline in terms of the level of adoption and compliance with International Accounting Standards.

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. More than other standards, they are self-contained and stand-alone in that their application does not require that the domestic legal system be changed – the so-called interdependence of rule, i.e., the rules have to be inserted and understood in the context of other legal concepts of the domestic system. The autonomy feature facilitates the introduction of international accounting standards as the rules embodied in the international standards do not need to make any, or very limited, reference to legal terms and concepts existing in the recipient legal system.

In addition, international accounting standards are intended, at least initially, to provide an interface, i.e. companies have the option of using the international standards together with the local standards. This feature helps to deal with the standardisation of legal systems, i.e. the cognitive aspect of law. The cognitive aspect underlines the reality that law has its roots in a given society, and that to be applied and enforced it has to be understood and accepted. Within this context, the objective of enforcement as well as that of harmonisation becomes more a medium- and long-term objective rather than an immediate one, and constitutes a necessary trade-off needed to attain the implementation of the standards in emerging economies.

This long-term goal cannot be pursued without a holistic approach aimed at creating the conditions for a strong and competent civil service in terms of central government, as well as in the various independent regulatory agencies, so that they are able to be effective counterparts in the negotiations with potential transnational companies and provide regulatory oversight.

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