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## The Institutional Reform of Electricity in Honduras

Ian Walker and Juan Benavides\*

### 1. Introduction

Demand for electricity in Honduras is relatively low. In 1999, peak demand reached 661 MW, while installed capacity was 906,3 MW. A single efficient generator could, in principle, produce the country's entire electricity requirements. The potential for competition in

wholesale power is modest, and further trading possibilities depend fundamentally on the creation of the Central American Electricity Market (CAEM).

Reform of the electricity sector began with 1994's framework legislation (Ley Marco), which was enacted to address supply shortages during the 1993 crisis.<sup>1</sup> This legislation created an

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\*Ian Walker is Director of ESA Consultores Internacional and Juan Benavides is an Infrastructure Specialist at SDS/IFM. This is a condensed version of the paper "Sustainability of Electricity Reform in Latin America - Honduras Case Study," by the same authors, presented in May 20, 2002 at a workshop on the Sustainability of Power Reforms, IDB, Washington, D.C.

[1] This crisis was originated by the paralysis in investment after the construction of the 300 MW El Cajón hydroelectric plant (in the early eighties) by the State. During almost a decade, there existed the perception of excess supply.



## International Accounting Standards or United States Generally Accepted Accounting Principles for Latin America and the Caribbean?

Ivan Sotomayor and Pietro Masci\*

### 1. The Role of Disclosure in Financial Market Development

Recent literature as well as experience have made clear the essential role

played by information and disclosure in capital market development and valuation of assets by market operators and agents (investors as well as research analysts and rating agencies) according to the risk-reward paradigm. Even

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\*Ivan Sotomayor is member of the International Strategies Committee of the American Institute of Certified Public Accountants (AICPA), Director for the USA and adviser to the editor of the "Journal of Accountancy" magazine. Pietro Masci is Division Chief of the Infrastructure and Financial Markets Division, Inter-American Development Bank.



electricity regulator and a ministerial energy cabinet to address policy issues. It also proposed to privatize distribution and facilitate private participation in generation. The process yielded progress in security of supply: seven private investors have signed PPA contracts to generate electricity in Honduras. Private thermal plants now produce 405 MW of electricity and the price of these contracts has progressively decreased over time. Coverage of service has also improved, increasing from 33% in 1989 to 62% in 2001. This is explained in part by heavy capital subsidies to increase rural coverage, which was financed by donors.

However, privatization of distribution never took off and sector governance remains leaves much to be desired. Very little responsibility was delegated to the regulatory agency when it was created. The regulator is neither independent nor financially autonomous. The energy cabinet is an *ad hoc* body

with no resources to formulate a long-term energy policy. Energy is just one of many issues that are the responsibility of SERNA (Secretaría de Recursos Naturales). Instead, ENEE, the state monopoly in charge of distribution, transmission and public generation, is the de facto policy-making entity in electricity.

Tariffs do not cover the full cost of service. Fiscal transfers to fill this gap (\$18.4 million per year, equivalent to 7.5% of current sector income) are unsustainable, and Honduras is a heavily indebted poor country (HIPC). Direct private investment is the only alternative to finance capital expenditures in electricity. But, under current conditions, bargaining between Honduran authorities and potential investors is asymmetric. A few players may dominate investment in infrastructure in Central America in the years to come, and reinforcement of sector governance is the major strategic goal of the reform. Electricity must be made available via private investment in conditions that do not foreclose the possibility of competition in the medium term. Other goals, like efficient pricing, increased coverage and enhanced quality (which provide the rationale for most of the reforms elsewhere), will be attained as the reforms are consolidated.

The recommendations of this paper are aimed at promoting private investment while improving governance in the electricity sector. The version of the new *Ley Marco* currently under congressional scrutiny addresses poorly the problems of governance and structure, and proposes construction measures that would make it easy to exercise oligopoly power in generation. The claim of this paper is that it would be counterproductive to recommend organizational changes that are not self-enforcing and do not provide sufficient incentives for customers to eventually defend the new order.

## 2. Electricity Reform as an Institution-Building Process

The new government that took effect in January 2002 is aware of the need to modernize the State and deep-

en the electricity sector reforms that started with the 1994 *Ley Marco*. The new Administration includes persons with vision and managerial skills who will play a prominent role in Honduran public life in the years to come, and is vested with a considerable mandate as a result of the large majority that the President garnered in the November 2001 elections. These are all positive factors.

However, the ruling party does not have a majority in the new Congress and the “political capital” accumulated during the election campaign needs to be used on many fronts other than energy. This suggests favoring strategies with minimum legislative content and provides the rationale for suggesting that planning the actual implementation of the strategy, the Executive should identify the opportunities for action based on its current mandates, rather than taking a *tabula rasa* approach to the legislation prior to implementing any change. While implementation of the reform will rely mostly on the initiative and creativity of the Executive power, its consolidation will depend on whether actual results meet the expectations of the public. This is not going to be easy. Surveys show that a substantial share of the Honduran population does not see privatization warmly, and there is no tradition of citizen participation in discussing public affairs. This is partly explained by previous experience with privatization in other sectors, which was surrounded by the suspicion that questionable deals were entered into.

What results are feasible in Honduras in the short and medium run? Control of ENEE has been politically important since the beginning, and the likelihood that it might impose discretionary measures poses a high risk for the private sector. The ministerial energy office is an *ad hoc* body with no resources to formulate a long-term energy policy, and SERNA is not fit to deal with energy issues. Moreover, SERNA is mainly concerned with promoting renewable energy sources against all odds, while the issues at stake in Honduras are of a more fundamental

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1300 New York Ave, N.W. Washington, DC 20577 Stop W-0508 Phone: 202-623-2617 Fax: 202-623-2517 Internet: pietrom@iadb.org	
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nature. The regulator of electricity is weaker than ENEE and it lacks independence. Moreover, there is a dearth of skilled individuals to perform regulatory and antitrust responsibilities, which is compounded by the decision to have individual regulatory offices for each public utility sector.

Traditionally, Congressional leaders have wielded great political leverage on presidential initiatives because presidential candidates either come from Congress or need the explicit endorsement of strong congressmen. In Honduras, sustained and visible Congressional opposition to proposals of the Executive branch may become future political capital. In spite of the all the achievements of the past few years in increased technical capacity and transparency, the judiciary is much weaker than the executive and legislative branches of government. The incentives for public servants are not to take the risk of being sued and prosecuted if their actions contradict strong special interests. This mechanism reinforces the exercise of discretion at higher levels and reduces the economic value of formal rights. The implication for private investors is an incentive to either mitigate the risk of expropriation or extract rents by capturing the State. At the same time, the State is at disadvantage when negotiating the entry conditions of large international players in electricity generation and distribution because of its weak bargaining power. The HIPC status of Honduras may not help in that regard.

In this context, the reform's chances of success might improve if three changes are made. The first is to create a governance structure (sector planning, multi-sector regulation, entitlement of customers rights) that is better suited to resist capture attempts from any source. The second is to unbundle ENEE, promote a politically acceptable private participation in hydroelectric generation (a very sensitive topic) and distribution, and not create future entry barriers in the process of negotiating conditions for current investors. The third is to adapt the struc-

**■ A multi-sector regulatory entity would establish a stronger regulation in Honduras. This suggestion needs to be discussed and coordinated with the needs and expectations of the other public utilities regulators. ■**

ture of the market to take into account the fact that competition is unlikely because of the small number of active agents in production and supply. The three changes are complementary. In isolation, each one would produce only limited results.

It is worth emphasizing that these changes will be of little use if they are not supported by the beneficiaries of reform. The reform will require a new mind set in Honduras about how electricity should be handled in the future. The reform will have better chances of success and continuity if, once in place, the two key economic groups (investors and customers) are willing to defend the results. A test of this sort would evidence that a self-enforcing arrangement has been reached through the shaping of institutional capabilities (both rules and beliefs).

### 3. Summary of the Proposed Reform Strategy

The following are suggested guidelines for a reform strategy:

#### *Governance*

- A separate Ministry of Energy would establish a suitable leadership in the sector and end the conflicts of interest within Ministry of Natural Resources between the planning function for energy sector development and the environmental control function.
- A multi-sector regulatory entity would establish a stronger regulation in Honduras. This suggestion needs to be discussed and coordinated with the needs and expectations of the other public utilities regulators. A point in favor of the proposal is that a new entity would save scarce human capital.
- Channels for effective citizen participation would provide citizens a sense

of ownership. Some channels to be explored are media campaigns, incentives to reduce consumption and periodic public hearings and consultation.

- A universal service fund to expand coverage would give priority to proposals that minimize the cost of supply and promote the active involvement of the communities.
- More discussion is needed about how to include private renewable energy projects in the reformed system. The best option would be to grant concessions for projects of this kind through competitive bidding.

#### *Market Structure*

- It is advisable that the restrictions on industry structure that are proposed in the current draft legislation be maintained, including the prohibition on vertical integration and limits to horizontal integration. At present, full liberalization could end up in concentrated industry structures in private hands.
- ENEE could be unbundled into independent enterprises (for example, one or two generation firms, one transmission/dispatch firm and two or three distribution firms.) Privatization could start in distribution. For the time being, the other industry segments would remain in public ownership but would be corporatized (SAs), opening the way for future sale to private owners.
- Before implementing a wholesale spot market in generation, the State's generation, distribution and transmission enterprises should be privatized to avoid conflicts of interest for the State when it exercises its regulatory function.



#### Market Structure

- To ensure sufficient expansion of generating capacity, Honduras should, for the time being, continue to issue power purchase agreements with capacity and generation components through competitive international public bids under the supervision of the regulator. This system would guarantee sufficient capacity to face demand and avoid the price instability caused by supply imbalances that has undermined the sustainability of reform in other countries. The contractual counterpart to the generators would be an association of distributors (see discussion below), which would act as a single buyer. The capacity costs of these contracts, along with those of existing PPAs, would be passed on to the final users.
- Implementation of a spot market for generation (without any central planning of capacity expansion) would be postponed until full integration of the Central American market is accomplished. A larger market will have enough players to offset market power problems that would certainly occur if complete liberalization of the Honduran generation market were to take place now.
- Generation would be dispatched through a central pool. Distributors would announce their projected demand for each period and all generators would have to make their functioning capacity available to meet that demand.
- To reduce the extra capacity requirements that arise from flat tariffs, it is necessary to introduce real-time sensitivity between demand and prices. A first measure would be to set differentiated prices for customers with adequate metering devices according to the time of the day. A second measure would be to implement a market mechanism for the temporary

suspension of excess supply, as discussed previously.

- Distribution firms need to be able to collect the full financial costs of all parts of the system through tariffs. If the demand subsidy were limited to those who consume less than 100 kWh/month, the available resources could be applied to the coverage expansion program.

#### 4. Implementation and Political Feasibility

The reform should proceed gradually for two reasons. First, the stock of political capital is insufficient for any reformer to achieve a far-reaching sector reform in the current conditions. And second, even in with the necessary resources to implement a formal reform overnight, it will take time to strengthen the sector and build a stable constituency to support the changes. Any attempt to introduce

**■ Implementation of a spot market for generation (without any central planning of capacity expansion) would be postponed until full integration of the Central American market is accomplished. ■**

reform packages that are not consistent with the country's political economy may provoke costly backlashes.

Based on these considerations, we suggest that the government consider a two part strategy in which it moves immediately to implement the measures that are consistent with the overall reform vision presented in this note and can be made without the need for legislation, while at the same time preparing reform legislation to rationalize sector governance and open the way to a more competitive market structure when this becomes feasible.

The following measures could be implemented without the need for legislation:

- Unbundling and corporatization of ENEE.
- Contracting of new generation capacity via PPAs, through transparent public bidding processes, on a scale that will permit a reasonable expectation of prices under \$0.065 per KWh. As a first step, successfully complete the contract presently being let.
- Privatization of distribution, with contractual terms (price-caps) that stimulate feasible but sustained improvements in distribution losses. Total losses (technical + theft) could be reduced to 12% within three years. This would be the equivalent of adding around 10% more capacity to the system. This approach would assign to the concessionaires the commercial risk of billing and collection, but would not require the concessionaire to act as a market agent (intermediary) between the generators and the consumers. The distribution tariff would be regulated based on efficient cost considerations. (This measure would require Congressional approval of the concession contract, but would not require primary legislation.)
- Creation of an electrification fund and development of a coverage expansion plan.
- Review of the final user tariff to ensure that it fully covers the financial cost of generation, and the efficient cost of transmission and distribution, in order to assure the financial sustainability of the system.
- Rationalization of the demand subsidy, either by abolishing it altogether or reducing its scope to those who consume less than 100KWh/ month. Reassign the resulting savings to the electrification fund.

Implementation of these measures would result in immediate gains for users in the form of supply security and cost reductions. They would also remove from the field or seriously weaken some of the main players opposed to sector reform. However, customers whose subsidy has been reduced may oppose the measures

if the change does not quickly deliver tangible improvements in their service. Therefore, complementary actions to empower users through public hearings, quality campaigns, etc, should be implemented, to maximize their input into the reform process and minimize customer resistance.

In parallel, a task force should be established to work on sector reform legislation whose goals should include the following:

- Create a new, credible sector governance structure including a policy and planning agency and a strengthened regulator, with greater technical capacity and functional independence than the present regulator, and possibly with cross-sector responsibilities.
- Level the playing field for generation remuneration, including renewable sources, hydro and small hydro plants, which should be developed on a competitive basis through concessions.
- Create a new private single buyer agency and define its relationship with the sector policy and regulatory agencies. Define a new format for contracts.
- Fix a new system of financially sustainable tariffs and properly targeted, rational subsidies.
- Create and nurture channels for consumer participation.
- Clarify the way that Honduras will participate in the regional electricity market.

The further the government advances with decisive actions based on its existing executive mandate, and

shows the positive results of these actions for the systems and potential users, the easier it will become to convince the legislature to pass a new law dealing with this second set of issues. It is our belief that, notwithstanding the constraints that the government faces, the strategy proposed is politically viable for the reasons discussed below:

- The strategy will allow Honduras to cash-in on the large efficiency gains that can still be obtained through the quick privatization of the distribution system. This could be done under existing law, so long as the government declares that it will not exercise the option of purchasing concession through state pension funds. Both the windfall income from the privatization and the resulting efficiency gains could be channeled quickly into benefits for the users, especially the poor. This would, in turn, increase the credibility of the reform process and make it easier to get legislative changes approved in other areas later on.
- The strategy plays down the privatization of transmission and generation assets, which was a major source of political opposition to the previous reform proposal.
- The strategy gives high priority to continuing to expand distribution coverage, which should make it possible to organize a coalition of mayors from remote communities and marginal barrio organizations in support of the proposal.
- The strategy will preserve subsidy mechanisms in favor of the poorest users but will end fiscally unsustain-

able subsidies to the middle class. With strong political leadership, this can be sold to the press and the public as a coherent part of the poverty reduction strategy.

- The strategy will guarantee expansion of capacity in line with demand, avoiding the political risk of supply crises. Better planning and timely and more transparent contracting will improve the composition of the stock of generation assets and reduce the average and marginal price of generation compared with the “no reform” scenario. It will also offer relative price stability in the generation market. All these points favor the interests of the current users, including the urban middle class.
- The strategy proposes that maintaining the current market structure in the medium term, thereby reducing the uncertainty and confusion that would arise from a strategy that proposed reforming everything at the same time.
- Most of the existing private sector actors in the sector will have nothing to lose from this strategy and can therefore be expected, at the very least, not to oppose it. Many of them will welcome opportunities for increasing their business in the electricity sector. Clarification of the rules for private development of renewable energy sources would be a major breakthrough from this point of view. ■



**◀ p.1 Accounting Standards**

before the “Enron Debacle”, the economic and financial crisis of the late 1990s, which started in 1998 in certain Asian countries and spread to other regions of the world, showed the need

for reliable and transparent accounting and financial reporting to support sound decision-making and supervision. The increased globalization of financial markets requires coordinating the standards for the disclosure and release of information. Some steps have been undertaken in that sense. For example, in 1998 G7 Finance Ministers and

Central Bank Governors committed themselves to ensure that private sector institutions in their countries comply with internationally agreed principles, standards and codes of best practices. They called on all countries that participate in global capital markets equally to commit to comply with the international-



ly agreed codes and standards.

Different accounting conventions - namely the United States Generally Accepted Accounting Principles (US GAAPs) and the International Accounting Standards (IASs)- make competing claims of being the only and appropriate standards. This duality has an impact on transparency because an event may have two or more accounting interpretations and therefore lead to different conclusions. This increases the cost of capital for those companies willing to undergo the reconciliation exercise and may well discourage other companies from going the same route to tap capital markets for investments and innovation.

This paper reviews the status of the controversy between U.S. GAAPs and IASBs, and discusses how a process of convergence is possible. It also reviews the differences in characteristics and application between the two standards, and the changes that are taking place in the two camps. It then reviews the situation in the region and draws some conclusions and recommendations in terms of public policy towards a long-term goal of accounting convergence and the role and initiatives of the Multilateral Financial Institutions (MFIs).

## **2. The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB): U.S. GAAPs and the IASs**

U.S. GAAPs and the IASs look similar thanks to the efforts of the respective

standard setting bodies in eliminating the differences. In reality, however, once the standards are applied within the context of the different international customs and policies, the differences remain substantial.

The Financial Accounting Standards Board (FASB)<sup>1</sup> and the International Accounting Standards Board (IASB)<sup>2</sup> are working together to resolve the difference in standards and provide the global business community with a common language. At the same time, the IASB Constitution envisages a “partnership” between IASB and national bodies to work together to achieve worldwide convergence of accounting

**■ The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are working together to resolve the difference in standards and provide the global business community with a common language. ■**

standards. For instance, it is becoming customary that when the IASB puts the review a particular practice on its agenda, the FASB immediately does the same.

In March of 2002, the European Parliament ruled that all companies listed on the European Exchanges, approximately 7,000, must present their financial statements using IASs, no later than December 31, 2005. Currently, the U.S. Securities and

Exchange Commission (SEC) -that has a fundamental interest in the process of disclosure and in the integrity of the accounting system- does not allow the presentation of financial statements using IASs and requires reconciliation to U.S. GAAPs.<sup>3</sup> Approximately 50 foreign issuers listed on the U.S. Exchanges must present the reconciliation. The new requirement of the European Parliament will affect approximately 600 European companies listed on the U.S. Exchanges, which will have to file U.S. GAAPs reconciliation as required by the SEC. It is clear that the new ruling will put pressure on both standard setters to converge their systems as soon as possible.

## **3. Differences in Principles between U.S. GAAPs and IASs**

Resolution of the differences between the two standards is complicated by cultural and political factors such as the debate involving the fact that FASB uses a methodology “based on rules,” while the IASB uses a methodology “based on principles.” Some proponents argue about the superiority of U.S. GAAPs as a standard because IASs allow too much room for interpretation. However, the opponents point out that the voluminous and detailed FASB guides were not enough to prevent the Enron disaster. The debate of whether or not Enron violated the 3% rule, which defines control of “special purpose entities” and the consolidation requirement, is regarded as meaningless. In fact, under IASs, control is not defined quantitatively, but looks at the ability to exercise operating control, execution and decision-making over the special purpose entity. In a

[1] FASB is a private, independent, non-profit body, based in Connecticut, led by members of the accounting profession and industry, responsible for establishing and interpreting generally accounting principles. The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information. It was formed in 1973.

[2] IASB is an independent, privately funded accounting standard setter based in London. Board members come from nine countries and have a variety of functional backgrounds. The Board is committed to developing, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require transparent and comparable information in general purpose financial statements. It was founded in 2001.

[3] In February 2000, the United States Securities and Exchange Commission issued a Concept Release (the first stage in a proposed change in its rules), which discussed the use of international accounting standards in U.S. capital markets. The release solicited comment regarding the quality of IASs and raised questions regarding what supporting infrastructure would be necessary in an environment where issuers and auditors often are multinational organizations, providing financial information in many countries. The release sought to identify what important concerns would be raised by acceptance of IAS standards; and then asked for comment on whether the Commission should modify its current requirement for all financial statements to be reconciled to U.S. Generally Accepted Accounting Principles.

testimony to the United States Congress on the Enron case, last March, the SEC Chairman,<sup>4</sup> gave support to the standards “based on principles” indicating that the SEC will use its power as regulator to insure that FASB as the standard setter in the United States, starts using the methodology “based on principles” instead of the complex and detailed methodology “based on rules.”

In some instances, eliminating the differences between U.S. GAAPs and the IASs will require replacing some of the existing standards with a completely new one. For example, both standards setting bodies allow the use of smoothing to determine the value of pension plan assets. It would be impossible to decide which is the appropriate methodology allowed under US GAAP or IAS standard. As a result, replacement of both standards seems the right course of action.

In other circumstances, the cooperation and influence of one standard setting body in its market could favor the standard setting process of the other, as was the case of the treatment of stock options. The IASB has taken the position that stock options must be recorded as an expense. In 1993, FASB took the same initial position while drafting FAS 123, Accounting for stock based compensation, but in its final version, the standard was changed following the lobbying by businesses and politicians. The result was a compromise that opted for disclosure in the footnotes to the financial statement rather than the recognition of stock options as an expense as suggested by FASB’s initial position. The IASB likewise is under the pressure by political and business interests that may undermine its capability as an independent standard setting body. In the process of convergence, it is essential that the national and international accounting standards bodies establish built-in mechanisms that assure independence from interest groups. This is crucial to ensure confidence in the pronouncements of the standard setting bodies.

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#### **4. Differences in Characteristics and Application**

The two standard setting bodies, FASB and IASB, have the mandate to serve different constituencies and respond to diverse needs. They have different support levels and apply distinct standard setting structures and processes. The differences between the two sets of standards may be inevitable and suitable. However, if financial statements presented under IASs are to be considered appropriate for cross-border filings, it is essential that they satisfy the need of world financial markets for high quality financial information. In this respect, the U.S. GAAPs have a much longer record than IASs and they have been repeatedly tested in the largest and most efficient capital market in the world.

Most of the controversy and debate surrounding the comparability of financial statements prepared under IASs and U.S. GAAPs revolve around the following themes:

- Although IASs and U.S. GAAPs are broadly similar and, in various cases, the use of IASs can provide results that are analogous to those obtained by using U.S. GAAPs, the existence of alternatives creates the potential for different results. For example, under IAS 23 Borrowing Costs, the allowed alternative treatment requires capitalization of borrowing costs incurred in the purchase, construction, or production of certain assets in a manner similar to that of FAS 34 Capitalization of Interest Costs. However, IAS 23 benchmark treatment requires that borrowing cost be expensed, which constitute an alternative treatment with respect

to U.S. GAAPs. The existence of different alternative treatments and benchmarks creates a potential for non-comparability of financial statements.

- Some experts argue that IASs are too broad and general and cannot guarantee that similar accounting methods are applied in similar circumstances, or that similar results are consistently achieved. Arguably, this is true in some instances, although in others IASs are equally or more effective than U.S. GAAPs. For example, both IAS 2 Inventories and Accounting and Research Bulletin No 43: Restatement and Revision of Accounting Research Bulletins provide broad, general guidelines on cost flow assumptions in estimating the cost of inventories. However, IAS 2 provides more detailed guidance than U.S. GAAPs regarding accounting for inventories of service providers.
- In some circumstances, the IAS and U.S. GAAPs standards are identical, but the lack of implementation guidance by IASs creates differences when applying the standards. For example, IAS 33 Earnings per Share and its U.S. GAAP counterpart, FAS 128 Earnings per Share resulted from a team effort between IASB and FASB. However, FASB 128 implementation guidance is more detailed for some of the calculations required for determining earnings per share, as is the case of determining the impact of different types of contingencies related to contingently issuable shares. Consequently, there may be different results in the calculation of earnings per share between entities

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[4] Harvey L. Pitt, Chairman, U.S. Securities & Exchange Commission. March 21, 2002, Accounting and Investor Protection Issues Raised by Enron and Other Public Companies. Testimony before the Committee on Banking, Housing and Urban Affairs United States Senate.



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following IAS 33 and FASB 128.

- The difference in reported results between IASs and U.S. GAAPs can be even more difficult to compare as more countries adopt IASs as their national standard. The lack of consistency in the application and enforcement of the standard in some jurisdictions will make it difficult to compare an IAS-based financial statement of an entity in Germany with a comparable IAS-based financial statement of an entity in Japan and, clearly, almost impossible to compare with a U.S. GAAPs-based financial statement.

## 5. At the Top of the Agenda of IASB and FASB

As a result of a debate among various interest groups in 2001, FASB eliminated the standard that allowed the use of the pooling of interest method for business combinations effective with acquisitions. The IASB also has a project on its agenda to converge in 2002. At the top of IASB's agenda is the "Improvements Project," which was undertaken following requests from the International Organization of Securities Commissions (IOSCO), the European Commission and national standards setters such as FASB. This project includes several changes both large and small in 14 international standards. The purpose of the project is to eliminate alternatives, redundancies and conflicts within exiting standards and align the IASs with U.S. GAAPs in areas such as accounting for foreign exchange and investment in subsidiaries that are not consolidated. A dramatic divergence in standards persists in other areas such as the LIFO inventory method, which is allowed under U.S. GAAPs and not under IASs.

The "Improvements Project" has also eliminated extraordinary items. Although in appearance, this area seemed to have significant differences, in reality, the differ-

ences are minimal since there are not that many transactions treated as extraordinary items. In the United States, the reporting of an extraordinary item has become an ordinary occurrence. FASB did not totally eliminate this category, but instead rescinded one of the principal originators of extraordinary items, i.e., the early extinguishment of debt. When FAS 4 Reporting Gains and Losses from Extinguishment of Debt was issued, this constituted an extraordinary item. Now, with all the innovations in the financial market, most companies have great flexibility on how to retire their debt. In reality, innovation coupled with the need to create global standards has made it necessary for the FASB and the IASB to re-evaluate the accounting standards. In addition, the creation of accounting standards is not static, rather it has to be continually adapted to new commercial and financial transactions in a global environment.

## 6. Standard Setting in Latin America and the Caribbean: Impact on Quality Control

Some emerging market countries have benefited by adopting one of the two accepted standards. This is especially true of those countries that had no national standards or their national accounting standards did not provide adequate transparency.

In Latin America and the Caribbean, the adoption and convergence of the national standard setters to one of the existing standards has been mixed.<sup>5</sup>

■ ***At the top of IASB's agenda is the "Improvements Project," which was undertaken following requests from the International Organization of Securities Commissions (IOSCO), the European Commission and national standards setters such as FASB.*** ■

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

The diversity of the standard setting process in Latin America makes difficult, if not impossible, the comparison of financial statements prepared under the national GAAPs with IASs or U.S. GAAPs. The difficulty of the comparison includes those countries adopting IASs or US GAAPs mainly due to the lack of consistency in the application of the standards and leniency in the local regulatory enforcement of the standards.

A Quality Control System would permit the comparison of financial statements prepared for those enterprises in the countries that have adopted IASs or US GAAPs. A Quality Control System for accounting firms in private practice consists in the application of the quality control standards against which the structural organization of the firm and its

[5] The table comparing the National Accounting Standards and Quality Assurance Policies across the Americas is available at [www.iadb.org/sds/ifm/publication/gen\\_151\\_2971\\_e.htm](http://www.iadb.org/sds/ifm/publication/gen_151_2971_e.htm).



established policies and procedures will be benchmarked to reasonably assure that professional accounting, audit and ethical standards –including conflict of interests– are observed in the performance of the engagement. The adoption of a system of quality control by the individual countries needs to be coupled with local regulatory enforcement.

In countries that have not adopted IASs or US GAAPs in their entirety, a reconciliation of the financial statements prepared under the countries' GAAPs to IASs or US GAAPs should be required for entities listed in the local exchange, banks, insurance companies, investment funds and, in general, all entities of public interest.

Table 1 presents a synopsis of the major differences between U.S. GAAPs and IASs. An overview of the status of the national accounting standards and quality assurance enforcement in Latin American and Caribbean countries is available at [http://www.iadb.org/sds/ifm/publication/gen\\_151\\_2971\\_e.htm](http://www.iadb.org/sds/ifm/publication/gen_151_2971_e.htm).

## **7. Conclusions**

The application of accounting standards in financial reporting constitutes a fundamental instrument for achieving the goal of releasing information according to the criteria of accuracy, completeness and comparability. These requisites allow the market to function and grow, introducing more effective market discipline –which boils down to a proper valuation of business entities according to the risk/reward trade-off. Latin American and Caribbean countries are at a cross-road; if they want to develop their financial markets they must embrace the process of transparency. While it is likely that in the long run the two relevant standards setting bodies will converge, at this point, Latin America and Caribbean countries have to make the political decision of implementing accounting standards that are appropriate and internationally accepted and prepare themselves for the process of harmonization and globalization.

Implementation requires more than enacting legislation. Making accounting standards become part of the routine of the local business community entails long-term efforts through enforcement, training and education, and quality control systems. Any change in a country's legal and regulatory system requires coping with its political, cultural and social realities. However, internationally accepted accounting standards have important specific characteristics that facilitate their adoption and effective implementation. More than other standards, they are self-contained and stand-alone in that their application does not require that the domestic legal system be changed, i.e., the so-called interdependence of rule under which the rules have to be inserted and understood in the context of other legal concepts of the domestic system. The autonomy feature of the accounting standards facilitates their introduction in national systems as the rules embodied in the international standards make only limited reference to legal terms and concepts existing in the recipient legal system.

The application of the standards may have significant benefits for the economies of the region because it will boost their ability to attract foreign capital, foster the development of local markets and ultimately reduce the cost of funds and improve competitiveness. By the same token, a single, uniform, high quality, globally applied and enforced set of standards of financial accounting and reporting is needed to support both domestic and cross-border investment and financing decisions.<sup>6</sup> These desirable outcomes display the characteristics of a regional public good.

To address these problems, many countries in the region are adapting and promoting International Accounting and Auditing Standards. The World Bank has been conducting Reports on the Observance of Standards and Codes (ROSCs) that summarize country compliance with selected international standards, including those related to

accounting and auditing. The ROSCs exercise regarding the accounting and auditing module assesses the status of the accounting practices in a given country and prepares a specific report for the Government. The report guides policy discussions with the relevant national authorities and is used by rating agencies in their country assessments, and by the private sector for risk analysis.

As countries undergo ROSC assessments, the demand for assistance in accounting and auditing standards will increase. The IDB's Multilateral Investment Fund (MIF) has launched a complementary program, called accounting cluster, aimed at supporting the competitiveness of Latin America and Caribbean countries through the adoption of internationally accepted standards and providing financial support to countries and/or accounting associations that want to move ahead in the areas of application of the standards, training and quality control. Projects in the accounting cluster will share the same technical theme and developmental goals, and can be managed and monitored as a group. This will promote the effective use of MIF resources, generating economies of scale and facilitating the sharing of project information and experiences that will yield important lessons. Moreover, these operations will provide important demonstration effects through the dissemination of results from projects that promote the implementation and harmonization of international accounting and auditing standards. Finally, clustering these projects offers a high potential for a catalytic impact that will promote learning and sustainable outcomes across the region.■

### **Websites of Interest:**

- IFAC: <http://ifac.org>
- IASB: <http://www.iasb.org.uk/>
- FASB: <http://www.fasb.org>
- SEC: <http://www.sec.gov/>
- IADB-MIF: <http://www.iadb.org/mif>
- AICPA: <http://www.aicpa.org/>

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[6] As a result of an assessment of International Accounting Standards made in 2000 by the Technical Committee of the International Organization of Securities Commissions (IOSCO), the Presidents' Committee of IOSCO approved a resolution permitting its members to allow multinational issuers to use the IASs to prepare their financial statements for cross-border offerings and listings, supplemented, where necessary, to address outstanding substantive issues at a national or regional level.



**TABLE 1: Areas Of Major Differences Between IAS And U.S. GAAP**

<i>AREA OF DIFFERENCE</i>	<i>IAS</i>	<i>U.S. GAAP</i>
Stock Compensation	No accrual and no disclosure of fair values.*	The fair value of the stock option is recorded as expense or disclosed. The FMV of shares and the appreciation rights of the shares given to employees must be recorded as expense.
Business combinations	The pooling -of-interest is allowed if the acquirer cannot be identified*	All combinations must be accounted under the purchase method.
Goodwill	Amortized over a period of 20years and also subject to the asset impairment test*	Generally is not amortized, but is subject to the asset impairment test
Research & Development - acquisitions in process	Must be amortized	Recorded as an expense
Financial Statement Consolidation	Control test (could be with voting rights less than 50%)	Control test (majority of voting rights - over 50%)
Asset impairment	Is recognized if the discounted present value of future cash flows is below the asset's book value	Is recognized only if the future cash flows (not discounted) are below the asset's book value
Provision for liabilities of uncertain timing and amount	One comprehensive standard exist, discounting is required	No general standard in effect. Some provisions are not discounted.
Issuance of convertible debt	The proceeds from issuance are divided between liability and equity	The proceeds are recorded entirely as a liability.
Hyperinflation	General price-level adjustment of subsidiary's financial statements is required and gain or loss of net monetary position is recorded in net income	Re-measure of subsidiary using parent's functional currency
Discontinued operations: Expectation for future operating losses	No accrual	Accrual
Direct initial costs for lessors	Amortize or expense over the term of the lease*	Recognized as an expense
Foreign exchange differences on monetary transactions	Sometimes is added to the cost basis of the asset*	Always recorded in net income
Segment reporting	Business segments are lines of business and geographical areas. Must report using consolidated GAAP. Segment definition	Segments are components for which information is reported to management and can use whatever GAAP is used for internal purposes. No segment definition
Property, plant and equipment	Revaluation is allowed	Revaluation is not allowed.
Investment in property	Can use either fair value or cost model	Only cost model is allowed
Correction of errors	Either re-state or include cumulative effect in earnings.*	Re-state.
Accounting changes - non-required	Either re-state or include cumulative effect in earnings*	Re-state
Financial statement formats	Specific line items are required.	SEC regulations require specific formats but no under FASB.
Comprehensive income	Reporting not required*	Reporting required
Statement of Cash Flows	Interest received and paid could be recorded as operating, investing or financing.	Interest received and paid is recorded as operating
Construction contracts for which the percentage of completion cannot be determined	Cost recovery method	Completed contract method
Capitalization of interest on constructed assets	Optional	Required
Preferred shares - mandatory redemption	Recorded as liability	Split between liabilities and equity
Investment in joint ventures - incorporated	Equity method or proportionate consolidation	Equity method
Change in value on investments with not ready available market	Either in equity with recycling, or in earnings *	In equity with recycling
Special Purpose Entities (SPEs)	Must be consolidated if controlled	Qualifying SPEs are not consolidated

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

## Book Reviews, Articles & Papers:

**Development Microeconomics,**  
*Pranab Bardhan and Christopher Udry,*  
New York: Oxford University Press.  
2000.

Multilateral banks are confronted with the task of designing and implementing programs to promote growth and alleviate poverty, yet most of their staff has no previous exposure to their microeconomic foundations. It's not their fault: except for programs in agricultural economics, the topic of development economics does not belong to the mainstream coursework in graduate school. This compact book fills several market niches: the academically oriented reader will find formal derivations and references to the literature, and the policymaker will be pleased to have a to-the-point reference for an impressive variety of topics, accompanied by clear interpretations and qualifications of the results.

The backbone of the book is the recognition of the pervasive role of imperfect information and its effect (often compounded with other kinds of failures) on the behavior of economic agents. This explains why perfect competition models rarely succeed when dealing with developing economies. Bardhan and Udry stress the importance of both the individual as economic agent and cultural norms as the framework of social interaction; the problems of assuming by default that efficiency and equity are separable; the role of market rivalry and the potential of information-based market breakdown and coordination failure.

Emphasis is placed on analyzing the problems faced by the poorest in developing economies. The models used in the book are rigorous but simple, and technical sophistication is skipped. The book addresses, among others, ten important topics. The first is household economics (simultaneous

decisions on production and consumption in a farm with complete and incomplete markets), and the second is population (reproductive decisions of families as a function of fertility, population, investment in human capital, and income). The chapter on population presents Dasgupta's model of fertility as influenced by cultural patterns. This form of externality involves strategic complementarity (each household's child-bearing decision helps set a cultural pattern, and this affects the preferences of all other households). It leads to a pattern that reemerges later on in institutional economics models: when there are strategic complementarities, it is possible that there are multiple equilibria and that some of these equilibria are strictly better than others. A third topic is labor markets (a discussion on efficiency wages and the social norms that may prevent undercutting). Migration is the fourth topic covered (from simple accounts to Carrington's results when forward-looking behavior, selectivity and search costs are incorporated). Fifth is rural land markets (review and extension of the classical sharecropping models, including the effect of limited liability constraints). The sixth topic is fragmented credit markets (basic models of moral hazard and adverse selection with different informational structures). Seventh is a discussion of risk and insurance in an agricultural economy (discussion of formal and informal risk-pooling within a community; intertemporal smoothing-consumption through saving and credit markets as imperfect substitute of full risk-pooling; and income stabilization measures like crop and activities diversification). The eighth topic is linkage of transactions and rural development and includes a discussion of the imperfections arising when impersonal, anonymous and functionally specialized relationships are not in place. Ninth is a chapter on human capital and income distribution explores the idea that there is joint causation between income and human capital



and that this, combined with increasing returns to investment in human capital and imperfect credit markets, generates a poverty trap. Finally, we wish to recommend the section dealing with poverty alleviation, specifically, with efficiency and equity issues (the debate about the efficiency-equity tradeoff, false or exaggerated when agency costs and coordination problems are taken into account; the relative efficiency of asset redistribution policies, as opposed to tax-transfer policies that take the form of subsidies; and discussion of governance structures and the role of local self-governing institutions in improving efficiency and equity in poverty alleviation).

**Financial Structures to Promote Private Sector Development in Southeastern Europe,** *Francesca Pissarides,* European Bank for Reconstruction and Development (EBRD), London, UK. Working Paper 64. June 2001.

It is always illustrative to review the trajectories of sector reforms in other regions *cum grano salis*. At least, we learn about the dynamics of proposed policy measures and its complementarity requirements. South-eastern Europe is, and has traditionally been, the least developed region in Europe. During the past decade, it has also made the slowest progress in the transition to a market economy. This paper discusses the extent to which the financial sector in southeastern Europe has evolved to respond to the need of the local private sector. It does so through an analysis of the sources of finance used by enterprises when making fixed investments, and by looking at the level of banking intermediation and the (lack of) development of the nonbanking financial sector.



The financial reforms have followed a stop-go cycle, partly due to varying levels of commitment to the reforms by the governments involved, and also to adverse political developments and economic crises. Many of the policy challenges remain to be addressed effectively (including the imposition of financial discipline). Slow progress in market reforms is one of the reasons for the very poor investment climate in southeastern Europe.

Firms in southeastern Europe mainly rely on internal funds to finance their expansion. Underdeveloped capital markets in these countries place the

burden on the banking system. However, with the local banking system still largely in need of significant reforms and in a state of poor capitalization, low liquidity, poor profitability, overall poor financial health and low provisioning levels, the resulting degree of intermediation is dismal. Poor attention to market risk, the inadequate legal and regulatory frameworks and poor effective supervision do nothing to dispel the danger of potential financial crises.

Two elements contribute to hinder the impact of financial measures. First, finance alone is insufficient to support firm entry and growth. To maximize the benefits of the financial system, the provision of funding should be accompanied by parallel efforts to improve the investment climate and create a support structure to provide advice to the

new entrepreneurs. Second, it is possible that the traditional instruments deployed in the region during the past ten years are neither efficient nor sustainable to deliver funds made available by international financial institutions and donors. Sometimes the credit lines provided by donors and IFIs have been channeled through inexperienced NGOs, due to the lack of suitable local financial intermediaries, with very poor results. Greenfield microfinance banks are considered to be unfair competitors by local commercial banks because they benefit from grants and subsidized credit lines that are rarely available to the local banking system. As a result, there is doubt that the sustainability of microfinance banks can be achieved because of the incentives implied in the availability of soft funding.

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