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CHANGING ROLE OF MEXICAN ACCOUNTING FIRMS AND OF THE COMISARIO, AND RESPONSE TO SARBANES-OXLEY

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In different degrees the world securities markets are facing crises of confidence. Much has been said and written on the alleged underlying causes of the problem: flagrant misuse and abuse of accounting policies, dishonesty of Wall Street, top management's use of corporate assets as personal piggy banks. No doubt these reasons have contributed to the crisis of confidence in the United States securities market. I maintain, however, that those sins would have been forgiven had the exuberant market not turned into a blue market. Thus the shattered dreams of millions of Americans, who banked on illusory net worth that would have meant earlier and more comfortable retirements, constitute one of the overriding causes of the crisis of confidence in the U.S. market. Fortunately, in Mexico we have few friends and neighbors who suffered the consequences of the U.S. stock market bubble burst.

Accounting scandals and auditors have borne the biggest share of the blame for the erosion of confidence in the markets. Undeniably, auditors' incompetence and unethical behavior as well as ineffective audit methodologies helped fuel the insatiable quest of top management in some companies for an ever-increasing bottom line and unstoppable growth. We cannot seriously believe that an accounting entry on the books of WorldCom drove it into Chapter 11. Clearly, the business models of Enron, Tyco, Vivendi and WorldCom were not meant to survive untouched in the down cycles of a real economy. Arthur Andersen's demise was a very high price to pay for the errors of a few. The accounting profession must capitalize this cost and ensure that its members discharge their professional responsibility with the highest sense of ethics and independence.

Mexico, an important participant in the regional and global economies, is not immune to the side effects of the medicine being administered to attempt to cure the ills of the U.S. crisis of confidence. The most potent remedy, the hastily conceived Sarbanes-Oxley Act,¹ affects many companies operating outside the U.S. and has permeated the regulatory environments of many countries. Mexico's securities regulatory agency, the *Comisión Nacional Bancaria y de Valores* (National Banking and Securities Commission), or CNBV, has issued rules that replicate some of the provisions of Sarbanes-Oxley, although they fall short by not requiring internal control certifications by top management. Except for the deferral of its effective date to 2005 and not requiring quarterly certifications and other minor concessions, Sarbanes-Oxley will apply to Mexican and other foreign private issuers--companies whose securities are traded in the U.S. markets. The following chart is a comparison

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1. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

of the requirements of Sarbanes-Oxley and the rules recently issued by the National Banking and Securities Commission:

COMPARISON BETWEEN CNBV REGULATIONS AND SARBANES-OXLEY REQUIREMENTS

	CNBV	SO
1. CFO and CEO certifications		
• Internal and disclosure controls	no	yes
• Annual assessment of effectiveness and monitoring of IC	no	yes
• Independent auditor attestation	no	yes
2. Auditor independence	yes	yes
3. Prohibited services	yes	yes
4. Audit partner rotation	yes	yes
5. Appointment of auditor	yes	yes
6. Public Company Accounting Oversight Board	no	yes
7. Directors' independence	yes	yes
8. Audit Committee	yes	yes

As can be seen, the Mexican regulations do not require internal control certifications or the establishment of an oversight body. I believe that the internal control certifications, although they impose an enormous personal responsibility on public companies' top management, are the single most important measure that will help restore confidence in the business environment as a whole and the stock markets in particular. Internal control on financial reporting certifications will enhance the reliability and transparency of financial statements, promote ethical business practices, and hold top management accountable for material information emanating from accounting and information systems.

In response to initiatives from the International Organization of Securities Commissions, the CNBV has asked the Mexican Institute of Public Accountants to propose an operating mechanism for an accounting oversight body, which would be partially or fully financed by large firms. I believe that in our circumstances, this is a move in the right direction, inasmuch as the establishment of a board similar to the Public Company Accounting Oversight Board² would require unavailable resources needed to attract the required talents to conduct a professional and fair oversight function. The Institute must ensure that its recommendation will consider independence as the bedrock of its proposal.

The auditor independence rules are similar to the Sarbanes-Oxley provisions. The Mexican regulations established the concept of prohibited services such as bookkeeping, information systems implementation and management, internal audit and legal services, management participation, valuation and appraisal services and executive recruiting, in addition to the basic prohibition against making investments

2. The Public Company Accounting Oversight Board is a private, non-profit corporation. It was created by the *Sarbanes-Oxley Act* to protect the interests of investors by overseeing the preparation of audit reports of public companies.

in the audited entities. The regulation also requires the rotation of audit partners every five years, with a two-year "time-out" period, the appointment of auditors based on the favorable recommendation of the audit committee, and the pre-approval of non-audit services.

Given the economic and banking crises of the mid 1990's, the Mexican private sector appointed a blue ribbon committee with the mandate to formulate a code of best corporate practices that would ensure good corporate governance in public and private companies. The result was a comprehensive document that anticipated the need to establish many of the rules that have been recently promulgated around the world. In 2000, the CNBV exhorted public companies to voluntarily adopt the 56 recommendations of the Best Corporate Practices Code and required formal reporting of the degree of adherence to the recommendations.³ Following are several tables showing the extent to which public companies have adopted the recommendations:

RECOMMENDATIONS - APPLICATION IS NOT MANDATORY

• Board of Directors	–Make up, structure, operation, and directors' duties
• Board of Directors' Committees	–Performance evaluation and compensation of top management
	–Audit
	–Finance and planning
• Information	–Disclosure to shareholders

Adoption of BCPC Recommendations	% Issuers		
	2000	2001	2002
1. Board of Directors			
• make up - 5 to 15 members, independent directors, etc	49	56	61
• operation – minimum attendance, etc.	80	84	88
• directors' duties – conflicts of interest, etc.	87	88	88
2. Board of directors' committees (structure)			
• performance evaluation and compensation of top management	46	47	49
• audit	68	76	80
• finance and planning	64	63	61
3. Information – disclosure to shareholders	60	67	73

3. C.N.B.V., *Código de Mejores Prácticas Corporativas*, (July 1999), at <http://www.cnbv.gob.mx/noticia.asp?>

Audit Committees	% Issuers		
	2000	2001	2002
Chaired by an independent director	26	58	70
Approves accounting policies and submits to board for approval	41	59	66
Evaluates and opines on effectiveness on internal control	48	65	71
Ascertains that interim and annual financial information is prepared using consistent accounting policies	55	76	77

Independent Auditors	% Issuers		
	2000	2001	2002
Audit partner rotation every 6 years	72	81	84
Independent auditor "validates" and opines on effectiveness of internal control	90	91	87
Auditor partner different from <i>Comisario</i>	67	75	78

As mentioned above, most of the BCPC recommendations are not mandatory and their adoption is largely unsupervised. Also, there is little guidance on what documentation must be generated to support reported adherence. Thus, in many cases the reported adoption is based on subjective management interpretations. A clear example is the reported independent auditors' "validation" and their opinion on the effectiveness of internal control. The reported adoption of this recommendation is based on management's erroneous inference that the auditor's annual letter of recommendations that includes suggestions to improve internal controls represents an opinion on the effectiveness of internal control. To the surprise of many, a financial statement audit is not designed to identify significant deficiencies or material weakness in internal control.

One of the BCPC recommendations which, in my personal view, constitutes gross misguidance is the suggestion that the *comisario* (statutory auditor-examiner) be different from the partner responsible for the audit of a company's financial statements. The *comisario* requirement is an anachronistic concept that imposes significant personal responsibility, and, in my opinion, no reasonably prudent person should accept this largely honorary position without the support of and personal involvement in the audit of a corporation's financial statements. Several *comisarios* have been personally sued for supposedly committing criminal acts.

The Mexican General Corporate Law establishes that one or several *comisarios* will be in charge of overseeing the corporation. According to the law the *comisario* has two principal duties. The first principal duty is to submit to the general shareholders' meeting an annual opinion on whether the policies, and accounting and information criteria followed by the corporation are adequate and sufficient taking into consideration the particular circumstances of the corporation, and

whether the policies and criteria have been applied consistently, and consequently, the information presented by management to the shareholders, reflects in a true and sufficient form, the financial position and results of operations of the corporation. The second principal duty holds the *comisario* individually responsible to the corporation for the compliance with the obligations established by the law.

In closing, I would like to touch on the need of Mexican public companies to implement strict corporate governance practices to offset the perception that closely controlled companies have overriding managements and boards of directors which remain exclusively an Old Boys' Club.

Mexican public companies, particularly those whose securities are traded in the U.S. markets, must think about corporate governance in a whole new way. They must upgrade internal controls on financial reporting and strengthen audit committee accountability. Truly independent recognized professionals must be appointed to boards of directors, professionals who will not hesitate to take a principled stance and confront management on questionable decisions.

