

SARBANES-OXLEY IMPLICATIONS FOR MULTINATIONALS DOING BUSINESS IN LATIN AMERICA

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TABLE OF CONTENTS

SARBANES-OXLEY IMPLICATIONS FOR MULTINATIONALS DOING BUSINESS IN LATIN AMERICA	1
Disclaimer:	2
Executive Summary:	3
Introduction:	4
Background of the Sarbanes-Oxley Act:	4
The provisions of Sarbanes-Oxley Act	8
Potential excessive orthodoxy of auditors:	8
Corporate responsibility rules:	10
Enhanced Financial disclosures:	19
1. Proforma accounts reconciliation:	19
2. Off-balance sheet vehicles:	20
3. Stock Options:	27
4. Pension Funds:	28
5. Revenue Recognition:	29
Conclusions and Suggestions:	32
APPENDIX	33
About FTAA CONSULTING INC	33
About the author:	33

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Several sources of historical events presented herein are public information. There is no intention to attack any individual or corporation, and none of the judgments herein may be construed as offensive in any respect. The Paper intends to provide a foundation to learn from mistakes of the past and build a better, more ethical and secure business practice environment.

Executive Summary:

The Sarbanes-Oxley Act introduced a set of obligations to management of large companies listed in the United States stock exchanges or public securities markets.

This White Paper analyzes the implications and consequences of applying the Sarbanes-Oxley Act for multinationals doing business or having a permanent presence through affiliates or subsidiaries in Latin America.

The events that affected auditing firms and stock exchanges at large, will certainly affect the interpretation of business realities in different cultural and legal environments as in all Latin American countries and will necessarily have bearing in the following fields:

- In the relationships between management and auditors, because the potential excessive orthodoxy of the latest could lead to question the unquestionable. While, on the other hand, it may also lead to identifying loopholes in the financial structure of Latin American subsidiaries.
- In the representation and warranties that multinationals' top management must grant to United States regulators in terms of their knowledge and understanding of all material facts and dealings of all their subsidiaries and the accuracy and effectiveness of their internal controls.
- In the enhancement of disclosure in their reports and financial statements, which lead them to understand and judge all material facts having consequences in revenue recognition, off-balance sheet classification, dealing with derivative transactions and so forth.

While the White Paper addresses the grounds and rationale of the Sarbanes-Oxley regulations (including these regulations issued by the Securities and Exchange Commission and other bodies), it also suggests how to build a solid control structure to ensure compliance with the Law and its regulations while complying with local laws and achieving business goals and objectives.

Introduction:

Latin American markets represent 7% of the global purchasing power, more than the total of Asian developed countries¹. For over a century several multinationals have established deep roots in the Region and the tendency of the global economy leads to an increased direct presence of multinationals in these markets.

Those multinationals doing business on a global basis, and whose stocks are traded in the United States' Exchange Markets, are subject to the very strict regulations imposed by the Sarbanes-Oxley Act of January 23, 2002. Most American Corporations are currently working in trying to align all of their operations in the United States in order to meet the requirements for information, representation, internal controls and accountability contained in the body of the Law. But when the corporation's reach of operations goes beyond the borders of the United States and reaches other legal systems, other financial accounting standards and other cultures, the question becomes: Can these multinationals cope with Sarbanes-Oxley regulations?

This paper will analyze some critical issues related to the engagement of business throughout Latin America, and formulates several conclusions and suggestions.

Background of the Sarbanes-Oxley Act:

Just days after the events of September 11th, in October 2001, a scandal involving Enron Corporation's accounting inaccuracies triggered a dramatic concern by Corporate America regarding loopholes, that still exist, in Corporate Law and Corporate Governance that can allow for misleading investors. As a result of the Enron scandal, subsequently followed by similar scandals at Worldcom, Tyco, Global Crossing, Adelphia and other public corporations, on February 14, 2002 Congressman Michael Oxley (R - Ohio) introduced to the House of Representatives the Bill that would eventually become the Sarbanes-Oxley Act² of 2002.

Enron Corporation practices included, among other, the following:

- “Enron recorded as revenues what on the stock market they simply referred to as volume: (...)” and “Enron was able to book its energy trading contracts at the full contract price. It would be like a stockbroker taking credit for the full sales price when a customer sold

¹ Source: The Economist Intelligence Unit, June 4, 2003.

² The name Sarbanes comes from Senator Paul Sarbanes (D - Maryland) who had a decisive participation in obtaining the U.S. Senate passed the bill.

stock, instead of the commission that they earned on selling the stock, which gave them a much inflated earning figure”³.

- “Take Enron's movies-on-demand deal with Blockbuster. That was a real partnership: To share profits 50/50 for 20 years. But before it could even go bad-- which it did-- Enron created a different company, code name: Project Braveheart. A Canadian bank invested \$115 million in it in return for the first decade of supposed future earnings from the Blockbuster deal. (...) Plus, Enron guaranteed the bank its money back if Braveheart fell. Then, get this, Enron recorded the bank's \$115 million money- back guaranteed investment as Enron's profit!”⁴
- “Enron and the third party (an Enron affiliate) amended certain forward contracts to purchase shares of Enron common stock, resulting in Enron having forward contracts to purchase Enron common shares at the market price on that day (...)Now, a key to this scam was perhaps Enron's main alchemical tactic: The use of its so-called related parties companies like Raptor or Braveheart, companies created and owned almost entirely by Enron; subsidiaries, really, some of them run by its chief financial officer. Yet when it suited Enron's interests, these "related parties" were treated as independent, arms-length businesses.(...)In the case we just heard about, another related party had invested in something called New Rhythms Net Connections. This is our fanciful representation of it. (Beethoven's "Ode to Joy" playing.) Unfortunately, New Rhythms had crashed. So Enron entered into something called a derivatives contract with its own subsidiary. The contract increased in value as New Rhythm's stock price went down.(...) So if the stock rose, Enron would report profits from the stock because it was an asset of the subsidiary. If the stock dropped, Enron would report the profits from the New Rhythms derivative contract, neglecting to report that the related party-- the subsidiary-- was losing exactly the same amount”⁵.
- “Watered stock : Enron gave to a related party 3.7 million shares of their common stock and disclosed that, among other assets received, 1.2 billion in notes receivable from a company owned by Enron. This “is called watered stock, because it inflates the capital. It makes the company look like it has more equity than it really does”⁶.
- “Enron borrowed money through related parties to hide its debts, sold off energy assets, then claimed the proceeds as pure profit, while never deducting the value of the asset it no longer had. (...) It sold now a nearly worthless fiber optic cable to one of its related parties, claiming a profit of \$53 million, and then, without explanation, reported that same transaction again the following quarter with an additional \$14 million profit, thereby just beating expectations on Wall Street”.
- “And finally, remember that initially successful Jedi partnership in California? When Enron's partner took out its gains, Enron hid the fact by creating Chewco Investments...”.

In the case of “Tyco International, Ltd., a corporation that makes a diversity of products, from healthcare supplies to alarm systems, three former high-level executives have been accused of fraud. The three accused executives, former CEO L. Dennis Kozlowski, former Chief Financial Officer Mark Schwartz and former general counsel Mark Belnick, have been indicted for fraud and theft by the Securities and Exchange Commission (SEC) as well as their former employer. They have all pleaded innocent”.

- “When was the alleged fraud discovered?”

³ Report by Paul Solman for the Public Broadcasting Service. See:

http://www.pbs.org/newshour/bb/business/jan-june02/enron_1-22.html Latest visited June 7, 2003

⁴ Ibidem.

⁵ Ibidem.

⁶ Ibidem.

“Tyco’s financial accounting first came under review in January 2002 after a tip suggested that a less-than-legal transaction might be taking place. In June of the same year, Kozlowski resigned just before he was accused of tax evasion on some expensive art purchases, allegedly made with company funds. On September 12, 2002, the SEC formally charged Kozlowski, Schwartz, and Belnick of civil fraud”.

- “What types of fraud are the men accused of committing?”
“The SEC and Tyco International have indicted the former executives on charges of civil fraud and theft. They are accused of giving themselves interest-free or low interest loans for personal purchases of property, jewelry and other frivolities. According to the SEC, these loans were never approved or repaid”.
- “Kozlowski and Schwartz are also accused of issuing bonuses to themselves and other employees without approval of Tyco’s board of directors. It is alleged that these bonuses acted as de facto loan forgiveness for employees who had borrowed company money or were used to buy the silence of those who suspected the former CEO and CFO of fraud. According to Tyco, the individuals who received loan forgiveness were not aware that they were participating in anything illegal; they were told the program had the board’s approval. Tyco and the SEC say it did not”.
- “Kozlowski, Schwartz and Belnick are also being indicted on charges of selling their company stock without telling investors, despite their obligation to do so under SEC rules. In sum, the three are accused of stealing \$600 million dollars from Tyco International”.
- “What is the current status of the case?”
“Kozlowski, Schwartz and Belnick have been indicted, and have all pleaded innocent. All three former Tyco executives have been released on bail bonds for the time being. Although a judge froze the assets of Kozlowski and Schwartz in September, Kozlowski has since been given a monthly living expense of over \$14,000. He was also allowed to pay over 3 million dollars in state taxes. The trial for the three is tentatively set for June 1, 2003.” (Note of the author: Further to June 1, 2003, it has been reported by the press that none of these enforcement actions have advanced⁷
- “As for Tyco, an internal investigation has concluded that, although accounting errors have occurred, there is no systemic fraud problem. As a show of good faith and in effort to restore confidence in the company, Tyco has spent the past several months replacing its top board members”⁸.

The third influential case that preceded enactment of the Sarbanes-Oxley Act was the Global Crossing scandal:

“In a press release issued Monday (Feb.4, 2002), Roy Olofson, former vice president of finance for Global Crossing, accused company executives of improperly describing the company's revenue to the public. Olofson, through his attorneys at Los Angeles law firm O'Neill, Lysaght & Sun, said Global Crossing improperly recorded long-term sales immediately rather than over the term of the contract, that the company improperly booked swaps of capacity with other carriers as cash transactions, and that Global Crossing fired him when he blew the whistle.”⁹

⁷ Financial Times, August 1, 2003 issue in:

<http://news.ft.com/servlet/ContentServer?pagename=FT.com/StoryFT/FullStory&c=StoryFT&cid=1059478655759> . Latest visited August 2, 2003

⁸ <http://www.tycofraudinfocenter.com/information.php> Latest visited: June 8, 2003

⁹ <http://archive.infoworld.com/articles/hn/xml/02/02/08/020208hncrossing.xml> .Latest visited: June 8, 2003

These cases were illustrative of the following misconduct:

- Deceiving accounting, creating artificial figures to overestimate revenues, and/or underestimate costs and expenses, trying to keep investors happy and attracted to the company (mainly Enron)
- Embezzlement of Corporate funds for the personal benefit of certain managers, through Corporate expenses, loans, bonus, golden parachutes and other creative schemes (mainly Tyco)
- Inflating revenues by using swap systems of cross-selling excess of installed capacity (Global Crossing)
- Silencing whistleblowers (Enron and Global Crossing)

To make matters worse, a critical ingredient of the crisis was the complicity or gross negligence of the Auditors, among them Arthur Andersen LLP for Enron which eventually led to the auditing firm's demise.

The Sarbanes-Oxley Act of 2002 was enacted in response to the above and other actions undertaken by management of Corporations who, basically, deceived both investors and regulators. The bottom line of the Sarbanes-Oxley Act is that by establishing more rigid formalities, additional "bodies" and increased personal responsibilities on managers and directors, the Law expects that management and directors should behave ethically. Is that a fair expectation?

The provisions of Sarbanes-Oxley Act

Sarbanes-Oxley Act of 2002:

- Creates the Public Company Accounting Oversight Board (PCAOB)¹⁰ to oversee the auditing of publicly traded companies.
- Enhances the rules in order to promote an auditor's independence, by prohibiting them to render consulting services to audited companies, mandatory rotation of its auditors and providing strict conflicts of interest guidelines.
- Reinforces Corporate Responsibility by ruling for the creation of internal audit committees (accountable to the Board of Directors), defining responsibility -potential liability- of managers and directors for financial reports, penalizing influence from management and directors towards conduct of audits, mandating to forfeit certain bonus and profits, creating prohibitions and penalties for managers and directors, involving outside counsel in being responsible for either controlling ethical behavior of their publicly traded clients or report misdeeds, and regulates the creation of Fair Funds for Investors in order to provide relief to harmed investors.
- Enhances financial disclosures in periodic reports, including conflicts of interest, transactions involving management and principal stockholders, management assessment of internal controls and real time events.
- Defines narrow conflict of interest criteria for securities analysts.
- Orders the Securities and Exchange Commission to undertake studies about consolidation of accounting firms, reliability of credit rating agencies, reports on violations and violators of securities laws, enforcement actions and investment banks.
- Sets forth criminal violations to corporate accountability and enhances the penalties, besides mandating that CEOs must sign the Corporation's Tax Returns, which also leads to potential criminal penalties in case of deceived or inaccurate reports to the Internal Revenue Service.

For the purpose of this Paper, we will only focus on such provisions and consequences that have the potential for concern in dealing with Latin American businesses as are: (i) Potential excessive orthodoxy of auditors in order to cover their responsibilities (ii) Corporate responsibility rules, in particular but without limited assessments of internal controls, and (iii) Enhanced financial disclosures.

Potential excessive orthodoxy of auditors:

¹⁰ Already nicknamed as "Peekabo" (See Fortune Magazine, June 8, 2003)

The demise of Arthur Andersen & Co. as the world's most respectable auditor for publicly traded companies occurred on August 31, 2002. When after being found guilty of obstruction of justice by a jury, the firm announced it would cease auditing publicly traded companies¹¹.

Resulting from such disintegration, "...with Andersen's (...) exit from public auditing, the big 8 of the 1970s was now down to the Final Four -PricewaterhouseCoopers, KPMG, Ernst & Young and Deloitte & Touche"¹².

After such debacle, Barry Melancon, president and CEO of the American Institute of Certified Public Accountants, indicated that for some firms the additional oversight from the federal government to auditors won't be worth the hassle, and was quoted declaring "There are huge regulatory and liability risks that have come into play"¹³.

"Tougher scrutiny of corporate books also is causing more changes in client rosters (...)"

"If anything, the scrutiny of accountants is expected to intensify (...)"

"At the same time, there's also much confusion within the accounting industry"¹⁴.

Then, orthodoxy certainly became the leading pattern for the accounting industry. But: What is orthodoxy in accounting? Who makes the rules? If the rules are written in stone, which they are not, how are they going to be construed?

Well partially, the answer to one of these questions is: The SEC makes "some" rules, and the rest are basically creation of private bodies, the Financial Accounting Standard Board (FASB), and the International Accounting Institute. But, interpretation of the rules and assessment of economic facts will rely upon the auditors, some of them well educated, prepared and understanding, some other that may lack the experience or the on-the-spot knowledge.

Here is where the history provides us with a good lesson: During the Middle Ages, the so called "Inquisition" was created, namely "...in Roman Catholicism, a papal judicial institution that heresy and such things as alchemy, witchcraft, and sorcery and wielded considerable power in medieval and early modern times. The name is derived from the Latin verb *inquirere* ("inquire into"), which emphasizes the fact that the inquisitors did not wait for complaints but sought out heretics and other offenders".

"After the Roman Church had consolidated its power in the early Middle Ages, heretics came to be looked upon as enemies of society. With the appearance of large-scale heresies in the 11th and 12th centuries —

¹¹ Chicago Tribune, September 4, 2002.

¹² Ibidem.

¹³ Chicago Tribune, December 24, 2002 "Outlook 2003: Accounting: More Rules, transition, turnover and competition".

¹⁴ All three quotes from the same Chicago Tribune, December 24, 2002 report.

notably among the Cathari and Waldenses—Pope Gregory IX in 1231 instituted the papal Inquisition for the apprehension and trial of heretics”¹⁵.

“The inquisitorial procedure was quite detailed but, in general terms it gave a person suspected of heresy time to confess and absolve himself., and, failing this, the accused was haled before the inquisitor and interrogated and tried, with the testimony of witnesses. The use of torture to obtain confessions and the names of other heretics was at first rejected but was authorized in 1252 by Innocent IV . On admission or conviction of guilt, a person could be sentenced publicly to any of a wide variety of penalties, ranging from simple prayer and fasting to confiscation of property and imprisonment, even life imprisonment. Condemned heretics who refused to recant, as well as those who relapsed after condemnation and repentance, were turned over to the secular arm, which alone could impose the death penalty”¹⁶.

The outcome of such procedure is that people who expressed ideas or opinions that did not match the mental structures of the Inquisitors were condemned to death by fire. As a result, many injustices were committed.

Could history be repeated in case of auditing? In other words, would auditors consider “heresy” any business, financial or legal structure that “they” do not understand? And there is a risk that this may happen and said risk would increase if the officers of publicly traded companies are not in a position to understand the economic realities of their business and countries beyond their own. Hence, a poor understanding of Latin American economies, cultures, rules, laws and regulations may lead to excessive orthodoxy that may unjustly harm United States publicly traded companies.

Multinationals having operations in Latin America must then anticipate tougher judgments from their auditors regarding their accounting and internal control practices.

When this happens, their local team and local outside counsel must be able to provide solid grounds and explanations about their business practices, accounting rules, risk assessments and internal controls. Are these companies prepared for that? Is your company prepared?

Corporate responsibility rules:

Corporate governance is typically perceived by academic literature as dealing with "problems that result from the separation of ownership and control."

“From this perspective, corporate governance would focus on: the internal structure and rules of the board of directors; the creation of independent audit committees; rules for disclosure of information to shareholders and creditors; and, control of management. A recent academic survey began with the following quote:

¹⁵ Inquisition." Encyclopædia Britannica. 2003. Encyclopædia Britannica Premium Service. 21 Jun, 2003 <<http://www.britannica.com/eb/article?eu=43442>>.

¹⁶ Ibidem.

"Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment. How do the 'suppliers of finance get managers to return some of the profits to them? How do they make sure that managers do not steal the capital they supply or invest it in bad projects? How do suppliers of finance control managers?"

"From this point of view, corporate governance tends to focus on a simple model:

1. Shareholders elect directors to represent them.
2. Directors vote on key matters and adopt the majority decision.
3. Decisions are made in a transparent manner so that shareholders and others can hold directors accountable.
4. The company adopts accounting standards to generate the information necessary for directors, investors and other stakeholders to make decisions.
5. The company's policies and practices adhere to applicable national, state and local laws."

"Focusing on these internal control processes is quite natural when the subject is a corporation governed within advanced market economies. Point number five above assumes that a functioning legal system is in place and although there are considerable differences between Anglo-American, German, Japanese and other systems, they all share the luxury of defining the subject of corporate governance within the context of functioning market systems and highly developed legal institutions".

"When the subject of corporate governance arises in the context of transitional or developing countries, it involves a much wider range of issues. The recent Asian economic crisis, the continuing turmoil in Russia, and the recent experience of the Czech economy (we must add Argentina -author's note-) have combined to push the issue of corporate governance from the sidelines to center stage. In Asia, what began as a financial crisis is now viewed to be a crisis of corporate transparency involving relationships between governments and businesses, between holders of debt and equity, and the legal remedies for bankruptcy and favoritism. Further, as seen in the daily newspapers, a lack of adequate institutions in Russia have resulted in several highly publicized cases involving allegations of asset stripping, stock register manipulation and fraud. The Czech Republic privatization program has demonstrated the weakness of the voucher method in the absence of sound corporate governance mechanisms since it resulted in a lack of corporate restructuring and a consequent decline in competitiveness".

"What these examples have in common is that they all involve the basic rules of the economy and the relationship between these rules and the way companies are governed".

"The issues involved include some very familiar topics. In the interest of space, here are just a few core issues:

- Transparency -- or full disclosure of financial and key performance information
- Conflicts of interest involving boards of directors and managers
- Procedures for bankruptcy
- Property rights
- Contract enforcement
- Corruption and theft"

Each of these issues poses grave challenges for both the functioning of a market economy and a democratic society. Solving corporate governance problems such as those listed above involve going beyond a narrow view of how owners and managers of capital interrelate. In developing or transitional economies, the standard definition should be supplemented by placing it in context as follows:

"Corporate governance systems depend upon a set of institutions (laws, regulations, contracts, and norms) that create self-governing firms as the central element of a competitive market economy. These institutions

ensure that the internal corporate government procedures adopted by the firms are enforced and that management is responsible to owners (shareholders) and other stakeholders”.

“The key point in this definition is that the public and private sectors have to work together to develop a set of rules that are binding on all and which establish the ways in which companies have to govern themselves¹⁷.”

The Sarbanes-Oxley Act certainly made the guidelines stricter in that Executives, Managers and Directors of Public Companies must comply in order to deserve the trust that shareholders and creditors deposit in them. Despite the fact that “(...) you can’t legislate honesty”, as declared former SEC chairman Harold M. Williams¹⁸, The Sarbanes-Oxley Act created additional formalities that lead to making managers accountable to their word, but overall on their word of assumption that they control any single piece of sheet and ethics of all its subordinates, worldwide.

The most outstanding set of rules is included in Title III of the Act. Here are the most relevant practical issues:

1. Who hires external auditors?
 - a. Under United States Corporate Law, the Audit Committee of the Board of Directors hires them, and must agree with them in the scope of work, their compensation, and oversee their work. Section 301(3) requires in addition that none of the members of the Audit Committee may be a company’s employee.
 - b. In Latin America,, external auditors are commonly appointed by a General Shareholders Meeting¹⁹, i.e. on an annual basis by the representatives of the shareholders, who tend to be either their own country management team or (in random cases only) independent Law firms who appoint auditors following the instructions given to them by Management of the parent company.
 - c. Therefore, the independence required by United States Securities Law between auditors and management, is not formally extended to the company’s worldwide (and therefore Latin American) subsidiaries, although it used to be an extended practice that the subsidiaries appointed the country affiliate of the same Big Accounting firm selected as auditor to the parent company. Does it comply with the objectives of Sarbanes-

¹⁷ Corporate Governance: Transparency Between Government and Business By John D. Sullivan
Center for International Private Enterprise, April 2002.

¹⁸ Chicago Tribune, September 4, 2002. “Repeat offender gets stiff justice”.

¹⁹ Mexico: Ley General de Sociedades Mercantiles, articles 164 thru 171(Auditors are called “Comisarios”); Brazil, Lei 6404, 1976 provides however a system similar to the US model: There is a Comité appointed by the Shareholders (Conselho Fiscal) responsible for auditing, who may, absent appointment by Conselho de Administração, appoint independent auditors; in Argentina, Ley 19.550, article 284 (Auditors are called “Síndicos”) assign the appointment of the Síndico to the Shareholders; in Colombia (where external auditor is called “Revisor Fiscal”, article 204 of the Code of Commerce; and so forth.

Oxley Act? Would it be more effective, in terms of control, to have different auditors for the subsidiaries to those of the parent company so that power over control is atomized?

2. “Whistle-blowing”: One of the key triggers in unveiling Enron’s wrongdoings was the attention paid by the SEC to complaints from both Enron employees and subordinate auditors at Arthur Andersen & Co. Section 301(4) mandates to guarantee immunity and stimulate complaints concerning “accounting, internal controls or auditing matters”. To which extent do these protections apply to foreign employees? It certainly will depend on whether or not the Audit Committee sets forth procedures for employees of foreign subsidiaries. It should be advisable to do so, and this is certainly a suggestion to be addressed by all publicly-traded multinationals.
3. The certifications that Chief Executive Officers (CEOs) and Chief Financial Officers (CFOs) must issue in all annual (10-K) and quarterly (10-Q) reports to public investors:
 - a. Requires a representation that CEOs and CFOs have reviewed the report
 - b. That the statements under these reports are not misleading:
 - i. Because it does not contain any untrue statement of a material fact²⁰
 - ii. Or, it does not omit to state a material fact necessary to be reported
 - iii. All these, subject to said officer’s knowledge (the next question is: What is the standard of care required to “inquire” information and

²⁰ What is a “material fact”? In the Securities Accounting Bulletin (SAB-99), the SEC provided this general definition of materiality: “The omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.

This formulation in the accounting literature is in substance identical to the formulation used by the courts in interpreting the federal securities laws. The Supreme Court has held that a fact is material if there is –

a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.

Under the governing principles, an assessment of materiality requires that one views the facts in the context of the "surrounding circumstances," as the accounting literature puts it, or the "total mix" of information, in the words of the Supreme Court. In the context of a misstatement of a financial statement item, while the "total mix" includes the size in numerical or percentage terms of the misstatement, it also includes the factual context in which the user of financial statements would view the financial statement item. The shorthand in the accounting and auditing literature for this analysis is that financial management and the auditor must consider both "quantitative" and "qualitative" factors in assessing an item's materiality. Court decisions, Commission rules and enforcement actions, and accounting and auditing literature have all considered "qualitative" factors in various contexts.(...)"

eliminate self-indulgent “ignorance”? This shall be understood in line with the next obligation: Internal controls and reporting).

- c. That both CEO and CFO are responsible for “establishing and maintaining internal controls (...) designed (...) to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities...” and that they perform a self-evaluation and self assessment about the effectiveness of such internal controls. On May 29, 2003, the Securities and Exchange Commission issued Rules pertaining to this obligation, the most relevant being:

- i. the definition of “internal controls” as “a process designed by, or under the supervision of, the registrant's principal executive and principal financial officers, or persons performing similar functions, and effected by the registrant's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that

1. pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the registrant.
2. provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and receipts and expenditures of the registrant are being made only in accordance with authorizations of management and directors of the registrant.
3. provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the registrant's assets that could have a material effect on the financial statements”.

- ii. Compliance with the rules regarding management's report on internal controls will be required as follows: Companies, other than foreign private issuers, meeting the definition of an "accelerated filer" in Exchange Act Rule 12b-2 (generally, U.S. companies that have equity market capitalization over \$75 million and have filed an annual report with the Commission) will be required to comply with the management report on internal control over financial reporting requirements for fiscal years

ending on or after June 15, 2004, and all other issuers, including small business issuers and foreign private issuers, will be required to comply for their fiscal years ending on or after April 15, 2005.

- iii. A new Rule 3a-8 under the Investment Company Act will modernize the test that R&D companies use in determining their status under the Act. (...)R&D companies tend to have few tangible assets and often hold large amounts of capital in liquid instruments so that funds are readily available for research and development activities. Some R&D companies also enter into strategic alliances that may include a strategic investment, where one R&D company purchases a non-controlling securities position in another company. As a result, an R&D company may fall within the definition of investment company. The new rule will serve as a nonexclusive safe harbor from the definition of investment company in Section 3(a)(1) of the Act.(...) The analysis set forth in the new rule generally will focus on an R&D company's use of its capital and other indicia of the company's primary engagement in a non-investment business. Generally, a company will be eligible to rely on the rule's nonexclusive safe harbor if it:
 1. has research and development expenses that are a substantial percentage of its total expenses for its last four fiscal quarters combined and that equal at least half of its net income derived from investments in securities for that period.
 2. has investment-related expenses that do not exceed five percent of its total expenses for its last four fiscal quarters combined.
 3. makes its investments to conserve capital and liquidity until it uses the funds in its primary business subject to certain exceptions.
 4. is primarily engaged, directly or through a company or companies that it controls primarily, in a non-investment business, as evidenced by the activities of its officers, directors and employees, its public representations of policies, and its historical development”.
- iv. The form as the certificate that must be signed by CEO and CFO must be furnished as opposed to simply filed.”

To understand the extent of the actions comprising such “internal controls” and its corresponding leads and tasks required in an international environment, including Latin America, consider the case of Xerox’ accounting practices in the UK, Brazil and in particular in Mexico”.

“Unknown to analysts and investors in July 1999, the favorable revenue and earnings numbers reported by Xerox from 1997 through 1999 were more the result of accounting manipulations than effective business practices. As revealed by, later, SEC investigations, Xerox had accelerated the recognition of revenue and boosted reported earnings through the use of both non-GAAP (Generally Accepted Accounting Principles) accounting practices and changes in GAAP accounting practices that were not disclosed to financial statement users. Some of these practices were as follows:”

“Lease discount rates in Brazil. Xerox sometimes accounts for the lease of a copy machine as a sale, with financing provided by Xerox. This is entirely acceptable (...). A sales-type lease involves both initial sales revenue as well as interest revenue over the life of the lease. An accounting assumption about the appropriate interest rate associated with the financing aspect of the lease determines the mix between initial sales revenue and subsequent interest revenue. For example, assume that a copy machine is leased for 10 years with annual lease payments of \$1,000. Over the life of the lease, total revenue of \$10,000 (10 years × \$1,000) will be recognized. If it is assumed that the appropriate interest rate is 6%, immediate sales revenue is \$7,360 (the present value of \$1,000 per year for 10 years at a 6% discount rate) and interest revenue over the life of the lease is \$2,640 (\$10,000 - \$7,360). In contrast, if the appropriate interest rate is assumed to be 25%, immediate sales revenue is \$3,571 and subsequent interest revenue is \$6,429. The key difference between sales revenue and interest revenue is that the sales revenue is reported immediately whereas the interest revenue is spread over the life of the lease. In order to increase reported revenue in its Brazilian subsidiary, Xerox’s accounting staff assumed interest rates as low as 6% when accounting for its leases. This assumption was made even though Xerox’s own borrowing rate in Brazil was in excess of 25%. Xerox did not disclose details about this key accounting assumption to financial statement users”.

“Income tax refund receivable in the United Kingdom. In 1995, Xerox won a tax dispute in the United Kingdom. As result, the company was entitled to a refund of \$237 million in overpaid taxes. Xerox recorded this victory by debiting tax refund receivable. However, instead of crediting income for the entire \$237 million immediately, as required by GAAP, Xerox deferred much of the income to be recognized in future periods. As explained later (...), this is known as creating a “cookie jar reserve.” Basically, through this accounting procedure Xerox was free to recognize the \$237 million in income in whatever quarter it needed in order to meet performance targets or analyst expectations”.

“Bad debts and sales returns at Xerox Mexico. In the mid-1990s, the managers of Xerox Mexico relaxed credit standards for customers in order to increase sales to meet revenue targets set by corporate headquarters. This practice did increase immediate sales, but it also increased the estimated amount of bad debts by \$127 million. To avoid recognizing this \$127 million in bad debts, the managers of Xerox Mexico renegotiated credit terms, lengthening payment periods for delinquent accounts in order to maintain the appearance that the accounts were actually collectible. In addition, Xerox Mexico received \$27 million in returned sales from 1996 through 2000. In order to avoid recording the equipment returns (and associated reduction in net sales), secret warehouses were rented in which the returned merchandise was stored. Again, these activities were done in order to allow the managers of Xerox Mexico to meet aggressive targets imposed by Xerox company headquarters”.

“In total, Xerox accelerated the reporting of over \$6 billion in revenue in the period 1997-2000, and increased reported earnings by \$1.4 billion during the same period. At the peak of the earnings manipulation in 1998, over 30% of Xerox’s reported earnings stemmed from undisclosed changes in accounting practices. A SEC investigation uncovering Xerox’s accounting abuses resulted in a \$10 million

fine for the company; at the time, this was the largest fine ever imposed for misleading financial reporting”²¹.

Similar details are indicated in the SEC complain against Xerox:

“B. Improper Record-Keeping at Xerox Mexico”

“77. From 1997 through the first quarter of 2000, senior management of Xerox's Mexico subsidiary (“XMEX”) fraudulently overstated revenue by \$170 million. XMEX management did this to meet demanding profit and revenue targets set for the subsidiary by Xerox corporate management.”

“78. XMEX's improper accounting actions included concealing \$129 million in uncollectible receivables, failing to record \$27 million in notes due to third-party resellers of Xerox equipment, and improperly recognizing \$14 million in revenue from equipment leased to government customers.”

“79. Pressured to meet financial targets, in the mid-1990s XMEX relaxed its credit standards and leased equipment to high-risk customers at low initial monthly rates that doubled or tripled after a short introductory period. This practice boosted XMEX's short-term results but quickly created a large pool of delinquent receivables.”

“80. Rather than write down the receivables or establish sufficient reserves, as required by GAAP, XMEX tried to conceal them by constantly renegotiating its contracts with delinquent customers to report an artificially low number of delinquent receivables and avoid an expensive write-off. Among other fraudulent tactics, invoice dates were changed so that an overdue receivable appeared current.”

“81. XMEX also fraudulently failed to record \$27 million in credits due to third-party resellers of Xerox equipment, known as concessionaires, in order to inflate XMEX's revenues and meet Xerox corporate's expectations. From 1996 through early 2000, XMEX managers secretly rented warehouses to store trade-ins. This practice prevented XMEX's accounting system from automatically generating credits for concessionaires, which would have occurred if the equipment had been brought to XMEX's warehouses.”

“82. XMEX inflated its revenues by \$14 million from 1996 to 1999 by improperly recording revenues from certain government operating lease contracts as FAS 13 sales-type leases that XMEX knew did not satisfy FAS 13 requirements. For these contracts to satisfy FAS 13 criteria as sales-type leases, the contracts had to have a three-year lease term and minimum monthly payments. They had neither. Therefore, the equipment income should have been recorded as received on a monthly basis and not recognized immediately.”

“83. The actions taken by XMEX personnel represented a substantial and widespread breakdown of Xerox's internal controls at XMEX. The impact of these accounting actions, which were taken by XMEX to mask disappointing operational results and satisfy the aggressive targets of Xerox corporate, totaled approximately \$170 million.”²²

The basis for the complain that eventually resulted in a settlement in April 2002, whereby “Xerox consented, without admitting or denying the allegations in the complaint, to the entry of an injunction for violations of the antifraud, reporting and recordkeeping provisions of the federal securities laws. In addition, Xerox agreed to pay a \$10 million penalty and to restate its financial results for the years 1997 through 2000. Finally, Xerox agreed to have its board of directors appoint a committee composed entirely of outside directors to review the company's material accounting controls and policies”²³.

One of the key charges of the complain filed by the SEC against Xerox was that “...By failing to disclose fully and accurately the impact and nature of these accounting actions, Xerox knowingly or recklessly deceived shareholders and investors with periodic reports and public statements that contained materially false and misleading statements and omissions regarding the operating results of Xerox”.(Author’s underline). The question is that CEO and CFO may not excuse themselves of

²¹ marriottschool.byu.edu/teacher/%20MBA%20501/Xerox.doc

²² <http://www.sec.gov/litigation/complaints/complr17465.htm> Last visited June 29, 2003

²³ <http://www.sec.gov/news/headlines/xeroxsettles.htm> Last visited June 29, 2003.

not knowing the actions or omissions of their subordinates and/or management of their companies subsidiaries. And this definitely applies to all public companies' subsidiaries in Latin America.

The lessons that must be learned from the Xerox case include the following:

- Public companies must have a very strong Regional Office that must oversee the business and risk environment of the subsidiaries in the Region. The officers or employees of such Regional Offices must have a very good knowledge and understanding of both cultural and business environments, i.e. the United States business, legal, Corporate and Accounting environment and the host country's business, legal, corporate and accounting environment. It would not be an exaggeration to assert that most of Xerox personnel who took in his/her hands the application of discounted rates of 6% for leases in Brazil were not aware that interest rate and financial conditions in Brazil were other than these of the United States and that with a SELIC rate over 20%, the minimum market implicit rate in Brazil should be 25%.

This is information that only a team of professionals familiar with both environments could detect. If such a Regional office cannot be established, or becomes very expensive or difficult to staff, then an outsourcing solution would be wise. This outsourcing is the kind of practice that FTAA CONSULTING, INC. has successfully put in place for several multinationals and which has worked very well.

- The role of the local outside counsel must be enhanced. Local outside counsel must not be accountable to local management but to the Corporation headquarters office of the General Counsel. Local outside counsel must undertake some periodical due diligence on the overall business and legal documentation of transactions by the subsidiaries. Definitely, such actions by local counsel in Mexico, with a Regional or International oversight would avoid the loose credit practices and standards, poor quality of transactions, "ghost warehouses", and other practices that Xerox in Mexico allegedly followed..
- Continuous reporting (at least once a month) from the Regional Office to the Corporate Headquarters shall be implemented and the Regional Counsel must also have a very demanding oversight role, reporting exclusively to the Headquarters' office of the General Counsel.

The key to understanding and applying adequate internal controls are stated in the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"), 1992 Internal Control -- Integrated Framework, which is the reference indicated by SEC proposed Rules:

PRACTICAL MEANING OF INTERNAL CONTROL

Definition	"a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives"
Categories	<ul style="list-style-type: none"> • Effectiveness and efficiency of operations • Reliability of financial reporting • Compliance with applicable laws and regulations
Activities	<ul style="list-style-type: none"> • Control environment • Risk assessment, • Control activities and information communicationMonitoring
Scope	<ul style="list-style-type: none"> • Policies • Plans • Procedures, • Processes • Systems • Activities • Functions • Projects • Initiatives • Endeavors of all types at all levels of a company

Enhanced Financial disclosures:

The lessons learned from the above mentioned corporate scandals, lead to enhanced financial disclosures. But when executives and accountants faced the need to define which specific aspects of financial information shall be subject to enhanced disclosure, confusion set in.

In an very interesting article, "The Economist" summarized the relevant issues that shall be subject to disclosure enhancement²⁴: (i) Pro-forma accounts reconciliation; (ii) Off-balance sheet vehicles; (iii) Stock options; (iv) Pension funds; (v) Revenue Recognition.

1. Proforma accounts reconciliation:

²⁴ The Economist: Special Report The future of accounts, April 26, 2003.

In March 26, 2003 “...Among other things, the Commission created new Item 12 of Form 8-K, that requires a registrant to furnish specified disclosure when the registrant, or any person acting on its behalf, makes any public announcement or release disclosing material non-public information regarding the registrant's results of operations or financial condition for a completed quarterly or annual fiscal period. The Item 12 disclosure requirement applies to earnings releases and similar announcements made after March 28, 2003”²⁵.

In the past, pro-forma statements were used to disclose good news to the public while in private the official reports showed the actual bad news. The same kind of dissemination must apply to the pro-forma report as to the conciliation numbers to GAAP (General Accepted Accounting Principles).

This is a very relevant issue dealing with Latin America: certainly, due to the different legal environments, United States GAAP are not necessarily applicable to accounting in Civil Law systems, where in general form prevails over substance (for instance, an asset disposition should take the form of a sales and purchase agreement- “*compraventa*” or “*compra e venda*”, which are subject to requirements for its existence and validity. Legal powers of officers of corporate customers are not deemed as in the United States, they must fit with what the bylaws registered in Public Records, Commercial Registries or “*Cartorios*”, must show. In addition in some jurisdictions, if the stamp tax has not been paid, the sales document is not enforceable, etc.). GAAP reconciliation requires profound knowledge and understanding of both systems. And such ubiquitous knowledge is scarce. There are not too many professionals having the skills and training to understand that.

Therefore, either the Corporation would be misstating its financial information under United States GAAP if the reconciliation is not thoroughly addressing the financial and legal realities, or the Corporation would incur, without noticing, in the “cookie jar” practice for ignoring the real implication of the financial information under the economic reality of the local environment.

2. Off-balance sheet vehicles:

As mentioned, the use of off-balance sheet vehicles by companies such as Enron, was one of the most outstanding forms of misleading investors.

“39. Enron, through a wholly-owned subsidiary, held an approximate 65% interest in a power plant and related pipelines under construction in Cuiaba, Brazil (the “Cuiaba project”). Enron was developing the project to generate and sell electricity. However, the Cuiaba project was troubled from its inception and caused Enron to incur significant costs. Enron's problems with the Cuiaba project were well known at Enron”.

“40. Enron did not want to consolidate the Cuiaba project's debt on its balance sheet, and attempted to sell its interest. Deconsolidating would also permit Enron to mark to market a related power supply contract, thereby recognizing earnings. However, the Cuiaba project was so problematic that no independent third-party would purchase an interest in the project”.

²⁵ SEC. Releases No.33-8176 and 33-8177, downloadable from www.sec.gov. Latest visited June 29, 2003.

“41. Enron and Fastow solved their Cuiaba project problem by "selling" an interest in the project to Fastow-controlled LJM1. On September 30, 1999, Enron sold LJM1 a 13% interest in the project for \$11.3 million. The sale of this interest (and the board seat that went with it) was purportedly sufficient for Enron to conclude that it did not control the Cuiaba project. The "sale" enabled Enron to keep the Cuiaba project's substantial debt off its balance sheet. Furthermore, this purported sale enabled Enron to recognize a total of approximately \$65 million of income in the third and fourth quarters of 1999, when it was struggling to meet its projected financial results”.

“42. LJM1, through Fastow, agreed to "buy" Enron's interest in the Cuiaba project because Enron agreed in an undisclosed side deal to repurchase the interest if necessary and guarantee LJM1 a profit. Enron agreed to repurchase LJM1's interest at a higher price regardless of the actual performance of the Cuiaba project”.

“43. Because such a buyback agreement would have destroyed the favorable accounting treatment, the buyback agreement, originally in writing, was not set forth in the final deal documents, but continued in fact as part of an oral understanding. The buyback agreement was also not included in the written documents out of concern that Enron's auditors, Arthur Andersen LLP, would not approve the sale to LJM1 with such a provision”.

“44. After LJM1's purchase, the Cuiaba project continued to suffer serious cost overruns, technical and environmental problems. Despite ongoing problems with the Cuiaba project affecting its value, on or about March 2001, Fastow and Enron agreed upon the buyback price of LJM1's interest. For various reasons (including the fact that Fastow did not sell his interest in LJM1 to Kopper until July 2001), Fastow delayed the closing until August 15, 2001. Enron bought back LJM1's interest for \$13,752,000. This purchase price was calculated to provide LJM1 a significant profit even though the market value for Cuiaba had decreased”²⁶.

“As directed by new Section 13(j) of the Securities Exchange Act of 1934, added by Section 401(a) of the Sarbanes-Oxley Act of 2002, (SEC) adopt(ed) amendments to (SEC's) rules to require disclosure of off-balance sheet arrangements. The amendments require a registrant to provide an explanation of its off-balance sheet arrangements in a separately captioned subsection of the "Management's Discussion and Analysis" ("MD&A") section of a registrant's disclosure documents. The amendments also require registrants (other than small business issuers) to provide an overview of certain known contractual obligations in a tabular format”²⁷.

For purpose of such disclosure, the Rule determined the following:

“The definition of "off-balance sheet arrangement" primarily targets the means through which companies typically structure off-balance sheet transactions or otherwise incur risks of loss that are not fully transparent to investors. For example, in many cases, in order to facilitate a transfer of assets or otherwise finance the activities of an unconsolidated entity, a company must provide financial support designed to reduce risks to the entity or other third parties. That financial support may assume many different forms, such as financial guarantees, subordinated retained interests, keepwell agreements”²⁸,

²⁶ United States Securities and Exchange Commission vs. Andrew Fastow, Complain No.17,762. In: www.sec.gov

²⁷ United States Securities and Exchange Commission: Final Rule: Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations Securities And Exchange Commission; 17 CFR Parts 228, 229 and 249; [Release Nos. 33-8182; 34-47264; FR-67; International Series Release No. 1266; File No. S7-42-02];RIN 3235-AI70: Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations.

²⁸ The footnote defines “keepwell agreements” as “any agreement or undertaking under which a company is, or would be, obligated to provide or arrange for the provision of funds or property to an affiliate or third party”. In this concept, a comfort letter should be included.

derivative instruments or other contingent arrangements that expose the registrant to continuing risks or material contingent liabilities. To appropriately capture these transactions, the definition of "off-balance sheet arrangement" includes any contractual arrangement to which an unconsolidated entity is a party, under which the registrant has:

- Any obligation under certain guarantee contracts.
- A retained or contingent interest in assets transferred to an unconsolidated entity or similar arrangement that serves as credit, liquidity or market risk support to that entity for such assets.
- Any obligation under certain derivative instruments.
- Any obligation under a material variable interest held by the registrant in an unconsolidated entity that provides financing, liquidity, market risk or credit risk support to the registrant, or engages in leasing, hedging or research and development services with the registrant²⁹.

The format to summarize such "off-balance sheet arrangements" is the following:

Contractual Obligations	Payments due by period				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
[Long-Term Debt Obligations]					
[Capital (Finance) Lease Obligations]					
[Operating Lease Obligations]					
[Purchase Obligations]					
[Other Long-Term Liabilities Reflected on the Company's Balance Sheet under the GAAP of the primary financial statements]					
Total					

Let us examine some of the effects that such requirements may have upon certain transactions or operations in Latin America:

- Guarantees

If the publicly listed company grants a Corporate Guaranty payable in case of default of one of its subsidiaries or affiliates, certainly these guarantees shall be disclosed. The good news is that the parent's treasury is still not required to raise the funds or incur in any liability to fund its subsidiary transactions, but the bad news is that the parent company must list them in the report, and necessarily, it must assess the probability of the risk of such guaranty becoming effective, therefore a liability into its balance sheet and a corresponding loss in its equity. The conclusion is that parent corporations must closely monitor their subsidiaries' cash generation and value creation, beyond just a presence in a

²⁹ Ibidem- Rule released No.33-8182.

given foreign market. Therefore, priorities are not now market presence or market share in a foreign environment, but value creation and cash creation.

- Credit, liquidity or market risk support over transferred assets

Latin American subsidiaries of publicly traded companies may enter, and usually do, into agreements with financial institutions in order to fund their working capital needs or their investment plans. Due to the current degree of sophistication by financial institutions, their ability to understand risks beyond pure credit risk (and sometimes including credit risk understanding) is poor. Parent companies are required to provide some kind of support to such financial institutions in case of credit risks write-offs (Customer defaults), liquidity risks (such as when the members of a given supply chain lack access to actual cash), or market risks (price downturns of certain assets in a given market, including, for example, real property markets, or telecommunications services fees). Such kind of arrangements must be disclosed, both in the tabular format and in the management discussion and analysis disclosure. For such purpose, it would be a good idea that these Corporations instruct their local subsidiaries to prepare similar reports for each of their transactions, so that top management might evaluate their materiality in order to include or not in the overall report (10-Q or 10-K).

- Derivative instruments

Derivatives are commonly defined as “A financial contract whose value depends on a risk factor, such as (a) the price of a bond, commodity, currency, share, etc.(b) a yield or rate of interest (c) an index of prices or yields; (d) weather data, such as inches of rainfall or heating-degree-days, (e) insurance data, such as claims paid for a disastrous earthquake or flood, etc”³⁰.

The Financial Accounting Standard Board issued FASB 133, in June 1998, requiring derivatives all to be included as assets or liabilities in the financial statements “and measure those instruments at fair value. If certain conditions are met, a derivative may be specifically designated as (a) a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment, (b) a hedge of the exposure to variable cash flows of a forecasted transaction, or (c) a hedge of the foreign currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security, or a foreign-currency-denominated forecasted transaction.

The accounting for changes in the fair value of a derivative (that is, gains and losses) depends on the intended use of the derivative and the resulting designation.

For a derivative designated as hedging the exposure to changes in the fair value of a recognized asset or liability or a firm commitment (referred to as a fair value hedge), the gain or loss is recognized in earnings in the period of change together with the

³⁰ <http://www.margrabe.com/Dictionary/DictionaryDF.html#sectD> Latest visited July 6, 2003

offsetting loss or gain on the hedged item attributable to the risk being hedged. The effect of that accounting is to reflect in earnings the extent to which the hedge is not effective in achieving offsetting changes in fair value.

For a derivative designated as hedging the exposure to variable cash flows of a forecasted transaction (referred to as a cash flow hedge), the effective portion of the derivative's gain or loss is initially reported as a component of other comprehensive income (outside earnings) and subsequently reclassified into earnings when the forecasted transaction affects earnings. The ineffective portion of the gain or loss is reported in earnings immediately.

For a derivative designated as hedging the foreign currency exposure of a net investment in a foreign operation, the gain or loss is reported in other comprehensive income (outside earnings) as part of the cumulative translation adjustment. The accounting for a fair value hedge described above applies to a derivative designated as a hedge of the foreign currency exposure of an unrecognized firm commitment or an available-for-sale security. Similarly, the accounting for a cash flow hedge described above applies to a derivative designated as a hedge of the foreign currency exposure of a foreign-currency-denominated forecasted transaction.

For a derivative not designated as a hedging instrument, the gain or loss is recognized in earnings in the period of change.

Under this Statement, an entity that elects to apply hedge accounting is required to establish at the inception of the hedge the method it will use for assessing the effectiveness of the hedging derivative and the measurement approach for determining the ineffective aspect of the hedge. Those methods must be consistent with the entity's approach to managing risk.

This Statement applies to all entities. A not-for-profit organization should recognize the change in fair value of all derivatives as a change in net assets in the period of change. In a fair value hedge, the changes in the fair value of the hedged item attributable to the risk being hedged also are recognized. However, because of the format of their statement of financial performance, not-for-profit organizations are not permitted special hedge accounting for derivatives used to hedge forecasted transactions. This Statement does not address how a not-for-profit organization should determine the components of an operating measure if one is presented.

“This Statement precludes designating a non-derivative financial instrument as a hedge of an asset, liability, unrecognized firm commitment, or forecasted transaction except that a non-derivative instrument denominated in a foreign currency may be designated as a hedge of the foreign currency exposure of an unrecognized firm commitment denominated in a foreign currency or a net investment in a foreign operation.”³¹

It is important to mention that in the most sophisticated markets of Latin America, namely Brazil and Mexico, dealing with derivatives has become a common practice. In

³¹ <http://www.fasb.org/st/summary/stsum133.shtml>

Brazil, there is a derivatives market called “Borsa de mercadorias e futuros”, where there is current trade of derivatives on foreign exchange currencies, interest rate index, stock exchange index (IBOVESPA- Index of the Sao Paulo Stock Exchange), commodities futures and even credit risks. In Mexico, there is a Derivatives Exchange Market called “Mexder”, a little less advanced than the Brazilian but with trading of derivatives in currency risks, interest rate risks (“CETES”) and inflation risks (“IPC”). And it can be expected that countries such as Chile, Argentina and Colombia would soon adopt derivatives markets and derivatives trading practices.

Since FASB 133 requires the incorporation of almost all derivatives in the financial statements (suppose for instance that a Mexican subsidiary owes US\$ 10 million to foreign creditors, maturing in one year. The Mexican CFO wants to hedge the cost of such currency and purchases a derivative of US\$ 10 million call option at Mx\$11+US\$ 1.00. If the prevailing rate in the market is Mx\$10.50=US\$ 1.00, then the Mexican subsidiary must record its liability at Mx\$ 10.50, and its call option records a loss of Mx\$0.50. But if the exchange rate goes up to Mx\$12=US\$1, then the liability shall be adjusted with a loss of Mx\$1.50 per US\$ 1.00, offset by a gain of Mx\$1.00 coming from the derivative instrument-the put option; all these records should be incorporated in the financial statements).

There are other derivatives that are not required to be incorporated in the financial statements: Such are the derivatives that are “both indexed to the registrant's own stock and classified in stockholders' equity in the registrant's statement of financial position, and therefore excluded from the scope of FASB Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities (June 1998)”.

Enron used them with great extent of creativity as the following extract of the SEC claim states:

“54. Raptor I was created in April 2000 through an off-balance-sheet SPE called Talon LLC (“Talon”). Talon was designed to generate accounting gains which would offset Enron's significant mark to market losses on certain investments. Talon would enter into transactions with an Enron subsidiary that would lock in the value of Enron's stock portfolio. If the price of Enron's stock portfolio increased, Talon would be entitled to the upside gain, and if the stock portfolio declined, Talon would be obligated to pay the Enron subsidiary the amount of the loss”.

“55. Talon was funded mainly by Enron through a promissory note and Enron's own stock. The remainder of Talon's funding, \$30 million, was from LJM2, representing the purported three percent outside equity required for Talon to be off Enron's balance sheet”.

“56. However, Talon should have been consolidated on Enron's financial statements because of an undisclosed side deal engineered by Fastow. Pursuant to the side deal, Enron agreed that, prior to conducting any hedging activity with Talon, Enron would return to LJM2 its full investment in Talon plus a guaranteed return. This undisclosed side deal would have “broken” the SPE, that is, it would have required Talon to be consolidated on Enron's financial statements because the supposed outside three percent equity was not at risk. Further, with the return of LJM2's capital by Talon, there was no outside equity at risk to justify Talon not being consolidated. Yet, Enron did not consolidate Talon on its financial statements filed with the Commission. In exchange for this side agreement, Fastow caused and allowed Enron employees to use Talon to manipulate Enron's financial statements. Pursuant to the undisclosed side deal, after LJM2

invested \$30 million in Talon, it received \$41 million from Talon on or about September 7, 2000, reflecting a return of its capital and \$11 million profit”.

“57. To conceal the side deal, Fastow and others devised a scheme to manufacture a \$41 million payment to LJM2. Fastow and others made it appear that the payment represented the premium paid on a "put option" on Enron shares that Enron purchased from Talon. Enron purchased the put option, set to expire on October 18, 2000, for a premium of \$41 million. Enron settled the put option early and Talon then distributed the \$41 million to LJM2. The transaction was unusual for several reasons, including the fact that the put option was a bet by Enron that its own stock price would decline. There was no true business purpose for the put option other than to generate funds to pay LJM2 under the undisclosed side deal”.

“58. One of Enron's Raptor I hedges related to its attempt to lock in substantial gains from its stock holdings in AVICI Systems, Inc., an Internet company that had recently engaged in an IPO. Because the stock price of AVICI had declined by the end of Enron's third quarter 2000, Fastow engaged in a fraudulent scheme to backdate the AVICI hedge to achieve a significant economic advantage for Enron”.

“59. Fastow caused the AVICI hedge to be backdated to August 3, 2000. Fastow chose this date because he knew it was the date AVICI traded at an all time high price of \$163.50. By back-dating the AVICI hedge in this manner, Fastow and Enron fraudulently locked in the recognition of a substantial gain and booked \$75 million in additional mark to market gains that they otherwise would not have recognized. To facilitate the fraud, the put option was purportedly settled early, also on August 3, 2000, so that Enron could use Raptor I for hedging purposes”³².

Pursuant to the new rule, all these derivatives transactions must be disclosed.

It is interesting to note the reverse side of the fundamentals for this disclosure: In 1992, SEC required Caterpillar to disclose the detail of its successful financial strategy in Brazil: “In *In the Matter of Caterpillar Inc.*, Release No. 34-30532 (March 31, 1992), the Commission found that Caterpillar had violated Section 13(a) of the Exchange Act [15 USC §78m(a)] by failing to have disclosed the magnitude of its Brazilian subsidiary's contribution to Caterpillar's overall earnings. Disclosure of the extent of that contribution was required under the MD&A disclosure requirements, even though disclosure was not required under GAAP, because the subsidiary's earnings materially affected Caterpillar's reported income from continuing operations. *See* Item 303(a)(3)(i) of Regulation S-K [17 CFR 229.303(a)(3)(i)]. Furthermore, Caterpillar's MD&A should have discussed various factors which contributed to the subsidiary's earnings, such as currency translation gains, export subsidies, interest income, and Brazilian tax loss carry-forwards, because such items were significant components of its revenues that should have been identified and addressed in order for a reader of the company's financial statements to understand Caterpillar's results of operations”³³.

- Any obligation arising out of a Variable Interest

“The term "variable interest" is defined in FIN 46 as "contractual, ownership, or other pecuniary interests in an entity that change with changes in the entity's net asset value." In other words, variable interests are investments or other interests that will absorb a portion of an entity's expected losses if they occur or receive portions of the entity's expected residual returns if they occur. To apply this element of the definition, a registrant must assess the variable interests it holds in the specified unconsolidated entities regardless of whether the entity is deemed to be a "variable interest entity" pursuant to paragraph 5 of FIN 46. To focus the disclosure on the most crucial off-balance sheet arrangements, however, the definition only applies to variable interests, that are material to the registrant, in entities that provide financing,

³² SEC Complain 17-762 above mentioned.

³³ Citation made by SEC Release 33-8182, March 2003.

liquidity, market risk or credit risk support to the registrant, or engage in leasing, hedging or research and development services with the registrant³⁴.

Financial Accounting Standard Board Interpretation No.46 (January, 2003) mentions in its Appendix B, some possible cases of “variable interests”:

“B2. Equity investments in a variable interest entity are variable interests to the extent they are at risk. (Equity investments at risk are described in paragraph 5 of this Interpretation.) Investments in subordinated beneficial interests or subordinated debt instruments issued by a variable interest entity also are variable interests. The holder of the most subordinated interest in an entity will absorb all or part of the expected losses of the entity. The return on that investment usually is a high interest rate or some form of participation in residual returns”.

“B3. Senior beneficial interests in variable interest entities and senior debt instruments with fixed interest rates or other fixed returns normally have little expected variability and usually would not, by themselves, make the holder the primary beneficiary of the issuer. Senior interests with variable rates of return have variability but normally still would not be sufficient to make the holder a primary beneficiary unless the subordinated interests of the variable interest entity are not large enough to absorb the entity’s expected losses (or unless there are provisions such as embedded derivatives that expose the senior interests to losses). By definition, there are interests subordinated to the senior interests that will absorb losses first. Senior beneficial interests or senior debt instruments normally are not entitled to any of the residual returns if they occur. Paragraph 364 of Statement 140 defines beneficial interests as “rights to receive all or portions of specified cash inflows to a trust or other entity, including senior and subordinated shares of interest, principal, or other cash inflows to be ‘passed-through’ or ‘paid-through,’ premiums due to guarantors, commercial paper obligations, and residual interests, whether in the form of debt or equity.”³⁵”

Therefore, if the entity has a sales-aid financing captive organization (such as, for example, Ford Motor Co. in Ford Motor Credit Co.), every arrangement providing interest rates subsidization (or “blind discounts”), credit supports, financial costs supports, liquidity costs, shall be included in such disclosure.

3. Stock Options

The cost of employees’ stock options must not only be disclosed, in terms of avoidance of conflict of interests and abuse of insider information, but also be registered as a company’s expense. How?

According to FASB No.123, the cost of such options should be based upon their fair market value. Therefore, suppose that an employee of IBM Corporation has been granted an option to purchase IBM stock for a striking price of US\$ 75.00 exercisable on July 3, 2003 (Date when the option is supposed to be vested). The price of the stock at that date was US\$ 83.95, so that such employee could purchase the stock for US\$ 75.00 and sell it the very same day earning a gain of US\$ 8.95. The fact is that the company could also do the same with its shares.

³⁴ Rule 33-8182.

³⁵ <http://www.fasb.org/interp46.pdf>

Therefore, the gain of the employee was the loss of the company. The company sold a share for US\$ 75.00 that otherwise would sell for US\$ 83.95.

If stock options were granted to employees of subsidiaries of the Corporation in Latin America, a couple of aspects must be addressed: The first one, is that the employment relationship of such employee should be only with the subsidiary, not with the parent company. If, for example, the letter of hiring is signed by the Human Resources Director of the Parent Company, a good labor litigator in any single country in Latin America could be able to demonstrate co-existence of labor contracts and link the relationship with the parent company. And, the second, as such options might be considered (Under prevalent Case Law) as part of an employee's ordinary compensation, some fringe benefits and social security contributions could be assessed therein, with further contingencies both at a labor and tax levels (Since tax deduction of employee costs and expenses could be at risk in several jurisdiction if the company has not fully complied its social security contributions).

4. Pension Funds

Corporations must undertake a detailed analysis about the pensions regulations in each of the Latin American countries where they do business. If pensions are either fully assumed by the Social Security System in force in the corresponding country, then no liability seems to appear. However, if either by Statute Law, by private employment contract or by Collective Bargaining Union Agreements, the company or any of its affiliate shall provide resources for funding a pension program, then accounting rules would chase the company.

The Accounting Standards are evolving as follows: "In November 2000, the UK Accounting Standards Board released a new financial reporting standard, numbered 17 ("FRS17"). The standard relates to the recognition of retirement benefits of all kinds within the accounts of a sponsoring employer (as opposed to the accounts of a pension scheme)."

"What will be required is actuarial estimates of how much the "intended benefits" are worth and how much they will cost. One of the major differences from "SSAP24" (the previous accounting standard) is that the figures are to be based upon market values. This is highly likely to lead to enormous volatility, raising the question whether investors will really be better informed..."³⁶.

In March 2003, FASB said it would start examining ways to improve accounting for employee pension plans: "The Board has received several direct requests from constituents asking it to consider changing the accounting and disclosures regarding pensions. There also have been numerous published articles and reports expressing concern about certain inadequacies of pension accounting and reporting. Most of these concerns are about the lack of transparency that results from delayed recognition for investment returns, the cost of plan amendments, and actuarial gains and losses. In addition, analysts and investors want more information regarding the portfolio of plan assets, future outflows for benefit payments, and contributions to the pension fund. These concerns have been heightened by the decline in equity markets, the exposure of plan assets to further risk, and the need for more information about cash

³⁶ <http://www.frs17.com/>

outflows to fund plan commitments. In response to the concerns raised by analysts and investors, the Board decided to add a limited scope project to its technical agenda to improve disclosures relating to employers' accounting for pension plans. This project will consider requests for improved disclosures related to pension costs, plan assets, obligations, and funding requirements³⁷.

The trend is clear: In the future, all commitments relative to pension funds, or all legal obligations therein, will be monitored to determine whether or not a Corporation is at risk when the stock market declines and a pension fund is established. And this will certainly require a careful assessment about which are the legal obligations or otherwise commitments assumed by the Latin American subsidiaries. It must be noted here, that sometimes, parent companies ignore that Industry Unions representing employees for the given industry (such as banking industry, for example) may legally bind their subsidiary even without local management awareness, and such Agreements may include pension plans structured in such a way that any shortfall in pension funds may trigger a liability to the company, which may have a material effect.

5. Revenue Recognition

When accountants invented the accrual method, they did not anticipate that they would create a lot of work for lawyers. In a cash based accounting method, revenue recognition is not an issue. Revenue should be recognized upon receipt of cash consideration for the sale of the good or service.

However, under the accrual system, revenue recognition is not that simple.

International Accounting Standard No.18 mandates:

- “Revenue should be measured at fair value of consideration received or receivable. Usually this is the inflow of cash. Discounting is needed if the inflow of cash is significantly deferred without interest. If dissimilar goods or services are exchanged (as in barter transactions), revenue is the fair value of the goods or services received or, if this is not reliably measurable, the fair value of the goods or services given up”.
- Revenue should be recognised when:
 - § significant risks and rewards of ownership are transferred to the buyer;
 - § managerial involvement and control have passed;
 - § the amount of revenue can be measured reliably;
 - § it is probable that economic benefits will flow to the enterprise; and
 - § the costs of the transaction (including future costs) can be measured reliably.
- For services, similar conditions apply by stage of completion if the outcome can be estimated reliably.
- Interest revenue is recognised on a time-proportion basis using the effective interest rate.
- Dividend revenue is recognised when the shareholder's right to receive the dividend is legally established.
- If revenue has been recognised but collectibility of a portion of the amount is doubtful, bad debt expense should be recognised when the revenue is recognised.

³⁷ <http://www.fasb.org/project/pensions.shtml> Latest visited July 6, 2003

- Revenues and related expenses must be matched. If future related expenses cannot be measured reliably, revenue recognition should be deferred³⁸.

The Securities and Exchange Commission issued SAB 101 in December 1999. SAB 101 imposed the obligation to publicly listed companies to recognize revenue when realized or realizable, and for that purpose the following criteria were set forth: (i) A persuasive evidence of the existence of an arrangement; (ii) Delivery occurred or services rendered; (iii) Seller's price to the buyer is fixed or determinable and (iv) collectibility is reasonably assured³⁹.

Implementation of SAB 101 is still in process of development. In its first year, only 2% of all SEC's registrants reported in the calendar third quarter of 2000 to make changes under SAB 101. Currently, FASB and IAS are working together implementing a globally acceptable and understandable standard.

The issue is basically the same: complex businesses or complex jurisdictions may create room for either anticipating or creating revenues when or where they do not exist: Companies dealing with infrastructure projects that are required to yield a return on their investment, may want to call revenue some contractual rights that they insert in specific agreements, even when such rights are either conditional, or future, or not enforceable or impossible to comply. Companies selling in credit terms, with extended payment terms, may want to accelerate their sales revenues, even though purchaser has not comply in full paying for its consideration, and so on and so forth.

Revenue Recognition in foreign transactions involving Latin American purchasers, may raise several issues to multinational companies doing business in Latin America. Here are some examples:

- 🌐 Cross Border Sales to a business resident of a country that is a party to the 1980 Vienna Convention for International Sales of Goods, when the sales contract does not exclude application of the Convention, may impair revenue recognition pursuant to FAS 48, because it creates a right of return to purchaser. These kinds of transactions must be analyzed from the legal perspective and its compliance cross checked with each Accounting Standard.
- 🌐 Cross Border Sales of goods that, pursuant to the INCOTERMS do not transfer risks and rewards of ownership, in an immediate manner, may also impair revenue recognition.
- 🌐 Sales of products in jurisdictions where Consumer Law protection establishes a threshold for right or return of goods under a deemed Statutory Guarantee, must be assessed, its legal foundations checked and the frequency for actual probability of these returns determined.

³⁸ International Accounting Institute. IAS 18: Revenue. In www.ias.org.uk Latest visited July 27, 2003.

³⁹ www.sec.gov/news/speech/spch495.htm Latest visited July 27, 2003.

- ④ Sales of products and/or services under extended payments terms, including sales type leases and operating leases, must be legally structured and affirmed in such terms that the sale becomes final. Generally, it is advisable to use a third party (Bank or Leasing Company) to perform the financial role in the Supply Chain. For these instances, FAS 140 establish the rules and regulations of assignment, in conformity with requirements under EITF 95-1 and 95-4.
- ④ Shipments to dealers, distributors, financial floor plans and other arrangements must also be structured in terms that such shipments comply with revenue recognition standards. Otherwise, no revenue should be recognized.

For all these types of transactions, it is advisable to have a legal counsel with experience and skills to overview, help structure such transactions, and determine whether or not the criteria to recognize revenues are met.

Regional counsel shall also evaluate all deals and at-arms-length transactions of the Publicly listed company subsidiaries, and guide the Management team about the compliance with all Revenue Recognition guidelines, before auditors review them.

Conclusions and Suggestions:

Sarbanes-Oxley Act created a heavy burden for Chief Executives Officers and Chief Financial Officers of publicly traded companies. The scope of their obligations thereunder is a worldwide scope.

Latin America represents 7% of global wealth and must represent no less than that percentage of total revenues for every multinational corporation. The growth potential of Latin America is tenfold, so greater emphasis and attention shall be placed to do business in the region.

To ensure compliance with Sarbanes-Oxley Act while achieving the desired business potential enjoyment, it is advisable to align the resources of the Chief Financial Officer and the General Counsel of each Corporation to work with expert counsel in:

- ❖ Organizing a Regional Contact Supervisory Compliance Office with understanding of both United States and Latin American local environments in order to monitor and understand all dealings, transactions, corporate governance and internal controls.
- ❖ Perform a due diligence check in their ongoing operations in Latin America in order to identify potential issues in terms of internal controls, material accounting aspects, revenue recognition and other financial aspects that are mandatory to disclose and rationalized.
- ❖ Rely on permanent advisory support for ensuring understanding and compliance with all obligations set forth by Sarbanes-Oxley Act.

APPENDIX

About FTAA CONSULTING INC

Endowed with the best human resources of the legal profession throughout boutique law firms long time established in Latin America, FTAA CONSULTING, INC. is the top cost efficient coordination center for legal services in support of multinational companies doing business across the territory that is expected to become the Free Trade Area of the Americas, including Canada from the North to Argentina in the South. FTAA CONSULTING provides services that range from outsourcing Regional Latin America Legal Counsel, supporting market entry strategies for multinationals in all countries of the Americas, providing consulting services for negotiation and contracting, Corporate Law with a particular focus in representing foreign investors in every country in the Americas, litigation support, delinquency management and representation of creditors' rights as well as ancillary legal services. Further details about the company and its background can be found at www.ftaaconsulting.com

About the author:

Dr. Rafael Castillo-Triana, born in 1957 is a Colombian attorney having 30 years of experience in the Corporate and international business legal arena. Mr. Castillo-Triana started his career in 1973 as a paralegal in the Law firm Roberto Uribe-Pinto & Associates, Mr. Castillo-Triana was further Assistant Vice President to Luis Soto & Co. a Colombian merchant banking, trust and foreign investors representative, which founded the Bogota's stock exchange. Mr. Castillo-Triana accumulated valuable experience in Securities, Trust, Corporate and Insurance practices.

In 1981, Mr. Castillo-Triana founded Finactivos Ltda., a money market brokerage firm, and started his practice as outside counsel for several business and Corporations, as also as advisor to major Importer and Exporters Companies. In 1984, Mr. Castillo-Triana was appointed as Executive Vice President of LEASING GRANCOLOMBIANA S.A. He coordinated and lobbied for the formal establishment of the Colombian Leasing Federation, FEDELEASING, and contributed to organize the initial International Leasing Conferences organized by FEDELEASING.

In 1986, as a guest speaker for Latin American at the IV World Leasing Convention in Tokyo, Mr. Castillo-Triana was appointed a member of the World Leasing Council. The same year, Mr. Castillo-Triana was invited to be a member of the legal committee of the Latin American Leasing Federation, FELALEASE.

In 1988, while he was founding MEGALEASING S.A., Mr. Castillo-Triana was appointed by the Government of the Republic of Colombia as its delegate at the Diplomatic Conference which finally discussed and adopted the UNIDROIT Conventions on International Leasing and International Factoring, in Ottawa, Canada. In 1989, while we was founding EQUILEASING S.A., Mr. Castillo-Triana wrote his book "Leasing: Mecanismo Financiero del Futuro", recounting all of the background leading to a universal regulation for Equipment Leasing.

In 1990, Mr. Castillo-Triana joined the Law firm of G.HOLLMANN RESTREPO ABOGADOS LTDA., established in 1939, and oversaw the Corporate Law Division of the firm. That same year, he was called by the Colombian Government regulators, Superintendencia Bancaria (Banking Superintendent) to train its personnel for Finance Leasing. Mr. Castillo-Triana also acted as a Law professor in the pre-graduate programs at University Sergio Arboleda, and on graduate programs at Universidad del Rosario, Universidad Javeriana, Universidad de los Andes, Universidad Externado de Colombia and the Bogota Chamber of Commerce and Colegio de Abogados Commercialistas Program for business lawyers.

In 1996, through the formation of HOLLMANN RESTREPO ABOGADOS CORPORATIVOS S.A., Mr. Castillo-Triana became senior partner of the firm. As an international member of the American Bar Association, Mr. Castillo-Triana is the Colombian Country Coordinator of the Latin American Division of the Business Law Section of the American Bar Association. He is also the permanent author of the Colombian chapter of the "World Leasing Yearbook", a Euromoney Publication. Mr. Castillo-Triana has been a guest lecturer three times in the World Leasing Convention in Tokyo, (Japan), London, (England) and Cancun (Mexico). He has been a guest panelist on Alternative Dispute Resolution in 1998 at the Forbes Magazine and the Council of the Americas Seminar for Latin American business; lecturer at the Economist Intelligence Unit, Latin American Regional Managers Club on "Logistics and Distribution in Latin America" in 1998; a panelist at the St. Mary Law School, San Antonio Texas on Alternative Dispute Resolution, receiving from the St. Mary Law School and the ADR Section of the American Bar Association a certificate of excellence; and panelist in 1999 at the Seminar "Legal Aspects of Doing Business in Latin America" organized by the International Law Section of the Florida Bar.

In 2001, Mr. Castillo-Triana wrote the book "Legal Aspects of Equipment Leasing in Latin America". The book recounts the Law and Regulation of the largest Latin American economies. He was also a guest speaker at the Equipment Leasing Association of America Conventions about Leadership, Globalization and Leasing in Latin America.

Mr. Castillo-Triana is based in Fort Lauderdale, Florida, and travels extensively throughout Latin America, providing outsourcing of regional legal counsel services for several multinationals operating in the Americas.