Abstract

Mexico has successfully implemented policies to open foreign trade, stabilize the Peso, control inflation, deregulate private business, scale back state enterprises, eliminate bureaucratic red tape, and welcome foreign investment. This process started before NAFTA was considered; however, NAFTA helped in making these economic changes more permanent.

Given a more propitious business environment, understanding the financial information reported by Mexican firms constitutes a relevant inquiry. This paper analyzes features of the accounting model used in that economy and compares them against the characteristics of its counterpart accounting practice in the U.S.

As a whole, the Mexican accounting practice has achieved a reasonably good level of competence. In their quest to find solutions to problems and issues not yet covered by their accounting norms, the Mexican Accounting Principles Committee has paid close attention to the U.S. GAAP and to the principles advanced by the International Accounting Standards Committee. A new Law of the Securities Market has added mechanisms to guarantee a healthy operation of the securities market and to increase the transparency of transactions and financial disclosures of the companies whose securities are traded in the exchanges. All this is a reflection of the new open economy and free market mechanisms embraced by the Mexican government.

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Mexico Under NAFTA: Accounting Information In a Changing Economy

1.Introduction

Even before the idea of a comprehensive trade agreement between the U.S. and Mexico started to germinate, there was evidence of a growing integration of those economies, and of a strong dependency of the Mexican economy on the U.S. market. Thus, between 1980 and 1987 the destiny of between 60 and 70 percent of total Mexican exports—of which 70 percent represented non-oil products—was the neighbor country to the north. At the same time, Mexican imports from the U.S. represented an average of 65 percent of total imports during the same period. The linking of business and economic relations is more significant because part of this two-way trade has taken place between domestic affiliates and their U.S.-based multinational corporations. The opinion of prominent scholars who studied the Mexican case is that the two economies were becoming more integrated thanks to an increasing proportion of trade in manufactured components, which created more value added at each step of the process (Weintraub, p. 75).

During the early part of the 1980s, a substantial redefinition of the Mexican economic system took place, characterized by the replacement of an import-substitution development model with one structured upon the foreign sector and economic comparative advantage. The impact of the

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change has been substantial and the transformed Mexico is one of the most open nations in the world. As evidence of this, the value of total exports went from $22.9 billion in 1985 to $110 billion in 1997, a 380% increase. Also, at the end of 1997, the trade (exports plus imports)/GDP ratio was 55%, definitely well above that ratio experienced by other major economies of the region, such as Argentina (16%), Brazil (13%) and Chile (15%).

2. Opportunities under NAFTA's Environment

For many years the U.S. wanted Mexico to eliminate trade barriers, stabilize the Peso, control inflation, deregulate private business, scale back state enterprises, recognize intellectual property rights, eliminate bureaucratic red tape, and allow foreign investment. This was all happening even before NAFTA passed. What NAFTA did was to institutionalize those measures, making the economic opening more permanent.

Simply stated, Mexico did everything of an economic and business nature that the U.S. wanted it to do. In return, it got access to the U.S. and Canadian markets, and the possibility of fresh investment from those countries, principally from the U.S. Since there already was a substantial trade link between the U.S. and Mexico, the North American Free Trade Agreement was described as an investment agreement to channel funds needed for the Mexican development. Mexico needs a strong inflow of capital investments to create jobs for its increasing poulation and the U.S. is a natural provider. Thus, about two-thirds of total foreign investment comes from the United States. U.S. direct investment in Mexico was $16.4 billion in 1995, mainly in manufacturing ($10.7 billion) and finance ($2 billion) (Gianaris, p. 195).

Foreign investment funds channeled to Mexico trickle down to Mexican businesses and consumers who spent mainly on U.S. goods. This, of course, does not happen with U.S. investments in East Asia where the economies are more intertwined with Japan's. Export-hungry American companies contemplate with optimism the prospects of an expanded market of 90 million people, half of whom are under 18.

It is still evident that NAFTA has contributed to increase trade between Mexico and the U.S. The U.S. exports from Mexico expanded from $5 billion in 1975 to over $41 billion in 1993 and up to almost $50 billion in 1994. In 1995, exports from the U.S. to Canada and Mexico

already exceeded exports to the European Union and to Japan and East Asia.

In addition to the progressive elimination of tariffs for North American products that NAFTA brings about, there is a proliferation of business opportunities, especially in Mexico. For instance, even though the Mexican state retains control of its oil, gas, refining and basic petrochemicals, investments in non-basic petrochemicals and electricity-generating facilities are now permitted. Government procurement is opening gradually, with good prospective business ventures for suppliers of goods, services and construction. Also, after earlier provisions of domestic market share limits, providers of financial services intermediation in banking, securities and insurance can now set business operations in the region. Each of the NAFTA countries will have no discrimination among its local and foreign (NAFTA) investors. Finally, each member country is to provide adequate and effective protection of intellectual property rights.

In addition to the economic liberalization and the opening of financial markets brought about by NAFTA, the treaty propitiated a climate towards more democratization and transparency in the Mexican Political System.

The area of services is particularly appealing to U.S. business ventures. American industrial companies are already dominant in the Mexican market, but the opportunities in the previously closed field of services are unlimited, especially more when the services sector accounts for 60 percent of Mexico's GDP. Opportunities are open now in areas such as banking, communications, transportation, publishing, insurance, tourism, computer software development, business consulting, and others. An area of special interest for Canadian and U.S. businesses is financial intermediation. Amendments to Mexico's stock market law intend to promote more savings, introduce new financial instruments, widen the range of financial services offered by participating institutions, and penalize the improper use of insiders' information. Under NAFTA rules, each member country must permit financial services providers to set up shop within their domestic boundaries. The establishing of local units with full or partial participation of foreign capital in the Mexican banking and securities sectors has already occurred. The cross border flow of professional, technical and managerial personnel in connection with marketing activities and business transactions is already operational.

3. Direct Investment in Mexican Listed Corporations

In the early 1990s the Mexican stock market (the Bolsa Mexicana de Valores) was one of the world's best performing markets in terms of dollars. During the ten year period ending in 1992 the stock market rose to 120 times its value. However, most of the increase has occurred in this decade. For instance, the Bolsa increased 99 percent in dollar terms between January 1 and early December of 1991. Foreigners—mostly American— became increasingly active participants in the Mexican Stock Exchange. At the end of November of 1992 investments by foreigners amounted to $27.7 billion, about 21 percent of the total market. Frequently, foreign investors account for more than half the daily trading.

Portfolio investment in Mexican securities can take place by purchasing non-voting shares of the "B" type, or Certificates of Ordinary Participation. The latter type of security—also referred as "neutral trust" shares—represents common stock with all but voting rights, which is kept into a Mexican trust that exercises the voting privileges. Foreign investors can also acquire stock in Mexican companies through the American Depository Receipts (ADRs) traded in the U.S. exchanges, as well as through special country portfolio funds. At the end of 1995, there were over 20 Mexican firms listed on the New York, NASDAQ and American stock exchanges under the ADRs modality (Gianaris, p. 184-185). The Mexico Fund, the Mexico Equity and Income Fund, and the Emerging Mexico Fund are three alternative investment portfolios available in the U.S. securities markets.

Given the increasing opportunities for direct foreign investment in established Mexican companies, understanding the financial information reported by Mexican firms constitutes a valid and relevant inquiry. The next sections discuss the features of the accounting model used in that economy and compare them against the measurement and disclosures that are typically present in the accounting practice as we know it in the U.S.

4. Accounting Principles in Mexico: A U.S. Influence?

The issuing of accounting standards in Mexico corresponds to the Accounting Principles Committee, a unit of the Mexican Institute of Public Accountants, which is the private professional association grouping state accounting societies. The committee is integrated by promi-

nent practitioners, academics and financers, but is different from the U.S. Financial Accounting Standards Board (FASB) because it is not an independent body.

The process of preparing a new accounting norm in Mexico follows steps that resemble those applied in the U.S., such as preparing an initial draft of the principle for discussion, receiving comments from the membership, deliberations by the principles committee, and final approval and publication by the Institute's Executive Board. A new standard must be approved by at least two thirds of the members of the Accounting Principles Committee before passing it to the Executive Board of the Institute for final consideration. The committee is also in charge of revisions, interpretations, and recommendations affecting the existing standards.

As per regulations from the Mexican National Banking and Securities Commission, observance of accounting principles and disclosures is compulsory for those companies whose securities are listed on the Mexican Stock Exchange. Use of accounting standards by non-listed companies is generally observed, and it is needed for businesses applying for commercial loans or credit from suppliers. Mexican certified public accountants can opt for registration with the Office of Federal Taxation, which enables them to issue an additional tax attestation that is similar in nature to the auditor's report on the company's financial statements. For the company, the benefit of the added tax report is the comfort of having been reviewed by an independent tax specialist, and the implied reduced likelihood of being audited by the tax authorities.

The influence of U.S. accounting is evident in several areas, partly due to the presence of numerous affiliates of U.S. multinational corporations, and also due to the prominence of local representatives of the Big Six U.S. accounting firms. For those areas where a Mexican accounting principle is not yet available—such as earnings per share or line of business disclosures—it is customary to find the corresponding U.S. standard being applied. Still, there are characteristics of the economy—not atypical of those found in the rest of Latin America—that call for addressing special accounting issues, such as inflation accounting.. Moreover, there are distinctive accounting practices and disclosures for regulated industries—banking, insurance, trusts—that go beyond the mold of generally accepted accounting principles as currently known.

The general characteristics of financial accounting information as known in the U.S.—such as objectivity, freedom from bias, timely information,

usefulness and consistency—serve as a general framework upon which the accounting principles are formulated. These basic concepts are referred to as "Series A" in the published official Mexican accounting standards. Three other series comprise general standards for financial statements, principles applied to specific items and accounts, and special issues on income measurement, respectively. The required financial statements include the balance sheet, the income statement, the analysis of changes in owners' equity, the changes in financial position and the corresponding footnotes.

5. Inflation Accounting

Up until the middle 1970s, inflation rates were kept in Mexico at such low levels that it was unnecessary for the accounting profession to abandon the historical cost model for reporting financial information. An initial attempt to recognize the effects of inflation occurred in 1979 when a new principle called for disclosing gains or losses resulting from holding non-monetary assets and liabilities. Also, the concept of capital maintenance in financial terms required the creation of a special reserve account in the equity section. The new accounting principle borrowed many of the features of the FASB's Standard No. 33 on inflation accounting, and it asked for additional disclosures without modifying the original historical data recorded on the accounts. The new principle never received general acceptance and was subsequently eliminated by the Mexican Accounting Principles Commission. When annual inflation shot up to double digits in the early 1980s—and reached 160 percent in 1987, there was a need for a mechanism to reflect the impact of inflation on a company's reported operations. Thus, the accounting profession came up with a new standard that replaced historical cost and included the adjustments for inflation within the body of the financial statements.

Mexican Accounting Standard B10 on the effects of inflation became compulsory for all companies in 1984. Its four amendments since then have served to fine-tune the basic structure laid down in the prescribed accounting treatment. The standard is built around three angular concepts, namely, the effect of inflation on the net monetary (assets minus liabilities) position, the gains or losses resulting from holding non-monetary assets, and the preservation of capital in financial terms. The method requires re-stating all financial data in monetary units as of the end of the current reported period. All comparative financial statements from prior

years should be restated to constant pesos as of the date of the most recent balance sheet.

To adjust for inflation, companies can use a consumer price index published by the central bank or restate the asset values to current replacement costs. As an option, the Mexican National Banking and Securities Commission allows listed companies to periodically revalue physical assets according to valuations by registered independent property appraisers. When this approach is used, the difference between the restated values and those that would result if a general price index were applied is reported as a gain or loss in holding non-monetary items. This special account is reported in the owners' equity section. The cost of sales and depreciation accounts in the income statements should reflect values adjusted for inflation, or the replacement values if the specific cost restatement option is selected. The owners' equity accounts also need to be adjusted for the effect of changes in the general price index. For purposes of consolidated financial statements, all the accounts of the controlled subsidiaries must be in inflation-adjusted terms prior to proceeding with consolidation.

A novel concept introduced by the accounting for inflation in Mexico is the "integral cost of financing," which is disclosed in the income statement. This is the net result of the nominal interest expense, the gain or loss due to price level changes on the company's net monetary position, and the differences due to variations in exchange rates for monetary assets and liabilities denominated in foreign currencies. Capital maintenance in constant peso units is achieved through inflation and exchange rate effects on net income for the year, and through the cumulative result of holding non-monetary items reported in a special account within the owners' equity section of the balance sheet.

6. Assessment of Accounting for Inflation in Mexico

After several attempts, Mexican accountants have been successful in accounting for inflation through a mechanism that is comprehensive and adheres to the idea of capital maintenance in real terms. Reporting the inflation adjustments on the cost of financing is similar to the integral correction method used up until 1994 in Brazil, with the added benefit that the various elements impacting that cost are properly and separately disclosed in the Mexican model. The consumer price index published by

the central bank is the inflation factor to use, thus standardizing the adjustment applied by all reporting firms. Comparability among companies is thus enhanced. Users of published financial information have become accustomed to the reported adjusted data and are pleased to know that the accounting data represent amounts in real constant pesos.

7. Other Accounting Issues

The majority of existing accounting principles in Mexico are not in disagreement with the standards of the International Accounting Standards Committee (IASC), nor with coverage of those topics in the FASB's norms. However, there are areas in wich accounting standards are simply not available in that country. For instance, there is not an accounting principle to disclose segmental information, nor a standard to translate to local Pesos a subsidiary's financial data denominated in a foreign currency. Moreover, there are no accounting standards requiring such disclosures as earnings per share, extraordinary earnings, or earnings from discontinued operations. Some of the companies listed on the stock exchanges voluntarily disclose sales figures for their main lines of business, but this is only an exceptional practice. The disclosure of segments by geographical areas is probably not essential at this point because only a few of the major Mexican corporations have controlled affiliates abroad, but that is likely to change as spillover effects of NAFTA and the open market policies are embraced by the Mexican government. In regard to earnings per share, the practice of presenting the primary (common) earnings per share for the period is widespread.

Valuation of the many items included in the financial statements is determined by the dictated adjustments to constant prices, but there are a few accounts that deserve attention. Cash, investments, and receivables or payables that are denominated in a foreign currency are translated to Mexican pesos at the spot exchange rates on the date of the balance sheet, thus being in general agreement with the accounting treatment for these items under FASB Statement No. 52. However, accounting for foreign exchange transactions or hedging instruments is not covered in the current Mexican accounting principles. Inventories can be measured and reported at cost adjusted for inflation, at last-purchase prices, at standard cost, or even at direct costing, with the only limitation that the reported values must not exceed replacement cost. On the other hand, Mexican

accounting principles are emphatic in treating research and development costs as expenses of the period when incurred.

One of the unique features in the income statement of Mexican firms is the annual profit sharing amount owed to all personnel of a company. Profit sharing has been in place for over twenty years. It results from binding legislation and is generally regarded as another cost of doing business in the country. This item—which is not really an expense—is appropriately disclosed at the bottom of the income statement, just before net income. Other relevant labor costs include a provision for severance payments to dismissed employees. This is because Mexican labor laws are onerous for a company when any employee is dismissed without a justifiable reason, and proving a just cause here is a burdensome task for any company.

Pension accounting was introduced through a new accounting standard effective for fiscal periods starting in 1993. The content of this principle follows pretty closely the accounting for pension plans as conceptualized and practiced in the U.S. Before the 1990s, pension plans were rare in Mexican business, and retirement funds for employees consisted mainly of social security benefits. A standard on accounting for leases, which was effective in 1991, resembles again much of the treatment for leases found in FASB's Statement No. 13, including the conditions needed for a lease contract to be capitalized.

Accounting for investment in affiliated companies is configured in the traditional mold found in the FASB's or the IASC's standards. Thus, consolidation is required when control exceeds the 50 percent mark, although it is possible to effect consolidation with less than 50 percent of capital ownership when agreements with other shareholders or similar arrangements effectively produce majority control on the investee. Participation by the equity method is called for when the investor exercises significant influence—but not majority control—on the investee. Significant influence is assumed to exist when participation in the voting shares of the associated company represents more than 10 percent and up to 50 percent of the total shares outstanding. The purchase method is the one authorized for acquisitions of an existing business, and pooling of interests is not covered in the existing Mexican accounting norms. The difference between the cost and the fair value of the net assets acquired could originate a positive or negative goodwill, which is normally amortized in the income statements during a period not to exceed

twenty years. Under certain conditions the standard permits the immediate disposal of this difference.

Income tax expense for Mexican companies is computed according to the partial liability method. Under this approach, deferred income taxes are recorded for identifiable, non-recurring timing differences—expected to reverse in the future—at rates in effect when those differences arise. A peculiar characteristic of Mexican accounting practice is the recognition of gains—and, though rare, losses too—in treasury stock transactions with the company's own shares. Contrary to accepted accounting theory that precludes recognizing gains from transactions with the company's shareholders, the Mexican Law of the Securities Market dictates this specific treatment. Accordingly, a company that purchases its own shares must include them as part of the short term assets. Under U.S. accounting standards, the differences resulting from treasury stock transactions are included as additional Paid in Capital.

8. Financial Disclosures by Mexican Firms

Notwithstanding the lack of information in areas such as segmental disclosures, off-balance sheet financing, hedging instruments, etc., the degree of disclosure provided in the published financial statements of Mexican listed companies is more than adequate. The content of footnotes typically includes contingencies, related party transactions, a listing of major financial commitments, analysis of pension expenses, explanation of the integral cost of financing, liabilities denominated in foreign currencies, and a list of affiliated companies. The statement of changes in financial position or fund statement—like its counterpart in the U.S.—constrains the concept of funds to cash and cash-equivalent short term investments, thus eliminating the previous option of using working capital as funds in the preparation of the statement.

Conclusion

After the signing of the NAFTA, progress in many key areas of the Mexican economy was achieved. The new economic and political apenness that accompanied NAFTA's implementation opened new opportunities for foreign investors. This process forced financial markets, securities and financial instruments, as mell as financial disclosures made by Mex-

ican corporations to adapt to the new conditions. Accounting information as a part of this process had to follow suit.

At this juncture the Mexican accounting practice, by adapting to increasing demands for measurement and disclosures, has achieved a reasonably good level of competence. In their quest to find solutions to problems and issues not yet covered by the existing framework of accounting norms, the Mexican Accounting Principles Committee has paid close attention to the U.S. GAAP and to the principles advanced by the International Accounting Standards Committee.

Notes

1. See Sidney Weintraub, *A Marriage of Convenience. Relations Between Mexico and the United State* (Oxford University Press, 1990) pp. 72-73.

2. For a capsuled review of developments in the Mexican economy prior to the NAFTA Treaty, see Harvard Business Review, *A Brief History of the Mexican Economy*, July-August, 1993, pp. 38-40; and The Economist, *A survey of Mexico*. February 13, 1993, pp. 3-22.

3. See, Grupo Financiero Banamex-Accival. *Review of the Economic Situation of Mexico*, Vol. LXXIV, No. 868, March 1998, pp. 114-119.

4. See William A. Orne, Jr. *Continental Shift. Free Trade and New North America* (The Washington Post Co., 1993) p 3,29.

5. See Dorinda G. Dallmeyer, Editor, joining Together, Standing Apart: National Identities After NAFTA (Klumer Law International, 1997, preface).

6. For a review of the general content of NAFTA rules and their impact on business and trade in the participating countries see, Claudio Loser and Eliot Kalter, Editors. *Mexico: The Strategy to Achieve Sustained Economic Growth* (International Monetary Fund. Occasional Paper No. 99, 1992); Nora Lustig, B.P. Bosworth, and R.Z. Lawrence, Editors. *North American Free Trade. Assesing the Impact* Brookings Institution, 1992); Gary Clyde Hufbauer and Jeffrey C. Schott. *North American Free Trade. Issues and Recommendations*. (Institute for International economics, 1992); and Banco de Mexico. *The Mexican Economy: 1993* (Banco de Mexico, 1993) pp. 119-150; and William A. Orne Jr., *Understanding NAFTA, Mexico Free Trade and the New North America* (University of Texas Press, 1996).

7. For a study of the impact of NAFTA on the democratic process, the education and the politial system of Mexico, see Paul Richa and Guillermo de los Reyes, Eds. *NAFTA Revisited: Expectations and Realities* (The Annals of the American Academy of Political and Social Sciences, 1997).

8. Evidence of interest on this by business professionals is found in Charles H. Heeter, Jr., "NAFTA Opens New Markets for CPAs," *Journal of Accountancy* (March, 1994) pp. 69-72.

9. "A Survey of Mexico." *The Economist* (February 13, 1993) p.16.

10. *Financial Times* December 18, 1991, as quoted in Hufbauer and Schott (1992) p. 80.

11. "A Survey of Mexico." *The Economist* (February 13, 1993) p. 16.

12. For a complete review of Mexican accounting standards, Instituto Mexicano de Contadores Públicos, *Principios de Contabilidad Generalmente Aceptados- Edición 1993* (IMCP) 1993; and Coopers & Lybrand, *International Accounting Summaries. A Guide for Interpretation and Comparison* (John Wiley & Sons, 1991) pp. M-1 to M-16.

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