

REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC)

Honduras**ACCOUNTING AND AUDITING****CONTENTS**

| | |
|---|-----------|
| EXECUTIVE SUMMARY | i |
| I. BACKGROUND | 1 |
| II. INSTITUTIONAL FRAMEWORK FOR CORPORATE FINANCIAL REPORTING AND AUDITING | 5 |
| A. Statutory Framework | 5 |
| B. The Accounting and Audit Profession | 13 |
| C. Professional Education and Training | 16 |
| D. Setting Accounting and Auditing Standards: Recent History and Current Institutional Arrangements | 17 |
| E. Ensuring Compliance with Accounting and Auditing Standards | 19 |
| III. ACCOUNTING STANDARDS AS DESIGNED AND AS PRACTICED | 21 |
| A. Standards as Designed | 21 |
| B. Observed Reporting Practices | 24 |
| IV. AUDITING STANDARDS AS DESIGNED AND AS PRACTICED | 24 |
| V. PERCEPTIONS ON THE QUALITY OF CORPORATE FINANCIAL REPORTING | 26 |
| VI. RECOMMENDATIONS | 27 |
| A. Short-Term Priority Actions | 28 |
| B. Medium-Term Objectives | 31 |
| C. Long-Term Challenges | 34 |
| ANNEXES | 37 |

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1 US\$ = 18.9 HNL as of December 31, 2006

MAIN ABBREVIATIONS AND ACRONYMS

| | | | |
|----------|---|-------|--|
| A&A | Accounting & Auditing | IES | International Education Standards for Professional Accountants |
| CAS | Country Assistance Strategy | IFRS | International Financial Reporting Standards |
| CNBS | National Banking and Insurance Commission | ISA | International Standards on Auditing |
| COHEP | Honduran Business Association | MIF | Multilateral Investment Fund |
| COHPUCP | Honduran Institute of Accounting Professionals with University Degree | MoF | Ministry of Finance |
| CPMCPH | Honduran Institute of Accounting Technicians and Public Accountants | NOHC | Honduran Accounting Standards |
| DEI | Tax Administration | OECD | Organization for Economic Cooperation and Development |
| DR-CAFTA | Dominican Republic – Central American Free Trade Agreement | ONCAE | National Procurement Office |
| ENEE | State electricity utility | PFM | Public Financial Management |
| FDI | Foreign Direct Investment | ROSC | Report on the Observance of Standards and Codes |
| FSAP | Financial Sector Assessment Program | SA | Corporation (<i>Sociedad Anónima</i>) |
| GAAP | Generally-Accepted Accounting Principles | SIS | Superintendency of Insurance |
| GoH | Government of Honduras | SMO | Statement of Membership Obligations |
| Hondutel | State-owned telecommunications company | SOE | State-owned enterprise |
| IASB | International Accounting Standards Board | TSC | Supreme Court of Accounts |
| IDB | Inter-American Development Bank | UNAH | State University of Honduras |
| IAS | International Accounting Standards | UPN | National Pedagogic University |

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EXECUTIVE SUMMARY

Improved financial reporting in both the public and private sectors is an issue of strategic importance for Honduras. The Government is looking to DR-CAFTA and a trade treaty that is currently under negotiation with the European Union to jump start economic growth; however, the country will not realize the full benefits of these trade agreements unless private suppliers appear credible, and financing instruments issued by Honduran banks can be accepted by the country's new trading partners. The first step toward attaining this credibility is for Honduran corporate and financial institutions to provide timely and reliable financial information that meets international standards.

This report analyzes corporate financial reporting and auditing practices in Honduras in support of the Government's efforts to (a) improve the business environment and make it more attractive for domestic and foreign direct investment, (b) enhance financial transparency and governance in the corporate sector; and (c) foster economic integration within the Latin America and Caribbean Region (LCR). For the purpose of this study, relevant benchmarks have been used, including the International Financial Reporting Standards (IFRS) and the International Standards on Auditing (ISA). The report also draws on international experience and good practice in those fields, particularly in LCR.

Accounting and auditing (A&A) standards and practices in Honduras have been improving; however, continued efforts to align these with international ones are still needed. Several factors explain the current situation, from a low demand for financial information, to the lack of legal incentive for companies to observe high standards of financial reporting. The current standard for financial reporting is based on an outdated version of US generally accepted accounting principles. Moreover, the accounting and audit profession is not well perceived among the business community, in part because the vast majority of practitioners have no university education. In practical terms, this means that the financial information prepared by Honduran companies are of limited usefulness since it does not meet the needs of local or international investors and lenders.

Commendable efforts have been made over the recent period to improve the situation, including the passing of the Accounting & Auditing (A&A) Law that mandates *inter alia* the full implementation of IFRS and ISA as of January 1, 2008, for financial reporting in Honduras; the setting-up of an A&A "Technical Board"; and the strengthening of regulations in the financial sector regarding accounting and auditing. The Honduran Government is also making an effort to reform its state-owned enterprises (SOEs), including major electric and telecom utilities, to make them more efficient, including through improved financial management practices. Moreover, a donor-funded technical assistance project with a strong focus on capacity building is currently being carried out to support the adoption of IFRS. These efforts, while they have yet to bear fruit, are important steps in the right direction.

One of the particular features of the accounting and auditing environment in Honduras has to do with the two-tiered structure of the accounting profession. The upper tier comprises university graduates and the lower tier those who have only secondary

education (“*peritos mercantiles*”); in fact, the lower tier represents the overwhelming majority of practitioners, most of which are in the business of bookkeeping. Both tiers have their own professional body (*Colegio*). What makes the case of Honduras peculiar is that (a) the law allows *peritos mercantiles* to carry out external audits and (b) the *Colegio of Peritos* is the one with most statutory and actual powers. The upshot of this peculiar structure is that, in general, the accounting profession is not very well perceived by Honduran businesses and financial institutions. As a result, the profession lacks institutional leadership; the accounting education of practitioners needs to be significantly improved and updated; and there is no evident group with the financial or human capacity to take charge of the needed reforms. This is compounded by the fact that corporate financial statements are not subject to any public scrutiny except in a limited number of instances and there is an absence of quality control mechanisms within the profession.

In the financial sector, the regulatory agency, CNBS, has established additional requirements which serve as a filter to ensure a minimum level of qualification on the part of bank and insurance company auditors, but, this additional filter does not affect the vast majority of companies, even large ones. However, some of these companies are headquartered in foreign countries and, as a result, follow international standards in their financial statements and audits.

Improving accounting and auditing standards to achieve the necessary level of corporate sector financial transparency will take time and effort, particularly to develop the required technical capacity among the accounting and audit profession. As a result, any reform program must necessarily be incremental in nature and reflect a phased approach as follows:

- (a) The first stage must focus on: (i) amending the A&A law; (ii) setting standards that can actually be met in the intermediate term; (iii) building the professional institutions and the technical board so they can provide leadership for the profession; (iv) continuing the efforts to upgrade the skills of existing practitioners and the standing of the audit profession, which requires revamping the accounting curriculum of the National Autonomous University; and (v) continuing to publish the balance sheets and income statements of banks and insurance companies on the CNBS website.
- (b) The second phase would be able to address issues pertaining to (i) accounting standards to be applied by financial sector entities; (ii) online publication of the complete set of audited, annual financial statements (including the cash flow statement, notes and audit report) on the websites of the CNBS and of the respective banks and insurance companies; (iii) the qualification of auditors of large corporate borrowers; (iv) raising awareness within the business community of the importance of reliable corporate financial reporting; and (v) improved SOE financial reporting.
- (c) For the long term, the Honduran authorities and accounting profession need to address more difficult issues including (i) substantially increasing the licensing requirements for auditors, bringing them to par with international standards; (ii) ensure the long-term effectiveness of quality control mechanisms for the audit profession; and (iii) upgrade the content of high school education for the *peritos mercantiles*.

For the short to intermediate term, the action program should consist of a limited number of measures entailing achievable outcomes that support the objective of strengthening the knowledge of auditors in Honduras. In the short run, the top four priorities to improve accounting and auditing in Honduras should be:

- (a) Amending the A&A Law;
- (b) Establishing a financial reporting framework consistent with the level of accountability that one would normally expect from different categories of companies, ranging from public-interest entities to micro-enterprises, the latter being exempt from any obligation;
- (c) Strengthening the institutional capacity and stature of the country's accountancy bodies', especially the Technical Board and COHPUCP;
- (d) Providing additional training to audit practitioners in order to build their technical capacity and professional competence to the necessary level.

The recommendations of this ROSC are summarized in the following table.

| Implementation of A&A ROSC Recommendations: Expected Results | | | |
|--|--|--|---|
| Theme | Short-term results (1 year) | Medium-term results (2-4 years) | Long-term results (>4 years) |
| 1 Consolidating the statutory framework for corporate sector A&A | <ul style="list-style-type: none"> The A&A Law is amended, setting out a clear framework for corporate A&A Size thresholds and other characteristics for classifying companies into the four categories are defined (i.e., public interest entity, large company, SME, etc.) | <ul style="list-style-type: none"> The role of the <i>comisario</i> is redefined in the Code of Commerce Complete annual financial statements of banks and insurance companies are made available to the public on the CNBS website | <ul style="list-style-type: none"> Certification to conduct audits of public interest entities and large corporate borrowers is required |
| 2 Setting A&A standards | <ul style="list-style-type: none"> A robust standard-setting process is adopted Simplified IFRS are reviewed First 15 GAAP are revamped (for SMEs) | <ul style="list-style-type: none"> CNBS commissions a study of the impact of the adoption of IFRS in the banking sector CNBS adopts IFRS 4 for insurance companies | <ul style="list-style-type: none"> Public interest entities and large apply either full or simplified IFRS CNBS mandates IFRS for all financial sector entities |
| 3 Strengthening A&A bodies | <ul style="list-style-type: none"> The Technical Board adopts by-laws and a three-year plan that give it a clear strategic direction COHPUCP applies for IFAC membership | <ul style="list-style-type: none"> Quality assurance mechanisms are established COHPUCP is accepted as associate IFAC member | <ul style="list-style-type: none"> Ongoing efforts to ensure the sustainability and effectiveness of quality assurance mechanisms are carried out COHPUCP is accepted as full IFAC member |
| 4 Licensing of external auditors | | <ul style="list-style-type: none"> CNBS auditor qualifications for large corporate borrowers (Category D) are strengthened | <ul style="list-style-type: none"> Licensing requirements for auditors is brought to par with international standards with the adoption of certification process accepted in the US |
| 5 Training and education efforts | <ul style="list-style-type: none"> Further training needs for accounting professionals in Honduras are evaluated A second wave of capacity building effort for Honduran accountants is initiated | <ul style="list-style-type: none"> A campaign is carried out to raise awareness in the business community of the importance of financial reporting University curriculum and high school <i>peritos mercantiles</i> curriculum are updated and revamped | <ul style="list-style-type: none"> High school teachers are trained, and teaching materials are updated Continuing professional education is required for auditor certification |
| 6 Strengthening accountability in state-owned enterprises (SOEs) | <ul style="list-style-type: none"> Action plans are developed in each SOEs to address issues raised in audit reports | <ul style="list-style-type: none"> Capacity building efforts to improve financial management of SOEs Needs assessment for improving financial management in SOEs Action plans to address audit issues are implemented SOE oversight body is established within the Ministry of Finance | <ul style="list-style-type: none"> SOEs publish audited financial statements in accordance with either full or simplified IFRS |

I. BACKGROUND

1. This review of accounting and auditing practices in Honduras is a part of the World Bank and International Monetary Fund joint initiative to prepare Reports on the Observance of Standards and Codes (ROSC). The review focuses on the strengths and weaknesses of the accounting and auditing environment in the corporate sector (which includes private companies and state-owned enterprises) and how they influence the quality of corporate financial reporting. International Financial Reporting Standards (IFRS)¹ and International Standards on Auditing (ISA)² were used as benchmarks for this assessment, which included both statutory requirements and actual practice.

2. **Honduras is a small, open economy whose GDP grew at approximately 4.6% in the 2004-2005 period.**³ The economy still relies heavily on agriculture, primarily bananas and coffee, which accounts for 13% of GDP; however, since the beginning of this decade, labor intensive, export-oriented manufacturing activities known as *maquila* have also grown significantly. Tourism activities have increased over the last five years and offer further significant growth potential to Honduras. Honduras still needs to deal with a number of issues in order to maintain growth and reduce poverty. Such issues include: maintaining macroeconomic stability, strengthening the financial sector, promoting investment, and making Honduran companies more competitive so they may reap the benefits of recent free trade agreements.

3. **Honduras presently has no active securities market. The banking and insurance sectors, while still underdeveloped, have benefited from strengthened regulation and supervision in recent years.** A stock exchange exists in Tegucigalpa but it has virtually no activity, and there is no exchange in the business capital, San Pedro Sula. Discussions held during the ROSC missions with large business owners and financiers, both in San Pedro Sula and in Tegucigalpa, clearly indicate that the private sector does not believe a stock market of significance can be developed in Honduras in the foreseeable future. The banking sector is dominated by local banks, but the presence of international banking groups has recently become significant. The banking sector is comprised of 16 banks with total assets of approximately US\$7.5 billion as of June 2006. At the moment, these banks are still controlled mainly by local family interests; however a recent trend has seen an increased participation of foreign interests.⁴ The insurance

¹ IFRS correspond to the pronouncements issued by the International Accounting Standards Board (IASB) and International Accounting Standards (IAS) issued by its predecessor, the International Accounting Standards Committee, as well as related interpretations.

² These are issued by the International Auditing and Assurance Standards Board, an independent board within the International Federation of Accountants (IFAC).

³ The Honduran economy is still recovering from the economic slow-down triggered by a series of external shocks beginning in 1998. Hurricane Mitch in particular had devastating effects, resulting in damages amounting to 40% of GDP. The combined effects of the hurricane and the subsequent decline in coffee prices and the increase in oil prices, led to substantial losses in the financial sector and an increase in the volume of bad debts. The latest available World Bank figures indicate that GDP in 2005 was US\$8 billion (in current US\$); GDP growth in 2006 is expected to reach 5.1%.

⁴ The country's second largest bank, BGA, was acquired in 2006 by Panama's Banistmo, one of the largest banking groups in Central America which itself was acquired by HSBC in 2006. Cuscatlán,

industry includes 10 companies, two of which are US-based and one of which is a subsidiary of Panama's Banistmo. The size of the insurance market is still very small and life insurance is almost nonexistent. The private pension sector is still underdeveloped.⁵ In the absence of institutional investors of any significance, there is currently no mechanism for channeling long-term private savings.

4. Accelerating economic growth is a critical development goal for Honduras.

Economic growth has been a key component of Honduras' Poverty Reduction Strategy, originally prepared in 2001 and embraced by all subsequent administrations, including the current Zelaya Administration, which took office in 2006. Likewise, the World Bank Country Assistance Strategy for 2007-10 has made "Equitable Economic Growth for Employment Generation" the first of its four pillars. In order to achieve this goal, the government must be able to maintain macroeconomic stability and a sustainable fiscal framework. The public sector fiscal deficit has been significantly reduced, from 3% of GDP in 2004 to 2.5% in 2005 and an estimated 1.7% in 2006.⁶ Still, improved tax collections are necessary to enable further improvements. Likewise, curbing the operating losses of public utilities is also essential. Finally, as part of the growth agenda, the government must make significant efforts to enhance the credibility of the financial sector and promote the competitiveness of Honduran firms to expand investment and exports.

5. The Honduran Government has also set increased public sector transparency and governance, as well as the reform of state-owned enterprises (SOEs), as a priority. In this regard, the Government passed, in late 2006, a Transparency and Access to Public Information Law, which requires, among other things, that SOEs make their financial statements available to the public. However, a recently completed Public Financial Management (PFM) Performance Report in Honduras highlighted the poor quality of external audits as one of the main areas of low PFM performance. In addition, oversight of public institutions is considered weak overall, and improved effectiveness and transparency of public spending is needed. In fact, one of the main challenges facing the government has been controlling the high levels of public debt (much of which backed by the Honduran government) and budget deficits in SOEs, particularly the public utilities,⁷ Honduras is eligible for the Highly Indebted Poor Country (HIPC) initiative, and has already obtained significant debt relief. To sustain the benefits of this relief, the country needs to impose financial discipline over the SOEs, especially the telecom and electric utilities.

another very large regional banking group, which was recently acquired by Citigroup, is also present in Honduras. In addition, BAMER and CREDOMATIC were taken over by GE CAPITAL.

⁵ The Honduran Government operates a state-run defined benefit system covering about 500,000 workers and dependents. Civil servants and military personnel have their own retirement funds; these invest primarily in treasury bonds and Central Bank notes. Additionally, the subsidiary of a large bank offers large local companies contracts for retirement pension coverage.

⁶ Source WB Honduras PFM Performance Report, February 2006.

⁷ The two largest SOEs are *Empresa Nacional de Energía Eléctrica* (ENEE), the national electric utility with a monopoly on distribution and Hondutel, the main telecommunications company which faces competition from private providers in the mobile phone and internet markets. Another significant SOE is the water and sewage utility (SANAA).

6. **Honduras is a signatory of the Dominican Republic – Central American Free Trade Agreement (DR-CAFTA), and is also seeking an FTA with the European Union (EU).** The DR-CAFTA treaty, which became effective in April 2006, includes the US, the Dominican Republic and the five Central American countries (Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua). In addition, discussions have begun with the European Union about a possible free trade agreement for the Central American area. These free trade agreements have the potential to jump start significant growth in the Honduran economy generally, and in the Honduran private sector in particular. They could lead to significant opportunities to attract foreign investment, develop export industries and create jobs; however, for their full benefits to be realized, Honduran companies and their banks need to make the internal adjustments to bring their operations up to acceptable international standards (Para. 8).

7. **Improving financial reporting and auditing practices and effectively aligning them with international standards will support the Honduran Government's strategic objectives, through:**

- ***Promoting an enhanced business climate*** – A business climate that fosters investor confidence and thus can attract foreign and domestic investment requires a high level of financial transparency on the part of private or state-owned companies operating in the domestic markets, and the observance by these companies of sound practices of accountability and governance. These requirements depend on a financial reporting regime that provides investors, creditors and other third parties with timely and accurate information for their investment and other business decisions.
- ***Enhancing management and governance within SOEs*** – Improving the financial reporting regime applicable to SOEs will provide a better and more complete understanding of their financial situation and enable better control over their operations. As a result, improved financial information about SOEs would support more effective management, enhance SOE accountability and contribute to safeguarding significant assets that belong to the citizens of the country.
- ***Reducing risks in the financial sector*** – The banking sector's ability to assess credit risks properly depends largely on the accuracy and reliability of corporate financial reporting. Improving the quality of the financial information provided by enterprises therefore contributes to mitigating the risks for banks and other lenders. In the current circumstances, better and more timely financial information from borrowers can ease liquidity constraints in the banking system.
- ***Increasing transparency in the economy*** – One of Honduras's priorities includes improving the overall image of the country with regards to transparency and the fight against corruption.
- ***Improved compliance with laws and regulations and better corporate tax collections*** – Even though unveiling fraud per se is not the main purpose of external audits of company financial statements, properly conducted audits do contribute to stricter compliance with domestic laws and help prevent the

concealment of illegal transactions. However, in order to do so, and an important aspect of the needed discipline is to ensure that they generate timely and reliable financial information.

8. **For Honduras to reap the benefits of DR-CAFTA and similar free trade agreements, its enterprises will have to adopt and apply internationally-recognized rules and practices for business activities, especially standards relating to accounting and financial information that are considered to be part of a normal business relationship.** Moreover, to attract a sustained flow of foreign investors from those countries, Honduras should keep up its efforts to curb corruption and strengthen the rule of law, as these are considered key elements of a favorable investment climate. Governance reforms needed to attract foreign investment should include a more transparent reporting regime for companies, overseen by external auditors with internationally acceptable levels of competence and independence. One of the priorities highlighted in the new CAS for Honduras is to maximize the opportunities offered by the agreement. For many of the sectors mentioned in the CAS as offering greater potential investment returns (including energy, financial services, telecommunications, and transportation), substantial inflows of capital will be needed to make Honduran companies ready to compete internationally.

9. **In this context, the ROSC Accounting & Auditing supports Honduras's strategic objectives by assessing the current state of financial reporting and auditing by the corporate sector and proposing concrete recommendations to improve the current framework, given Honduras's specific circumstances and constraints.** It is important to note that the purpose of the ROSC is not to propose a long list of recommendations that would raise Honduras to the “gold standard” of financial reporting and auditing. Rather, the aims are (a) to set forth a series of necessary reforms that would set Honduras on the right path to complying with international standards in the medium to long term; and (b) to highlight the short-term reforms that can be achieved along the way, thus maintaining momentum and allowing for quick wins. Specifically, the ROSC recommendations are aimed to:

- ***Making the business environment in Honduras more conducive to private investment.*** Timely and reliable corporate financial reporting is necessary to allow companies' access to credit from banks and other pools of savings. Moreover, it can help improve the flow of FDI to the country by fostering investors' confidence in the ability of local companies to allocate resources effectively. Enhanced access to credit and higher flows of FDI will in turn support the country's objective to boost the level of private investment, especially in industries with higher added-value.
- ***Promoting the governance agenda in Honduras, especially for SOEs.*** A larger cadre of adequately prepared accountants and auditors will contribute substantially to strengthening public sector accountability and transparency by adding weight to the control environment. This will lead to improved operating efficiency among these SOEs, and derivative governance improvements for the private corporate sector.

- **Ensuring the sustainability of the reform agenda through building the capacity of accountants and auditors.** One of the main objectives of this ROSC will be to help develop a cadre of properly skilled and trained accountants and auditors, through (i) enhanced institutional capacity of the accounting associations, (ii) improved quality of accounting education and (iii) a strengthened regulatory framework governing the accounting and audit practices in Honduras.
- **Supporting donor-funded assistance.** Since virtually all external assistance projects in Honduras are audited by private firms, the quality of the work performed by these auditors is directly relevant to the ongoing efforts to improve financial management practices in relation to donor-funded projects.

10. Moreover, by providing inputs for improving financial transparency in the domestic corporate sector and strengthening accounting and audit practices, the ROSC A&A will contribute to the country's economic integration agenda. In addition, the recent experience of the ROSC A&A in El Salvador and in Guatemala should help foster inter-country dialogue on issues of corporate financial transparency, so that the three countries can share their experience and work together toward a common model of regulation in the accounting field.

II. INSTITUTIONAL FRAMEWORK FOR CORPORATE FINANCIAL REPORTING AND AUDITING

A. Statutory Framework

11. The Commercial Code sets forth the legal forms private companies may take and their respective financial reporting requirements. The most common and economically significant legal forms appear to be the corporation (*sociedad anónima*, or SA)⁸ and the limited liability company (*sociedad de responsabilidad limitada*, or SRL).⁹ The Commercial Code requires companies to keep accounting records, and sets forth some requirements relating to financial statement approval by management (Para. 14). Other accounting-related requirements previously set in the Commercial Code have been revoked and substituted by the Accounting and Auditing (A&A) Law of 2004 (Para. 12). The application of corporate financial reporting and auditing requirements to different enterprises is summarized in Table 1.¹⁰

⁸ SAs are required to have a minimum of two shareholders and minimum capital of HNL 25,000 (US\$1,325). Source: Commercial Code (Decree 73/1950, as amended by the Administrative Simplification Law—Legislative Decree 255/2002), Art. 92.

⁹ SRLs are required to have a maximum of 25 partners and minimum capital of HNL 5,000 (US\$265). Source: Commercial Code, Art. 69 and 70.

¹⁰ Table 1 summarizes the salient points of Paras. 12 to 32.

Table 1 – Overview of Financial Reporting and Auditing Requirements in Honduras

| | Law and Regulator | Accounting Standards | Audit Requirement | Publication and Other |
|--|---|---|---|--|
| Banks, insurance companies and other regulated financial entitiesⁱ | (a) Banking and insurance laws and (b) Commercial Code and A&A Law. Supervised by CNBS. | CNBS rules. After 2008: IFRS also required insofar as consistent with CNBS rules. | - External auditor must be registered with CNBS (Levels A to C). - ISA required. | <ul style="list-style-type: none"> • Annual and quarterly FS must be published in 2 major newspapers. Monthly balance sheet and income statement are posted on CNBS website. • Audit partner rotation every 5 years. |
| Large corporate borrowersⁱⁱ | Commercial Code and A&A Law | Until Dec. 2007: HN GAAP From 2008 on: IFRS | Banks must obtain FS audited by auditor CNBS-registered (minimum Level D) | <ul style="list-style-type: none"> • No publication or public filing required. • SAs must appoint a <i>comisario</i>. |
| Other non-financial companies | | | Only if company applies with ONCAE for State procurement | |
| State-owned enterprises | Relevant Organic Laws <i>Contaduría</i> and TSC | <i>Contaduría</i> Rules IFRS (?) | Subject to audits by TSC | No publication required |

ⁱ Any listed non-financial companies would have to follow similar requirements to financial entities; however, no company is currently listed in the local exchange.

ⁱⁱ Companies with bank borrowings of HNL 5 million (approx. US\$250,000) or more.

A1. Financial Reporting Requirements

12. **Financial reporting by Honduran companies is governed by the A&A Law.¹¹** The enactment of the A&A Law represents an important step towards improving Honduras's financial reporting and auditing practices and, thus, supports Honduras's strategic development objectives. The A&A Law requires the application of IFRS and ISA beginning on January 1, 2008, and establishes a multi-disciplinary standard-setting body, the Accounting and Auditing Standards Technical Board (*Junta Técnica de Normas de Contabilidad y Auditoría*, hereafter referred to as the Technical Board), which is responsible for adopting IFRS and ISA (Paras. 47 to 50 amplifies on the Technical Board). It also provides much-needed legal backing for financial reporting and auditing standards. See Annex 1 for further details.

13. **However, the law also has a number of weaknesses that need to be addressed in order for it to be implemented effectively.** First, the deadline for adopting IFRS is too ambitious given the current level of human and financial resources. Second, the scope of the A&A Law is broad, and its requirements apply to both public and private sector entities, without clarifying what parts of the public sector would be governed by the law

¹¹ *Ley sobre Normas de Contabilidad y de Auditoría*, Decree 189/2004.

(e.g., autonomous agencies, state-owned companies, etc.). In addition, in the private sector, the requirement to use IFRS applies to almost all companies, including most small and medium enterprises (SMEs), with the exception of small retailers.¹² IFRS were not designed for SMEs, which make up the vast majority of companies in Honduras. Rather, IFRS should apply only to *public interest entities*, i.e., companies and other corporate entities which, due to their size or the nature of their business, have public interest characteristics.¹³ In the case of Honduras, these would include banks, insurance companies, other financial institutions, state-owned enterprises, and large private corporations.

14. The A&A Law requires the public and private entities to prepare annual financial statements, consisting of a balance sheet, income statement, statement of changes in equity, cash flow statement, and notes. In the case of SA, shareholders must approve the annual financial statements at the annual general meeting, which must be held within four months of the year-end.¹⁴ For SRL, management is required to present the balance sheet and income statement of the company to shareholders, on an annual basis at least.¹⁵ In cases where the requirements of the A&A Law conflict with tax rules or regulatory requirements (i.e., in the case of financial institutions), the latter take precedence over the requirements of the A&A Law. In addition, companies that wish to apply IFRS prior to 2008 are allowed to do so under the law. Annex 1 presents a detailed overview of the A&A Law's requirements.

15. Until the IFRS requirement under the A&A Law comes into force, non-regulated companies are required to follow the 15 Honduran Generally Accepted Accounting Principles (GAAP), which have been in force since 1996,¹⁶ for the preparation of their financial statements. Honduran GAAP require companies to prepare financial statements consisting of a balance sheet, income statement, statement of retained earnings, cash flow statement and notes.¹⁷ Honduran GAAP, which are loosely based on USGAAP, represented a commendable effort to standardize financial reporting in Honduras; however, many types of transactions and other important aspects of financial reporting are not addressed in these standards, largely because accounting for

¹² The one exemption given in Art. 17 covers retailers with annual revenues of less than HNL 6,000 (approximately US\$300).

¹³ Public interest entities (PIE) are usually defined as companies that: (i) receive funds from the public in a fiduciary capacity (i.e. banks, savings and loan institutions, investment funds, pension funds, and insurance companies); (ii) provide essential public services and are subject to public procurement; (iii) are active in strategic sectors in the economy, such as defense and those who operate as monopolies; (iv) are owned by the state (i.e. SOEs); (v) have issued or have taken legal steps to issue securities on an exchange, or have a large number of shareholders representing a substantial ownership interest or (vi) are economically significant to the country as a whole which can be measured through a combination of indicators such as revenues, number of employees and amount of assets. The notion of PIE is reflected in the European Union legislation and has been recognized by the IASB.

¹⁴ Commercial Code, Art. 168.

¹⁵ Commercial Code, Art. 52 and 89.

¹⁶ “*Primeros 15 Principios de Contabilidad Generalmente Aceptados en Honduras*” promulgated by Decree no. 160/1995 and published in the Official Diary “*La Gaceta*” dated March 16, 1996.

¹⁷ Set forth in Pronouncement no. 8.

such transactions was considered too complex¹⁸ (see paragraphs 60 to 61 for a detailed analysis of Honduran GAAP).

16. **State-owned enterprises (SOEs) are governed by specific statutes and thus follow financial reporting requirements that are not consistent with good international practice.** SOEs are required to follow the accounting rules set by the General Accounting Office (*Contaduría General de la República*), based on a compulsory accounting system (*plan de cuentas*) designed to facilitate the integration of SOEs' accounts within the public sector consolidated accounts. It is not clear whether SOEs are subject to the requirements of the A&A Law, and would thus be required to follow IFRS as of 2008.

17. **Banks, insurance companies and other financial institutions must follow, primarily, the accounting requirements set forth by the National Banking and Insurance Commission (*Comisión Nacional de Bancos y Seguros*, or CNBS).**¹⁹ The CNBS requires that financial institutions follow a set accounting system, mandates the calendar year as the reporting period, and stipulates the accounting rules that must be followed in the recognition and measurement of transactions. In addition to the CNBS accounting rules, financial institutions must abide by the A&A Law. Furthermore, since financial institutions must be incorporated as SA,²⁰ they are obliged to follow the corresponding requirements under the Commercial Code. In cases where CNBS rules conflict with other legislation, CNBS rules take precedence.

18. **Banks, insurance companies and other financial institutions are required to submit financial statements monthly, quarterly, and annually to the CNBS.** Subsidiaries of foreign financial institutions (including banks and insurance companies) are required to present, on at least an annual basis, the audited, consolidated financial statements of the parent company to the CNBS.²¹ However, the responsibility for submitting the audited annual financial statements to the CNBS rests with the external auditor, and not the financial institution itself.²² This runs counter to international practice and shows a lack of clarity regarding the role of the external auditor in Honduras.

¹⁸ Important issues addressed international accounting standard (IAS) through specific pronouncements at the time and not covered in the First 15 Honduran GAAP include: construction contracts, leases, employee benefits, deferred income taxes, and consolidation. This issue and its implications are further discussed in Para. 60.

¹⁹ The following types of institutions are considered to be under the purview of the CNBS: public and private banks, insurance companies, reinsurance companies, savings and loan associations, bonded warehouses, stock exchanges, brokerage firms, foreign exchange operators, pension funds and social insurance institutions, public and private managers of pension and retirement funds, and other financial institutions. (Decree 155/1995, Art. 6).

²⁰ Set forth in Decree 170/1995, Art. 5.

²¹ Decree 155/1995, Art. 32.

²² Resolution 684/2004, Art. 8.D.

A2. Statutory Audit Requirements

19. **As compared to most other members of DR-CAFTA member countries, Honduras has some of the least stringent statutory audit requirements,²³ which can jeopardize the credibility of Honduran companies vis-à-vis their regional counterparts (and competitors).** Potential investors, lenders and business partners need be able to have confidence in the opinion of the external auditors of Honduran companies in order for the country to fully realize its development goals, particularly those of enhancing the business climate and attracting investment.

20. **Private companies other than those regulated by the CNBS generally do not face a legal external audit obligation.** CNBS requires an external audit of the financial statements of all institutions under its purview. Despite the strong, traditional influence of the Continental European model—which includes an independent audit requirement for all corporations—on its commercial law, Honduras (and several other Latin American countries) has diverged from the Continental European practice with regard to this matter. Currently, the Commercial Code does not mandate independent audits of annual financial statements and only requires SAs to appoint a *comisario* with broad oversight responsibilities, accounting and otherwise, but whose role cannot be equated with that of an external auditor (Para. 29).

21. **SOEs' financial statements are required to be audited by the Supreme Court of Accounts (*Tribunal Superior de Cuentas* or TSC), Honduras's supreme audit institution, which is responsible for the external audit of all public sector accounts.** In addition, SOEs that have borrowed from international financial institutions are generally required by them to submit a set of financial statements audited by an audit firm belonging to or affiliated with one of the large international audit firms. The Guidelines on Corporate Governance in State-Owned Enterprises recently published by the Organization for Economic Cooperation and Development (OECD) recommend that SOEs “be subject to the same high quality accounting and auditing standards as listed companies,” and that they be audited by an independent external auditor.

22. **Banking regulations encourage financial institutions to obtain audited financial statements from their largest corporate borrowers, i.e., clients who wish to take out loans in an amount greater than HNL 5 million (approx. US\$250,000).** This is not a “hard” requirement, and if a bank wishes to extend credit to a large corporate borrower even without obtaining audited financial statement, it is allowed to do so. However, in such cases, the CNBS requires that the banks make the necessary loan loss provisions, which automatically increases these banks' capital requirements. Considering that external audits are not legally required and because financial statements present the essential information for banks to manage credit risk, the CNBS requirement appears

²³ For instance, in El Salvador and the Dominican Republic, all SAs and SRLs are required to have an external audit whereas in Guatemala the same situation prevails as in Honduras.

adequate. The number of companies that are currently affected by this provision is not known.²⁴

23. **The A&A Law requires audits to be conducted in accordance with International Standards on Auditing (ISA) as of January 2008.** This provision has little practical implication since the CNBS already mandates ISA for all regulated entities and, as previously noted, no other entity is subject to a statutory audit requirement.

24. **In addition to ISA, external auditors must follow any other specific auditing instructions issued by CNBS in relation to the statutory audits of regulated entities.** In particular, audits must include a number of specific verifications including evaluations of internal control systems, assessments of computer information systems, and audit plans to be submitted to CNBS for approval. Some of the CNBS's instructions go against sound international practice. For example, auditors are required to reveal the disparities between CNBS accounting rules and IFRS in the notes to the financial statements,²⁵ which denotes a misunderstanding regarding the role of management of the company (i.e., to prepare financial statements, including notes), and that of the auditor (i.e., to provide independent verification of the financial statements). The involvement of external auditors in the preparation of financial statements hinders their ability to provide an independent opinion on them, which goes against the very purpose of an external audit.

25. **There are no Honduran auditing standards for non-statutory audits conducted in the private sector.** Neither of the professional bodies,²⁶ nor the government has issued any auditing standards that would apply to non-statutory audits in the private sector. In practice, auditors conducting non-statutory audits have said that they use the Mexican Institute of Public Accountants' translation of the 2005 version of ISA.

26. **Statutory audits must be conducted by auditors or audit firms registered with the CNBS.** The CNBS does not specify the appointment process for external auditors; thus, it is likely that management, not shareholders, appoint auditors. The CNBS does require, however, that the board of directors approve the hiring of auditors. In addition, the CNBS has established an auditor registration system due to the absence of proper qualification mechanisms for professional accountants (Paras. 34-35). In order to register, audit firms must submit information about the firm, its partners and staff, and its clients to the CNBS. The CNBS uses a four-tier classification system for its auditor registry, and classifies firms into one of the four categories. Firms are authorized to audit those institutions listed within its category or lower (i.e., a Category C audit firm may audit all companies in its category as well as in Category D). The classification system is as follows.

A: Banks and insurance companies;

²⁴ According to CNBS, the 15 banks currently operating in Honduras have collectively extended nearly 1,900 loans in excess of HNL 5 million.

²⁵ Resolution 684/2004, Art. 14.A.

²⁶ See Para. 33 for more information on the accountancy bodies active in Honduras.

- B:** Private pension funds, rating agencies, leasing companies, non-banking financial institutions; this category would also include listed companies when there are some;
- C:** Insurance brokers, bonded warehouses, foreign exchange operators, stock brokerage firms, microfinance institutions; and
- D:** Large corporate borrowers.

27. **In order to register with the CNBS, an audit firm must submit a written application with detailed information about the firm, its staff and its clients.** The registration must be renewed on an annual basis. The CNBS relies on a sworn statement that the information presented is accurate; it does not conduct due diligence (e.g., visits to the audit firms to review working papers, interview staff, etc.) to ensure the validity of the application. However, the CNBS recognizes the potential problems with this and has expressed its intent to begin checking of the information that is presented to them.²⁷

28. **The CNBS sets forth a number of other requirements pertaining to the statutory audits of the institutions under its purview, which are consistent with good international practice.** The most significant of these requirements include:²⁸

- The institutions must have their periodic financial statements audited upon request by the CNBS. Additionally, if the CNBS finds irregularities in the audited financial statements of a regulated institution, they may require that it hire another auditor to conduct a second audit of the financial statements (i.e., to obtain a “second opinion”).
- The institutions must notify the CNBS within 5 days of hiring a new auditor; they are also required to explain the reasons for changing auditors.
- Audit firms must rotate the audit engagement partner every five years.

A3. Publication and Other Requirements

29. **The Commercial Code requires shareholders of corporations (SA) to appoint one or more *comisarios*, charged with broad control functions.**²⁹ *Comisarios* are appointed at the shareholders’ annual general meeting for a three-year period. Their role is to supervise the management of the company. They are required to examine the company’s financial information on at least a monthly basis, and must issue an opinion

²⁷ The application for categories A-C must include the following information: (a) firm’s articles of incorporation, ownership structure, social capital, and details on the computer information system; (b) professional affiliations (of the firm and individual auditors); (c) curricula vitae of partners; (d) list of clients; (e) a sworn statement that, among other things, the firm will not conduct audits that could hinder their independence, that the firm is knowledgeable of relevant laws, regulations and ISA, and that there is no legal action being taken against the firm; (f) information on technical, administrative and logistical staff (name, title, academic background, professional experience, and number of years working at the firm); (g) list of clients, including a specific list of all CNBS-regulated companies the firm has audited over the previous three years; (h) description of the firm’s quality control systems and (i) copy of the professional liability insurance policy. For Category D, items (a) to (e) above are required.

²⁸ These requirements are set forth under Resolution 684/2004.

²⁹ Commercial Code, Art. 231-239.

on the company's annual financial statements. In addition, they have the right to attend – but not vote at – all board meetings and shareholders meetings, and may call a meeting of shareholders in cases they deem necessary. Thus, the *comisario* combines some characteristics of an internal auditor, external auditor and audit committee in one individual; however, there is limited coherence to these disparate roles and functions. While *comisarios* are personally liable for failures to fulfill their duties toward the company, the law does not explicitly give them full access to all company information, which can hinder their ability to carry out their responsibilities. *Comisarios* are a legacy of corporate law in civil law countries, especially in Latin America, and their role is currently being questioned in many countries.³⁰ In the case of Honduras, in practice, *comisarios* do not seem to exercise an effective supervisory function and their role is widely perceived as limited.

30. **The CNBS, recognizing the need for improved governance arrangements in Honduran banks, requires institutions under its purview to form an “audit committee.” However, the composition and responsibilities of these committees may not be conducive to effective oversight of the financial reporting process.** The audit committee must consist of five members, including an owner-director, the general manager and the internal auditor of the company. This precludes it from being independent of the company's management,³¹ which is an essential characteristic of a body charged with governance. Furthermore, the tasks attributed to the audit committee are primarily of ensuring compliance with applicable rules and regulations. Whereas it may provide management with its opinion on whether to maintain or change the external auditor, the audit committee is not responsible for overseeing the work of external auditors, or the company's financial reporting process. In practice, implementing effective audit committees in Honduras currently is a difficult challenge, in view of the small number of individuals who are qualified to perform the function of independent director. However, as the approach to supervision of banking and insurance evolves from compliance-based to risk-based, thereby making financial reporting and auditing more and more important to the supervisor's work, the CNBS may want to consider making gradual adjustments to the role and composition of audit committees, in line with good international governance corporate practices. For example, the CNBS could require at least one independent member and set forth minimum requirements for individuals to serve on audit committees (e.g., education, professional experience, etc.). Finally, overlapping responsibilities between the *comisario* and the audit committee call for a clarification to avoid unnecessary duplicative efforts.

³⁰ In France, where the code of commerce traditionally featured a similar function, the *commissaire aux comptes*, the legislator opted to combine this function with that of independent auditor, which avoided any overlap or redundant functions. A similar situation has occurred in Spain. Chile has eliminated the requirement for an equivalent of the *comisario* for companies that are statutorily required to have an independent auditor.

³¹ Res. 684/2004 requires audit committees to be presided by an owner-director who does not have administrative responsibilities, and to include among its members: one director-owner or alternate director who does not have administrative responsibilities, the executive director or general manager, the *comisario*, and the internal auditor.

31. **Only banks, insurance companies and miscellaneous financial entities are required to disclose their financial statements to the public.**³² Non-regulated companies and state-owned enterprises generally do not have to publish their financial statements. Banks, insurance companies, and other CNBS-regulated financial entities are required to publish their balance sheet, income statement, notes to the financial statements, and the auditor's report in two major newspapers, annually.³³ These are also required to publish their quarterly financial statements in two major newspapers, within 10 days of the quarter's end; and annually, they must publish the names of their managers, *comisarios*, and main staff. Furthermore, the CNBS publishes on its website the non-audited, monthly balance sheets and incomes statements of companies under its purview.

32. **Companies that wish to bid on government contracts are required to submit their audited financial statements to the State Procurement Agency (ONCAE).**³⁴ However the financial statements at ONCAE as well as those of large corporate borrowers are not publicly available. Moreover, as evidenced by the review of a sample of financial statements filed with ONCAE (Para. 67 and Annex 4), these statements and the related audit reports overall do not comply with international standards. Requiring such financial statements to meet international standards would better meet the objectives of the law. Additionally, in order for ONCAE to better fulfill its mandate, it should enhance its human and financial resources so that it is better able to review and analyze financial statements to ensure that bidders for government contracts are solvent and in good financial standing.

B. The Accounting and Audit Profession

33. **In order to provide accounting and/or auditing services, individuals or firms must be affiliated with one of the following two self-regulated accounting professional associations in Honduras:**

- ***Honduran Institute of Accounting Technicians and Public Accountants (Colegio de Peritos Mercantiles y Contadores Públicos de Honduras).*** The *Colegio de Perito Mercantiles* was established in 1966 and has approximately 8,500 active members.³⁵ The title of *perito mercantil* (i.e., accounting technician) is awarded to high school graduates who specialized in accounting at the latter stage of their secondary education curriculum. The *Colegio de Peritos Mercantiles* is a member of IFAC and the Inter-American Accounting Association (AIC). While most accounting technicians tend to provide only bookkeeping or miscellaneous services, they are authorized to perform independent audits of

³² According to the Ministry of Finance, the General Accounting Office makes the financial statements of state-owned companies available to the public through its annual report to Congress.

³³ Art. 32 of Decree 155/1995.

³⁴ Executive Agreement 055/2002 (regulating the State Procurement Law), Art. 33.

³⁵ Source *Colegio de Peritos Mercantiles*. This information is contradictory with the information the *Colegio* has provided to IFAC, which indicates 7,400 members of which 60 are firms. The *Colegio* was established by Decree 74/1966 (Organic Law), as amended by Decree 71/2004.

financial statements, including the statutory audits for large corporate borrowers (Para.21) and bidders for government contracts (Para. 32).

- **Honduran Institute of Accounting Professionals with University Degrees** (*Colegio Hondureño de Profesionales Universitarios en Contaduría Pública* or COHPUCP). The COHPUCP was founded in 1993 and has some 1,200 members. It belongs to AIC but not to IFAC, although it has recently applied for membership to the latter. It is by far the less influential of the two associations. University graduates with a degree in accounting, either from the State University of Honduras or approved foreign universities, may join COHPUCP. Since it was recently created, most COHPUCP members are also members of the *Colegio de Peritos Mercantiles*.

34. **Entry requirements for either of the accounting professional bodies are not only below internationally acceptable practice, but also fall short of regional norms.** The only requirement to apply for membership with either of the two *Colegios* is to have completed the relevant academic education: high school degree for *Colegio de Peritos Mercantiles* and bachelor degree (*licenciatura*) in accounting for COHPUCP. Neither Colegio requires its members to pass a professional examination or to have a minimum number of years of professional experience. As a result, individuals serving as practicing accountants may not have the technical capacity, professional skills or knowledge of ethical issues to perform audits of acceptable quality or properly certify tax returns.

35. **The possibility for a person with no other qualification than a high school degree performing independent audits of financial statements raises serious concern as quality of these audits.** Auditing is relatively complex process, requiring a broad knowledge of financial reporting and auditing standards, thorough understanding of the accounting process, capacity to analyze the activity of a company and the corresponding operational and financial risks, ability to have access to and interact with company executives. The International Education Standards for Professional Accountants (IES) issued by IFAC in October 2003 have codified minimum education requirements for practicing accountants.³⁶

36. **Despite low entry requirements, corporate bookkeeping is a reserved function for members of either of the two professional bodies, which is somewhat at odds with a recent international trend to eliminate any condition for performing this type of activity.** This trend reflects the fact that nowadays bookkeeping functions can be carried out using information technology systems which, particularly in the case of SMEs, are relatively easy to operate. In addition, many countries now consider that independent audits of financial statements and certification of tax returns, but not bookkeeping, are functions with a public interest nature which ought to be reserved to licensed practitioners. In developed countries that still consider bookkeeping to be of such importance that it must be reserved to licensed accountants, entry requirements are

³⁶ The minimum education requirements for practicing accountants should include a university degree, passing a professional examination and a three-year minimum professional experience in auditing.

generally high and specific statutes have been enacted to regulate bookkeeping (e.g. compulsory accounting systems and charts of accounts).

37. **Although no information is compiled by the professional bodies on the market for audit and related services in Honduras, indicators point to an auditing market that is small in size, and limited mostly to the financial sector, a few local corporate groups, and the subsidiaries of foreign groups.** Larger companies and financial institutions tend to be audited by local affiliates of international audit firm networks (the so-called Big-4). Large corporate borrowers, companies that participate in government tenders and SMEs generally use the services of accounting technicians. Maintaining a reputable system for qualifying and registering auditors is resource intensive (as it includes creating arrangements for setting professional standards, continuing professional development, quality assurance, etc.), and requires significant fixed costs. Given its small auditing market, Honduras may not be able to achieve the requisite economies of scale to sustain such a system on its own. For that reason and with a view to harmonizing the regulatory environment within the DR-CAFTA area, the Technical Board and the *Colegios* should seek cooperation agreements with other Central American countries.

38. **Each Colegio has its own Code of Ethics.** The *Colegio de Peritos Mercantiles* applies a Code of Ethics (issued in January 2005) which falls significantly short of IFAC's. The *Colegio de Peritos's* Code sets forth some general requirements and recognizes the public interest role of accountants; however, it is very brief (five pages) and falls short particularly on issues relating to independence, quality assurance, potential conflicts of interest and remuneration.³⁷ In May 2007, COHPUCP adopted the current (2006) version of IFAC's International Code of Ethics for Professional Accountants at its general assembly. However, due to its recent adoption, the ROSC team has been unable to determine to what extent IFAC's code has been effectively implemented by COHPUCP. .

39. **The tax returns of corporate taxpayers are required to have the stamp of a registered accountant.** The stamp, which costs HNL 50 (approx. US\$2.50), must be issued by a registered member of the *Colegio de Peritos Mercantiles*.³⁸ This type of stamp tax constitutes a *de facto* State subsidy to the profession, and is generally regarded as an outdated means of financing. Indeed, it fosters a perception of the profession's role as being part of the local bureaucracy.

40. **One of the main problems the Colegios are faced with is their severe lack of resources.** Regarding the *peritos mercantiles*, annual dues to the *Colegio* amount to HNL 600,³⁹ equivalent to US\$30. Including the stamp tax, which represents about 20% of revenues, the *Colegio's* budget is US\$300,000 per year, of which a significant portion is to absorb the premium for unemployment insurance for the members. With only 1,200

³⁷ In its strategic plan, the *Colegio de Peritos Mercantiles* intends to enhance its code of ethics and align it with IFAC's (2006).

³⁸ Decree 71/2004 (Organic Law of the *Colegio de Peritos Mercantiles*), Art. 46.

³⁹ Source: IFAC.

members, it is reasonable to infer that the COHPUCP budget is at least as limited as that of the *Colegio*. With limited budgets, the *Colegios* cannot develop the necessary research and capacity-building activities, and maintain an infrastructure of adequate quality. For instance, their facilities are in poor condition and neither of them have a library.

C. Professional Education and Training

41. **In Honduras, most practitioners in the accounting profession have only the requisite high school education.** High school in Honduras requires four to six years of study, depending on the area of specialization. During the first three years of high school, students complete their general studies requirements, and at the end of their third year, students elect a specialization (among them, accounting, which requires three additional years of study). All high school teachers – including accounting teachers – must obtain a university degree from the National Pedagogical University (*Universidad Pedagógica Nacional*, or UPN).

42. **Only one university in Honduras offers a degree in accounting, the National Autonomous University of Honduras (*Universidad Nacional Autónoma de Honduras* – UNAH).** UNAH is a public university (i.e., it does not charge tuition), which has had an accounting program since 1967. There is no entrance examination for the university; thus any high school graduate interested in studying there is able to enter any of their academic programs. Since accounting is a popular major several thousands of students enter the accounting program each year, but only several hundred graduate. Thus, the university expends a great deal of resources to educate a large number of students who never receive an accounting degree. As a result, the Economics Faculty (of which the Accounting Department is a part) has recently begun to require an aptitude test for would-be students, which would help them choose a major that is best suited to their needs and abilities, in an effort to reduce drop-out rates.

43. **UNAH has been making a commendable effort in educating accountants in Honduras. Although it lacks the necessary resources, it is updating its curriculum in order to align it with IFAC’s International Education Standards.** While some accounting subjects, including general accounting and tax, are covered in the curriculum, there is a need to include ethics and more advanced accounting courses, particularly courses on IFRS and ISA.

44. **An ongoing technical assistance project, funded mainly by the Multilateral Investment Fund (MIF), includes a component aimed at strengthening accounting education and training in Honduras.**⁴⁰ Component II of the “Adoption of International Accounting Standards in Honduras” project, which was initiated in 2005 and is due to be completed in late 2007, includes the following activities:

- A train-the-trainers program consisting of a series of training sessions for 80 instructors from academia (UNAH and UPN), the public sector, and accounting and audit profession;

⁴⁰ This is a technical cooperation project for which the MIF has provided US\$490,000 in grant funding.

- Courses on IFRS and ISA given to 500 persons in several Honduran cities;
- Workshops to provide accountants with application guidelines and specific case studies relating to implementation of the IFRS and the ISA, which will train 450 persons;
- The implementation of a continuing education system for professional accountants;
- Implementation of an IFRS and ISA certificate program at the UNAH, for an estimated 450 accountants; and
- The review of the accounting curricula at the UNAH and UPN. The project does not cover the high school accounting curriculum.

45. **There is no continuing education requirement for professional accountants registered with either of the two *Colegios*.** Both *Colegios* offer continuing professional education courses – most of them free of charge – which their members may attend on a voluntary basis. In fairness, although continuing education is an important function of a professional accounting association, the two *Colegios* have neither the human nor the financial resources to fulfill that obligation.

D. Setting Accounting and Auditing Standards: Recent History and Current Institutional Arrangements

46. **Honduras does not have a strong legacy of standard-setting in the field of financial reporting and auditing.** Historically, generally accepted accounting principles (GAAP) in Honduras were based on US pronouncements as commonly practiced by the local representatives of international audit firms. A first attempt to codify Honduran GAAP was made in October 1995 with the *Colegio de Peritos Mercantiles*' (Para. 15) adoption of the so-called "15 Generally Accepted Accounting Principles in Honduras." However a period of transition of at least two years would have been necessary as it would have allowed companies and practitioners to prepare themselves for the implementation of the new standards. While formally adopted by the *Colegio de Peritos Mercantiles*, the 15 standards were in fact developed by a group of professionals mainly from the larger local audit firms, who contributed their time *pro bono*. The *Colegio de Peritos Mercantiles* did not have a properly resources standard-setting committee at the time, for either accounting or auditing.

47. **The introduction of a legally-backed standard-setting body for both accounting and auditing, the Technical Board, was a significant step in the right direction.** The Accounting and Auditing Law of 2004 establishes a Technical Accounting and Auditing Standards Board (*Junta Técnica de Normas de Contabilidad y Auditoría* or Technical Board) responsible for adopting IFRS and ISA, ensuring compliance with the standards, and defining the implementation and application of the standards. The main benefit of creating an ad hoc institution is that it facilitates a collaborative approach to adopting, disseminating and implementing standards among the various stakeholder groups (Para. 49 describes the Technical Board's composition). In

particular, it can also reach out to the business community, which has an important stake, but generally does not currently consider corporate financial reporting as a priority.⁴¹

48. **A number of shortcomings in the A&A Law may hinder the Technical Board's ability to carry out its mission in an effective and sustainable manner.** The Technical Board has no consistent source of funding and no permanent staff or offices, which will hinder its ability to carry out its mandate. In addition, some of the Technical Board's responsibilities and the process by which IFRS and ISA are adopted need to be elucidated, particularly in light of existing human and financial resource constraints. A number of issues need to be clarified, including: (a) the rules for amending standards in the IFRS and ISA adoption process; (b) the Technical Board's enforcement role; (c) how the Technical Board will issue implementation guidance for IFRS and ISA in a sustainable manner. See further details in Annex 1.

49. **Although most of the sectors within the Honduran society which have a stake in corporate financial reporting are represented at the Technical Board, the requirement for all members to be accountants or accounting technicians deprives the Board of necessary diversity in its membership.** Per Article 4 of the Accounting Law the following seven institutions or groups are entitled to designate a representative at the Technical Board: Ministry of Finance; CNBS; COHEP; COHPUC; *Colegio de Peritos Mercantiles*; UNAH; and "Audit Firms registered with the *Colegio de Peritos Mercantiles* or the COHPUC". Board members are designated for periods of five years, renewable once. They are not entitled to compensation for their work. Article 7 requires all Board members to have a bachelor degree (*licenciatura*) in accounting or a high school accounting technician degree (*perito mercantil*). Restricting membership to accountants is not the usual practice at international level. For instance, some of the members of the International Accounting Standards Board (IASB, the standard-setter for IFRS) are not accountants by education. Indeed a diverse membership is an essential feature of a standard-setting body, as it ensures balance between the perspectives of preparers (i.e. financial executives), users (e.g. financial analysts, investment or commercial bankers), auditors and regulators. It also allows the standard-setter to reach out beyond the accountants' community and contribute to raising awareness of the importance of financial accountability within the local business community.

50. **During the first two years of since it was established, the Technical Board has struggled to define its strategy for adopting and implementing IFRS in Honduras.** Since it was established, the Technical Board has issued two documents: (a) a pronouncement establishing some transition arrangements until IFRS is adopted by the Technical Board (January 1, 2008) and (b) a draft Resolution no. 001/2006 introducing a set of Norms for the Preparation of Financial Statements, also known as Honduran Accounting Standards (*Normas Hondureñas de Contabilidad* or NOHC).⁴² The objective of the NOHC was to provide a "bridge" toward the full adoption of IFRS. A brief

⁴¹ This does not mean that COHEP, which represents the private sector within the Technical Board, does not play an active role in the current process of adopting international standards.

⁴² These documents were issued as drafts and never published or made official. Copies were kindly provided to the ROSC Team by the Central Bank of Honduras.

comparison of these norms with IFRS is provided in Para. 62. As of the date completion of the report, the future of these NOHC and whether they would be come into force was uncertain. According to information obtained by the ROSC Team, some members of the Technical Board were leaning toward a direct adoption of IFRS.

51. **The General Accounting Office (*Contaduría General de la República*) sets the financial reporting standards for the entire public sector, including state-owned enterprises.** As stated previously, it is not clear if SOEs will continue to follow *Contaduría's* rules or IFRS after 2008.

52. **In the banking and insurance sector, accounting and auditing standard-setting is handled by CNBS.** The CNBS Law of 1995, Art. 14, empowers it with “establishing the criteria to be followed for the valuation of assets and liabilities (...) by supervised institutions” and “dictating general norms for the presentation of accounts and for supervised institutions to provide the public with sufficient, truthful and timely information on their legal, economic and financial condition”. CNBS circulates drafts regulations within the banking or insurance community for comments, which it may or may not consider when finalizing these regulations. It does not normally provide a “basis for conclusion” for the standard. This process which is fairly standard among banking and/or insurance supervisors, is inherently much less open than the one a typical standard-setter for general-purpose financial reporting would follow, mainly because the law gives the supervisor a wide margin of discretion for carrying out its mission, including for issuing accounting regulations. The consequence is that such accounting rules can either be biased toward conservative treatment or, on the contrary, might provide for a more flexible treatment than GAAP would allow, especially in the context of what is usually referred to in the banking supervisors’ community as “regulatory forbearance”.

E. Ensuring Compliance with Accounting and Auditing Standards

53. **The CNBS enforces financial reporting requirements applicable to banks, insurance companies, and other financial institutions.** The CNBS has separate supervision departments for insurance companies and pension funds, and for banks and other financial institutions. The CNBS is also responsible for enforcing financial reporting requirements for listed companies; however, since there are no listed companies in Honduras, this report will not address enforcement issues for listed companies.

54. **The supervision departments responsible for the financial sector (i.e., banks and insurance companies) enforce financial reporting standards using a two-tier supervision system.** Each supervision department is sub-divided into an on-site and an off-site unit. The off-site supervision unit collects and analyzes the information that institutions are required to send on a monthly basis via an online system. Based on this information, the on-site supervision unit is able to identify specific areas that need to be investigated further when they conduct their annual inspection. All financial institutions are inspected at least once a year. Since there are few financial institutions in Honduras,

and the on-site supervision departments are well staffed, the CNBS is able to carry out an effective monitoring and supervision function.

55. **The CNBS has the power to impose administrative sanctions on the financial institutions under its purview. It can also remove external auditors from the CNBS registry.** The CNBS may apply a series of sanctions, including warnings, fines and suspensions to financial institutions (management, directors, *comisarios*) and external auditors⁴³ for late submission of financial statements, submitting false or erroneous financial statements, failing to publish financial statements on time and failing to comply with internal control requirements. All sanctions are published on their website, on about a monthly basis.⁴⁴

56. **The mechanisms for enforcing financial reporting requirements for companies not subject to CNBS supervision are very weak.** While the procurement office (ONCAE) requires companies to submit their audited financial statements to participate in government tenders, the office does not verify their contents. As a result, companies sometimes submit documents that are not financial statements (see Annex 4). While the ONCAE requirement is a positive one in theory, since it could play a role in safeguarding the government procurement process, in practice, it is only a pro forma requirement. The TSC, which is responsible for auditing the financial statements of state-owned enterprises, does not have the resources to conduct annual audits; instead, it conducts selective audits of SOEs every few years.

57. **The A&A Law states that the Technical Board is responsible for ensuring compliance with the Law.**⁴⁵ This is a significant responsibility, and under the current structure of the Board – consisting only of seven *ad-honorem* members and with no sustained source of funding – there are neither the financial nor the human resources to carry out this duty in an effective manner.

58. **Neither *Colegio* enforces auditing or ethical standards within the profession.** Both Colegios have a body responsible for disciplinary issues (*Tribunal de Honor*), including receiving complaints and accusations made against its members, and mediating disputes. The disciplinary bodies do not have sanctioning powers on their own; however, they can recommend that the Boards of Directors of the respective *Colegios* apply sanctions on their behalf. The sanctions are not made public. In practice, these bodies have not been effective in ensuring compliance with auditing or ethical standards.

59. **There are also no requirements for audit practice quality reviews to ensure that auditors are working to required standards of quality, as is required under IFAC's Statements of Membership Obligations (SMOs).** The MIF technical assistance project (Para. 44) includes a component that would address this, through the

⁴³ Art. 86-102 of the Financial System Law (Decree 129/2004).

⁴⁴ The fact that the CNBS has applied number of sanctions on a regular basis (mostly fines, and including a one-year suspension of an audit firm) seems to indicate that CNBS has been in effect carrying out its enforcement role to some extent.

⁴⁵ Art. 3 of the A&A Law.

establishment of a “technical comptroller” responsible for quality control over the profession (the form and specific attributes of these are still to be defined). A separate technical comptroller would be created in each of the accounting professional associations, and their main responsibilities would include monitoring the quality of financial statements of Honduran companies, developing application guidelines for the IFRS and the ISA, and establishing disciplinary procedures. However, it is not clear how these comptrollers will be funded after the MIF project ends, in late 2007.

III. ACCOUNTING STANDARDS AS DESIGNED AND AS PRACTICED

A. Standards as Designed

60. **The “First 15 Accounting Principles” which currently represent GAAP in Honduras require a standardized format for financial statements, which can be used by a wide variety of companies; however, they are significantly less demanding than IFRS.** While Honduran GAAP may represent a suitable reporting framework for Honduras’s smallest companies, they are not comprehensive enough for larger companies or companies that deal with certain types of transactions. As compared with IFRS, Honduran GAAP fall short in several respects. First, they do not require several types of transactions, assets or liabilities which are potentially very significant to be recognized.⁴⁶ In addition, they are largely based on the historical cost model, under which companies are required to value their assets and liabilities based on past transactions, whereas IFRS fundamentally geared toward the fair value model, which is based on a forward looking approach and uses market values rather than past transaction values. This difference affects a wide range of categories of asset including investments, property, plant and equipment, and biological assets. Finally, Honduran GAAP require a much lower level of disclosure than IFRS in the notes to the financial statements. A summary of differences between Honduran GAAP and IFRS is provided in Annex 2.

61. **The implications of these differences are basically twofold:**

- ***Financial statements prepared under Honduran GAAP tend to be of far lesser quality than those of companies with similar characteristics that observe IFRS.*** Honduran GAAP allow management more discretion on how to report on financial performance, and may yield potentially misleading financial statements that overstate a firm’s value. For instance, not recognizing a liability relating to leases, deferred taxes or employee benefits may mean that total company indebtedness, which is one of the most important indicators for financial statement users, may be understated.
- ***Transition to IFRS will represent a very significant leap and will require not only retraining the overwhelming majority of accountants in public practice or***

⁴⁶ Areas where Honduran GAAP are prone to provide substantially incomplete information or to lead significant differences in valuation compared to IFRS include business combinations, consolidation, construction contracts, employee benefits, financial instruments, impairment of assets, income taxes, inventories and leases.

in business, but also that company executives become aware of their role in the financial reporting process. Because IFRS make wide use of fair value and rely to a large extent on economic assumptions regarding the state of affairs and future of the reporting entity, inputs from management are crucial to the financial reporting process in an IFRS environment.

62. **The draft “NOHC” developed in 2006, while bringing some improvements to existing Honduran GAAP, would not significantly bridge the existing gap with IFRS.** The most serious shortcomings of the draft “NOHC” are that they (a) depart fundamentally from the fair value model, which is the main thrust of IFRS; (b) leave out most of the “difficult” accounting treatments including deferred taxes, impairment leases, and recognition and measurement of financial instruments; (c) follow a rules-based and “formulaic” approach, offering several methods which, although simple, are unlikely to be adequate under certain circumstances; and (d) lack the required precision and clarity. Accordingly, the Technical Board’s decision not to adopt these standards seems wise, as the effort and cost of moving to an interim set of standards would be significant, but would represent only a marginal improvement. However, rather than discarding the idea of a “bridge” altogether, the Technical Board may wish to consider adopting IFRS for SMEs⁴⁷ instead of the comprehensive version of IFRS (“full” IFRS). The SME standards are a simplified version of full IFRS; they would be a suitable reporting framework for larger Honduran businesses and SOEs, and could serve as an adequate stepping stone to full IFRS for Honduras’s public interest entities.

63. **The financial reporting standards that SOEs are required to follow are those broadly applicable to the public sector, which fall significantly short of IFRS.** Although the *Contaduría* has issued standardized accounting forms along the general lines of the GFS framework, it does not issue rules relating to the valuation and measurement of assets, liabilities, etc. As a result, there are no assurances regarding the completeness, reliability, or consistency of financial statements prepared by SOEs, as they all follow their own internal accounting procedures, which are not necessarily compatible with the 15 Honduran GAAP, nor are they always comparable across SOEs. SOEs should be treated as entities wholly separate from the government department to which they belong, and as such, they should follow the accounting rules applicable to private companies, i.e. IFRS for SMEs (of “simplified IFRS”) or full IFRS.

64. **The CNBS Accounting Standards are mandatory for both regulatory reporting and general-purpose reporting for banks, insurance companies and other entities supervised by CNBS.** In recent years, the CNBS has made significant efforts to standardize the accounting rules for banks and insurance companies. These efforts came as a response to the financial crisis that followed Hurricane Mitch, in order to avert future crises. As a result, accounting standards for banks and insurance companies are currently designed with a prudential focus, and therefore do not provide an appropriate framework

⁴⁷ The IASB has issued an Exposure Draft for a simplified set of International Financial Reporting Standards for SMEs (IFRS for SMEs), which set forth fewer choices for accounting treatment, eliminate topics that are not generally relevant to SMEs and simplify methods for recognition and measurement.

informing third parties. Financial sector supervision in Honduras is gradually moving away from a post-crisis environment to one that is more risk-based, following a trend observed both in Latin America and on an international level.⁴⁸ This is evidenced by the fact that the CNBS has taken some steps to adapt its accounting norms for greater alignment with IFRS. Currently, however, banks and insurance companies publish financial statements that are of significant lesser quality than if they observed IFRS, particularly with regard to level of disclosure, and their key financial indicators would be significantly different if the financial statements were prepared in accordance with IFRS.

65. For the banking sector, there are several areas where differences between the CNBS Accounting Standards and IFRS significantly impact the financial picture presented by a bank's accounts. The most significant differences involve loan loss provisioning, the valuation of investments, the capitalization of certain costs, property received as collateral, assets held for sale, commissions on new loans, deferred tax, and disclosures (see Annex 3 for further details).

66. Accounting standards for the insurance sector also differ with IFRS on a number of significant aspects and need strengthening. A number of the differences with IFRS are similar to those identified for the banking sector (e.g., valuation of investments or property, absence of deferred tax, lower level of disclosure in the notes to the financial statements). CNBS regulations also require insurance companies to include in the notes to the financial statements a summary of the main differences with IFRS. In 2004, the IASB issued IFRS 4, *Insurance Contracts* as a transition standard completing Phase I on its Insurance Contracts project. IFRS does not modify fundamentally the way value insurance contract-related assets and liabilities except insofar as it (a) requires a liability adequacy test (i.e., that insurance provisions are supported by the company's own estimates) and (b) prohibits equalization and catastrophic provisions. Currently, CNBS-issued accounting rules present significant differences with IFRS 4. The IASB is in the process of developing a new standard as part of Phase II of insurance contract project, in which the International Association of Insurance Supervisors is closely involved. The new standard is not expected to be issued before 2009 and would come in force in 2011. The insurance industry in Honduras has started taking steps to familiarize itself with IFRS, both on existing standards and the substance of the forthcoming new insurance contract standard. This is not only a positive sign and can facilitate the convergence and future adoption of IFRS. A well planned adoption of IFRS by CNBS would contribute to strengthening insurance supervision.

⁴⁸ One of the most significant developments in Latin America has been the Central Bank of Brazil's decision to require that commercial banks apply IFRS effective in 2010.

B. Observed Reporting Practices

67. **The 36 sets of corporate annual financial statements reviewed by the ROSC team were unlikely to meet the needs of potential investors, especially those with international exposure.**⁴⁹ The review found that key measures of a company's financial situation (e.g., equity and indebtedness) or economic performance (e.g., net income) were not included in the financial statements, which hampers confidence in the local corporate sector. On a positive note, however, several companies voluntarily observed some of the provisions of IFRS even though Honduran GAAP would not require them to do so. This is an encouraging sign as it provides some evidence that capacity exists in Honduras to begin applying IFRS (especially the SME version) in the future. The findings of the review of financial statements filed with the National Procurement Office, on the other hand, were more sobering. Most of the documents could not be considered to be financial statements proper, and the accountants certifying these documents (most of whom were *peritos mercantiles*) did not observe internationally acceptable professional standards.⁵⁰ Annex 4 provides detailed information on accounting standards as practiced in Honduras.

IV. AUDITING STANDARDS AS DESIGNED AND AS PRACTICED

68. **There are currently no Honduran auditing standards for non-statutory audits in the private sector; statutory audits as required by CNBS regulations must be in accordance with ISA.** International audit firms in Honduras generally tend to apply ISA in their audits. However, pursuant to the A&A Law, ISA will be compulsory for all financial statements audits in Honduras for periods beginning in January 2008.

69. **The analysis of the audit reports relating to the financial statements covered by the ROSC review raises several questions on the quality of the audit practice in the non-financial sector.** For example, most departures from applicable standards were not mentioned in the corresponding audit reports. In fact, most companies were given clean audit opinions, which suggests that auditors are not carrying out their required duties to assess compliance with accounting standards. In addition, some audit reports did not clearly identify which auditing standards were applied, making evaluation of compliance difficult.⁵¹ Further, while the most audits were said to have been conducted in accordance with ISA, the text of the audit reports did not always adhere to the IAASB model. This suggests that auditors do not have a clear understanding of one of ISA's

⁴⁹ The ROSC Team reviewed the audited annual financial statements of 19 Honduran companies (which were supplied by the companies themselves), five sets of audited financial statements of banks and insurance companies (published in the newspaper), and 12 sets of audited financial statements filed by local companies with the National Procurement Office (ONCAE).

⁵⁰ For instance, very few of these statements included a cash flow statements or accompanying notes, which are under any basic GAAP an integral part of the financial statements. The accountants did not qualify their opinion in any ways. In addition, the latter did not follow a standard formulation as the one set out in IAS 700, *The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements*.

⁵¹ For example, many firms stated that the audit was conducted in accordance with Generally-Accepted Auditing Principles in Honduras, which do not exist as such (Para. 68). In two cases, no auditing standard was specifically mentioned, and in one, "IFRS" was mentioned.

fundamental principles, the need for standardization and consistency in the wording of audit reports to ensure they are easily, clearly and unambiguously understood.

70. Several systemic factors tend to hamper the quality of audit in Honduras. Based on the interviews conducted by the ROSC team with audit practitioners, regulators and other stakeholders in Honduras, a number of significant factors constrain the application of ISA. First, most accountants in Honduras do not have the necessary experience and technical expertise to conduct independent audits. This stems from the lack of minimum requirements to enter the auditing field (e.g., only a high school education is needed, no entrance examination, no practical experience requirement)⁵² and is compounded by the absence of compulsory continuing professional education. Second, the accounting profession is not always well perceived, which makes it difficult for professional accountants to charge appropriate fees. This is compounded by a relatively low demand for audit services, which in turn lowers the incentives for accountants to maintain the specific skills required. Finally, the accountability of auditors in Honduras is very limited, which hampers investor confidence. Several factors contribute to this environment of low accountability, including: (a) the lack of a quality control system for the work of auditors outside the audit firms themselves (with the possible exception of CNBS-regulated sectors); (b) the inability for third parties to access financial statements of non-CNBS regulated companies; and (c) the absence of legal provisions subjecting errant auditors to either civil or criminal penalties. There are no known cases of lawsuits involving auditors in Honduras, and only certain CNBS-registered auditors (those in Category A, B or C) are required to take out professional liability insurance. The current shortcomings in the enforcement regime may contribute to auditors' limited exposure to actions against them in case of inadequate audits.

71. There are, however, several favorable trends in the accounting and auditing environment on which current and future efforts to strengthen the audit practice can build. First, the efforts of the CNBS to strengthen financial reporting and auditing in sectors under its purview, particularly the creation and implementation of the auditor registry, has been an important step in strengthening the monitoring and enforcement of professional requirements for auditors. Further, the MIF technical assistance project currently under implementation includes a component on developing interpretations and guidelines for applying IFRS and ISA, and disseminating the standards among the profession and the business community. The project also establishes “technical comptrollers” responsible for enforcing professional requirements (Para. 59), and includes a significant training component for the accounting profession and academia (Para. 44).

⁵² Accounting students at UNAH are required to have 800 hours of supervised professional practice as part of their required coursework.

V. PERCEPTIONS ON THE QUALITY OF CORPORATE FINANCIAL REPORTING

72. **Demand for high quality corporate financial reporting in Honduras is low even compared to most emerging economies including those in Latin America.** This stems from a series of factors ranging from the absence of an active securities market to conservative lending practices whereby banks generally require sureties from borrowers and place little reliance on borrowers' financial statements. While this vicious circle will be difficult to break, it is in the best interest of both banks and borrowers to move away from a collateral-based lending system, which significantly raises the cost of borrowing, to a credit scoring system based on the analysis of financial statements.

73. **Commercial banks interviewed did not have definite views on the issue of the quality of corporate reporting, although a consensus exists for the need to improve it.** Some of the concerns voiced by lenders included (a) insufficient of standardization in the financial and accounting information, especially among SMEs; (b) lack of enforcement of accounting and auditing requirements; (c) a pervasiveness of qualified audit opinions; (d) the lack of timeliness in the financial reporting process; and (e) the undue influence of tax rules which, for instance, leads companies not to record provisions or write-downs of assets when these are not tax deductible. Specifically regarding lenders to SMEs, while they generally require all prospective clients to submit financial statements, SMEs rarely present audited financials, as the cost of external audits is prohibitively high. As a result, lenders must make many adjustments to the financial statements of SMEs, which in some cases has a significant impact on the cost of credit to these companies. Moreover, many bankers and business people interviewed expressed doubts as to the quality of the services by most of the *peritos mercantiles*. Regarding external auditors, discussions with banks tend to indicate that only the ones classified in Category A by the CNBS (see Para. 26) are recognized by the market.

74. **There seems to be a lack of interest on the part of the business community for corporate financial reporting, and many are reluctant to provide transparent financial information, mostly for fear of tax consequences.** Honduran companies are still largely family-owned and the business community generally sees limited interest in external financial reporting. In fact, many businesses view financial reporting as possible threat to business secrets, as well as to their personal safety, as they believe that disclosing financial information about their companies would expose them to significant risk of kidnappings and other crimes.

VI. RECOMMENDATIONS

75. **Overall, corporate sector accounting and auditing are still developing in Honduras. Considerable efforts will be needed to achieve levels of financial information transparency and corporate accountability necessary to reap the benefits of DR-CAFTA and a future trade agreement that may be entered into with the European Union.** Under such agreements, Honduran companies could conclude strategic partnerships with large or mid-sized companies based in the US and Europe, involving export arrangements out of Honduras or shareholding agreements that would provide long-term funding for capital investment. For such partnerships, Honduran companies will need to provide credible financial statements, as close as possible to international standards. Several efforts have been made over the last few years to improve A&A practices in Honduras, including (a) passing the A&A Law, which recognizes the need to adopt IFRS and establishes a multi-sector, ad-hoc body charged with standard-setting; (b) strengthening A&A regulations in the financial sector, in the wake of the banking crisis; and (c) conducting capacity building efforts under the MIF-funded technical assistance project. However, those can only be considered initial steps and much more will be needed in the future to raise the quality of financial reporting and auditing in Honduras to needed levels.

76. **Any strategy to develop accounting and auditing in Honduras should focus on a limited set of objectives that seek to build on recent efforts.** Rather than attempting to address the whole scope of weaknesses that Honduras faces, such a strategy should set as a priority a first set of short- to medium-term actions that would be fully consistent with the above recent trends and which can realistically bring positive outcomes. These actions would pave the way for further medium- to long-term measures, to develop the audit profession.

77. **Significant follow-up activities and technical assistance from international donors will be needed to support the recommendations of this ROSC.** The findings and recommendations arising from this ROSC will be discussed during two workshops to be held in Tegucigalpa and San Pedro Sula with the participation of the Government, CNBS, the main accountancy bodies, the business community and other key in-country stakeholders. A detailed action plan, focusing on the priority actions set forth in Section A below, should then be developed under the aegis of the Ministry of Finance (MoF) and the A&A Technical Board, with the assistance of the World Bank, the IDB and other international development partners.

A. Short-Term Priority Actions

78. The short-term priorities to achieve improved accounting and auditing in Honduras should be:

- a) *Amending the A&A Law*;
- b) *Establishing a financial reporting framework consistent with the level of accountability that one would normally expect from different categories of companies*, ranging from public-interest entities to micro-enterprises, the latter being exempt from any obligation. This entails:
 - i. Establishing four categories of companies to which different levels of requirements would apply; and
 - ii. Developing a plan to adopt the simplified international financial reporting standards (“SME IFRS”) which are currently being developed by the IASB;
- c) *Strengthening the national accountancy bodies’ (especially the Technical Board and COHPUCP) institutional capacity and stature*; and
- d) *Providing additional training to audit practitioners*, in order to build their technical capacity and professional competence to the necessary level.

79. **The A&A Law should be amended in order to set a clear framework for corporate sector accounting and auditing in Honduras and make the transition toward IFRS possible. This requires extending the year of effective adoption of IFRS from 2008 to 2011 or even 2012 [Responsibility: GoH].** The main weaknesses of the A&A Law are discussed in Annex 1. Setting a realistic target date for the implementation of IFRS is essential to the success of the adoption. International experience shows that at least four years are necessary for companies, users, accountants and regulators to take the necessary measures to be adequately prepared when the obligation to apply IFRS become effective. Therefore, the effective implementation date should be no earlier than January 1, 2011 and quite likely January 1, 2012. By then, a series of prerequisite actions amendments should have been completed including the passing of the amended A&A Law, the completion of the ongoing train-the-trainers program and additional capacity building efforts which most probably will be needed.

80. **As part of the process of revising the A&A Law, the functions of the Technical Board and its role in enforcing A&A standards should be clarified, and the Law should set certain overarching principles under which the standard-setting process should be conducted [Responsibility: GoH].** The process by which members of the Technical Board are appointed should also be strengthened, by requiring the Government’s no objection. In addition, to ensure its independence, the Law should require that a majority of the Technical Board’s members be non-practitioners. The requirement that all members be accountants should be removed to ensure an appropriate variety of backgrounds, especially financial statement users (e.g. financial analysts and commercial bankers). Finally, the Technical Board’s mission being to serve the public interest, the Law should establish some mechanisms making the Technical Board accountable for the satisfactory fulfillment of its mandate and it should be required to report every year to the Government and the public on its activities and achievements.

The Government will need to establish a means of funding the Board's operation (Para. 82). This would increase the Technical Board's visibility and contribute to improving the image of the audit profession, which in turn would foster confidence in audited financial information on the part of both domestic and international users.

81. The A&A Law should also explicitly acknowledge the fact that different categories of companies should be subject to different levels of A&A requirements reflecting their degree of public accountability [Responsibility: GoH]. Indeed, it does not make economic sense to subject small businesses let alone micro-enterprises to any particular statutory reporting requirements other than basic tax returns and possible information to the statistics department; conversely, it is essential that banks, other entities that hold funds from the public in a fiduciary capacity, and large Honduran companies, be subject to a high level of financial accountability. The amended A&A Law should therefore provide a definition of four categories of reporting companies as follows: (a1) large SOEs, banks, insurance companies, undertakings of collective investments, listed companies, etc.; (a2) companies with public accountability characteristics on account of their large size as well as other SOEs; (b) SMEs and (c) micro-enterprises. Detailed formulas and numerical thresholds should be left to regulations to enable an appropriate level of flexibility should these need to be modified in the future (see Para. 85). Similarly, the law should define to which public sector entities it applies; it is important that SOEs fall within its scope and that SOEs be subjected to the same financial reporting regime as private companies.⁵³ The A&A Law should therefore explicitly state that the Technical Board is in charge of setting standards for SOEs. This would allow the Accountant General's office to focus on government financial reporting per se.

82. The Technical Board should adopt by-laws and a strategic plan in order to play an effective role as standard-setter and enforcer. In addition, a mechanism should be established to ensure sufficient and sustainable funding for the Technical Board to carry out its responsibilities [Responsibility: Technical Board and GoH]. The by-laws should include guidelines and safeguards governing the procedure that the Technical Board must follow in order to make adaptations to IFRSs and ISAs, including the requirement for a clear rationale for any modification to the text of the international standards. In particular, one of the critical functions of the Technical Board in reviewing each new or revised IFRS standard should be to ensure that implementing it would not pose any legal or tax-related difficulties, and propose solutions to avoid or resolve such difficulties. The strategic plan should include a description of the projects the Technical Board needs to embark upon to fulfill its role, as well as of the corresponding human and technical resources that would be required. Finally, it must establish a sustainable stream of revenues and ensure that it can meet its responsibilities. Both the by-laws and strategic plan should be submitted to MoF for comments and approval.

⁵³ Aside from the requirements related to the preparation public sector consolidated accounts, which involve specific presentation and the use of a specific chart of accounts compatible with the government accounting plan. These additional requirements should not impede SOEs from preparing financial statements in the same way as is they operated as private sector companies.

83. **The proposed set of simplified IFRS currently being developed by the IASB should be carefully analyzed and reviewed for applicability in Honduras; and, if deemed appropriate, these should be adopted without modification as the mandatory accounting standards for all large companies [Responsibility: Technical Board].** In 2003, the IASB initiated a project to develop a set of international financial reporting standards appropriate for SMEs worldwide. As of the date of this report, an exposure draft of “SME IFRS” has just been issued⁵⁴ for public comments. These standards omit a number of disclosures required by full IFRS and provide for simpler ways to recognize and measure transactions (i.e. to determine when and how these transactions are recorded in the accounting books).⁵⁵ Nevertheless, they are very close to full IFRS in substance, especially as compared with the existing First 15 Honduran GAAP or the NOHCs, and provide a very robust financial reporting framework. In particular, they contain all of the requirements that Honduran GAAP or NOHCs omit (e.g., deferred taxes, leases, impairment of assets, and measurements at fair value—see Paras. 60-62). Considering (a) the substantial gap between current reporting practices in Honduras and IFRS, (b) that some of the provisions of IFRS (full version) are technically very complex and (c) the credibility of an IASB-issued simplified IFRS, a logical step for Honduras would be to adopt simplified IFRS for all large companies once they are finalized. Companies could be given the possibility to report under full IFRS if they wish to do so. A simplified set of standards will be highly beneficial to Honduras as it will make it easier for local companies to prepare financial statements of acceptable quality at a reasonable cost, which in turn will facilitate access to credit for them.

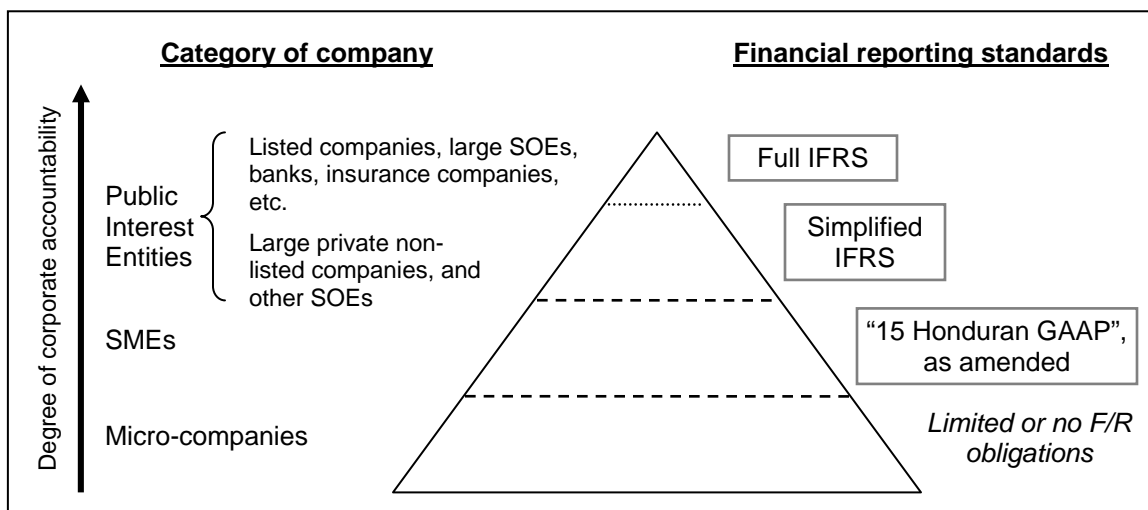
84. **As regards Honduran SMEs, the best approach for the foreseeable future would be to ensure that they are able to apply the existing First 15 Honduran GAAP, which could be amended in a limited manner [Responsibility: Technical Board].** It would not seem wise to oblige Honduran SMEs to apply a stringent set of standards such as the ones contained in the draft simplified IFRS, although such application should be possible on voluntary basis. Figure 1 illustrates the proposed approach to delineating financial reporting obligations based on the four categories of companies mentioned above.

85. **As part of the A&A Law’s revamping, research should be undertaken to delineate precisely the four categories of companies according to their level of accountability as discussed above [Responsibility: Technical Board].** The demarcation between large, medium and small/micro-enterprises should be based not just on a single criterion but several, including number of employees, total amount of assets, and sales. In that regard, the existing revenue threshold for exempting companies will need to be increased. Furthermore, exemptions should be available to all types of businesses, not just retailers. Appropriate consultations with the private sector, banks, accountants and other stakeholders should take place before setting the thresholds delimiting large companies, SMEs and micro-enterprises.

⁵⁴ *Exposure Draft International Financial Reporting Standard For Small and Medium-Sized Entities* issued February 15, 2007.

⁵⁵ The simplifications are summarized and explained in the “Basis of conclusions” section (Paras. 70-93) of the draft standards.

Figure 1 – Financial Reporting Framework Reflecting Levels of Corporate Accountability



86. **COHPUCP should as a matter of priority seek to become an IFAC member [Responsibility: COHPUCP].** Membership in the international accountancy body would confer COHPUCP a higher stature, especially since IFAC has initiated a program to increase the set profile of its members with the issuance of seven statements of membership obligations (SMOs) and a compliance monitoring program. Moreover, by aiming to observe IFAC's SMOs, COHPUCP would be pursuing objectives that are consistent with the needs of the Honduran profession such as establishing continuing education programs, and monitoring the quality of the audit practice.

87. **In order to build on the ongoing train-the-trainer project supported by MIF, and to ensure a successful outcome of that program, the professional bodies should evaluate its impact once it is completed and determine additional training needs for accountants and audit practitioners [Responsibility: Technical Board and COHPUCP].** Such an evaluation should be based on a mock exam covering the subjects of the train-the-trainer program and individual self-assessments of needs.

B. Medium-Term Objectives

88. **It would be useful for the CNBS to commission an evaluation of the differences between current accounting practices among Honduran banks and IFRS.** As previously noted (Para.24), current CNBS regulations require banks to disclose the discrepancies between the CNBS accounting rules and IFRS. In practice, however, banks simply disclose a generic and incomplete description of the differences, without any mention of the amounts involved. To be able to evaluate properly the impact of a transition toward full IFRS, and be in a better position to manage the transition process, the CNBS, in cooperation with the Honduran banking association, should launch a detailed and comprehensive evaluation of these differences as of December 31, 2007 or June 30, 2008.

89. **Similarly for the insurance sector, a study should be launched on the impact of adopting IFRS 4, Insurance Contracts. CNBS should adopt that standard and implement it after a two-to-three-year transition period [Responsibility: CNBS].**

90. **In order to facilitate the access by depositors and other third parties to banks' and insurance companies' financial statements, the law (or CNBS) should require the audited, annual financial statements (including balance sheet, income statement, cash flow statement, notes and audit report) be posted on the websites of the CNBS and on those of the respective institutions' [Responsibility: CNBS].** The current requirement to publish the complete set of annual financial statements in newspapers only makes access to these statements burdensome for third parties. This would require amending the law that creates the CNBS.

91. **CNBS should set more stringent conditions for audit firms to be registered under "Category D" which audit large corporate borrowers [Responsibility: CNBS].** The impact of the obligation for commercial banks to obtain audited financial statements from their larger corporate borrowers is somewhat hindered by the fact that virtually all persons applying for Category D are accepted, because the level of requirement for registration is minimal. In the long run, a credible professional certification (Para. 98) should be required, at least from the auditors of companies that meet the definition of a public interest entity. At a minimum, CNBS should only grant registration to audit to partners having a university degree or, as an acceptable alternative, can demonstrate sufficient professional experience in the field of auditing, after being interviewed by the staff of CNBS.

92. **The responsibilities of *comisarios* should be reassessed and, at a minimum, their role under the Code of Commerce should be redefined so that there is no overlap with the function of independent auditor [Responsibility: Technical Board].** For those companies that are required to have their financial statements audited, the best solution would probably be either to combine the two functions, following the example of France, or to eliminate those functions that can impair the independence of the *comisario*. Another scenario that should be contemplated is abolishing the *comisario* altogether.

93. **Financial reporting and auditing within SOEs, particularly ENEE, should be strengthened [Responsibility: GoH, in collaboration with SOEs' boards and managements].** Currently, some large SOEs, including ENEE, appear ill equipped and unprepared to prepare financial statements of an acceptable quality. Their information systems cannot support a financial reporting process consistent with the requirements of IFRS. In addition, their financial and accounting staff would need to be trained to be able to manage such a process. As a result, significant investments in information technology and training efforts are needed to bring SOE financial reporting up to an acceptable standard. In addition, the financial statements of SOEs should be required to be audited by an independent auditor in addition to, and in coordination with, the TSC, since TSC's mandate with respect to SOEs is mainly oversight of over budget execution, and it does not have the capacity to conduct timely audits of SOEs. In the short run, as a preliminary

step to improve SOE financial accountability, action plan should be developed within each public enterprise to address the issues raised by the auditors in their reports.

94. **Moreover, an ad-hoc structure could also be set up within the MoF to monitor SOE financial reporting, follow-up on all significant issues reported by external auditors and on their timely resolution [Responsibility: GoH].** Considering the current fragile condition of some large SOEs, particularly ENEE, the assistance of the Government of Honduras and the donor community seems necessary, as it does not seem that the company can sustain an effort to improve its financial reporting with its own resources.

95. **In order to achieve real improvements in local accounting and audit practices, efforts should be made to raise awareness among local businesses of the benefits they could draw from enhanced corporate financial transparency and accountability [Responsibility: Technical Board and COHPUCP, in cooperation with COHEP].** The stakeholder workshops in San Pedro Sula and Tegucigalpa to discuss the conclusions of this ROSC will provide a unique opportunity to generate more interest among the business community for corporate financial reporting. Nevertheless, convincing local entrepreneurs that accounting and audit services can bring real value to them will require the Technical Board and COHPUCP to make additional efforts to reach out to local business entrepreneurs, in cooperation with COHEP.

96. **Update and strengthen the UNAH's accounting curriculum [Responsibility: GoH and UNAH, in collaboration with the Technical Board and COHPUCP].** Accounting and financial reporting have . Un the same manner, auditing approaches and techniques have changed drmatically. In order for future practitioners, especially would-be auditors, to have an adequate academic background in the field of accounting and auditing, the university curricula leading to the degree of contador público should be harmonized at national level. In that regard, the government agencies involved in the accreditation of university degrees should establish guidelines consistent with IFAC's recently issued International Education Standards for Professional Accountants (IES) . Furthermore, professional accountants should be required to follow training programs to improve and update their knowledge of international standards and best practices in the field of accounting and auditing.

97. **Similarly, strengthen secondary education for accounting technicians to meet changing business needs [Responsibility: GoH].** The bookkeeping and accounting professions have evolved significantly in recent years, relying increasingly on information technology, and thus requiring a very different skill set. Secondary education for accounting technicians must therefore keep pace with these changes, which in the case of Honduras will require overhauling the curriculum, training high school teachers, and updating teaching materials. Improving the quality of accounting education would provide accounting technicians with marketable skills to help them get better jobs; in addition, it would give them a more solid foundation for university studies, should they opt to continue their education. Since there are currently several donor-supported projects

to improve secondary education active in Honduras (IDB, European Union, USAID), accounting education reforms should leverage these existing efforts.

C. Long-Term Challenges

98. **With a view to ensuring that all independent auditors of public interest entities have adequate qualifications, a system of professional certification should be established. This certification should be of such quality that it could be recognized in the US, pursuant to DR-CAFTA, and in the EU, if the prospective trade agreement is completed and ratified [Responsibility: Technical Board, in close cooperation with CNBS and COHPUCP].** Independent auditors play an essential role in ensuring that corporate entities—including banks, insurance companies and other public interest entities—present adequate, reliable financial information. It is therefore critical that only individuals with sufficient academic background, technical knowledge and professional competence be allowed to conduct external audits of financial statement. Key elements of such certification mechanism include

- a) A bachelor's degree with a concentration in accounting (or business administration with sufficient credits in accounting and related courses),
- b) A high level professional examination and
- c) A three-year minimum professional experience in the field of auditing.

99. **Moreover, the certification system should be designed in such a way that it could be accepted by CNBS as an essential step in its process for licensing audit firms.** As a member of the Technical Board, CNBS should support the development of auditor certification by requiring it from all engagement partners of banks and insurance companies (i.e. for “Category A” auditors) and possibly for Category B. Cooperation with one or more fellow DR-CAFTA countries should be pursued in order to develop a common model; in particular, organizing common exams would help contain the cost of the certification. The person to whom the certification is awarded should be required to demonstrate the updating of his or her knowledge through appropriate training and other acceptable forms of continuing professional development.

100. **A system of quality assurance should be established for the external audit function, with disciplinary actions taken as needed [Responsibility: Technical Board in cooperation with CNBS and COHPUCP].** The introduction of a quality control program is already being contemplated as part of the ongoing MIF-supported technical assurance project. In order to ensure compliance with auditing standards and the ethics code, either the Technical Board or COHPUCP, or both, should conduct reviews of audit firms and have a system in place to investigate cases of complaints or alleged irregularities brought to their attention. When applicable, appropriate disciplinary measures need to be taken, including disbarment. In that regard, the A&A Law should give the Technical Board powers to require statutory auditors to provide any document related to their audits that they it may require. The existence of a system of quality assurance would help deter non-compliance by practitioners and would lead to an improvement in the quality of the audit practice. In addition, it would give more credibility to corporate financial reporting in Honduras, thereby contributing to improve

the country's business climate. The development of a quality assurance system is a sensitive issue, especially because of the negative implications of non-compliance for the practitioners who will be subject to such system. It will therefore require gradual steps, following a phased-in approach.

101. **In developing a quality assurance system, the Technical Board should seek to reach an collaborative agreement with El Salvador's A&A Oversight Board [Responsibility: Technical Board].** El Salvador A&A Board's has been trying to establish such system since 2004.⁵⁶ Developing a common system would help share the costs and efforts associated with designing and implementing such system, and would contribute to further convergence in the regulations and practices pertaining to auditing on a regional level.

102. **In the financial sector, whereas a primarily prudential approach to accounting seems justified for the near future, gradual steps should nonetheless be taken toward the adoption of IFRS, after an appropriate period of transition [Responsibility: CNBS].** There are number of reasons for Honduras's financial sector to move toward IFRS. First, in the context of DR-CAFTA and as Honduran enterprises develop their activities abroad, especially in the US, Honduran banks will need to provide credible financial statements to form correspondent relationships with credible partners. From that standpoint, IFRS, if correctly applied, lend more credibility to a bank's financial statements than locally developed standards with no international status. Second, a growing number of banks operating in Honduras belong to European, US or Canadian groups, which already apply IFRS or similar standards. Requiring these foreign-owned Honduran banks to apply IFRS would not only impose little burden on them but would be consistent with the way they manage their accounting process. Third, IFRS have been tested on a large scale since 2005, after Europe implemented them for all listed companies; the banking and insurance supervisors' community has recognized IFRS as acceptable even for regulatory purposes, subject to certain supervisory safeguards. Fourth, as the financial sector in Central America becomes more and more integrated, a stronger emphasis is being placed on consolidated supervision across the six countries comprising that sub-region. As part of that process, all six countries have started aligning their regulatory accounting standards with IFRS.

103. Implementing a common set of accounting standards for Central America would facilitate the efforts to achieve consolidated supervision; in that respect, adopting an existing set of standards which is recognized internationally would be one of most obvious options to be considered. Given the importance for CNBS to keep a close watch over the solvency of entities under its purview, and since an entity's solvency is determined based on its financial position as reflected in its accounting records, transition toward IFRS should be well planned and carefully conducted. Efforts to reach out to and cooperate with other supervisors, especially the Bank of Spain, other financial sector supervisors in Europe, or the Central Bank of Brazil, would seem most useful in that regard.

⁵⁶ Further details at http://www.worldbank.org/ifa/rosc_aa_elsalvador.pdf.

104. **A number of improvements should be pursued in the long run through closer cooperation with fellow DR-CAFTA countries.** In light of their similar economic structures and common objectives of improving private sector governance and the business climate through the observance of international standards, DR-CAFTA countries would greatly benefit from enhanced collaboration. Indeed, this would allow them to share the efforts and costs associated with adopting IFRS, establishing a certification process or improving accounting education. Moreover, harmonizing the regulatory environment within the DR-CAFTA area would contribute to reducing the cost of doing business across for companies operating across that economic zone. Areas where cooperation at sub-regional level would be particularly relevant include: (a) accounting and audit standard-setting process (since all DR-CAFTA countries have adopted or are in the process of adopting IFRS and ISA); (b) certifying accountants and/or external auditors; (c) strengthening the capacity of accounting technicians (i.e. *peritos mercantiles* in the case of Honduras); (d) establishing quality assurance relating the statutory auditor function; and (e) harmonizing audit requirements in such a way that public interest entities would be legally required to present audited financial statements and SMEs would be exempted from audits.

105. **Insofar as they support important development priorities for Honduras, the recommendations of this ROSC can benefit a wide range of in-country stakeholders, especially the following:**

- ***Honduran businesses*** – By providing credible financial statements to investors, lenders and international business partners, local enterprises will increase their ability to obtain long-term capital to finance their investment needs at a lower cost, and to develop joint-ventures and trade agreements. This will help them expand their activities domestically and abroad;
- ***Employees in the private and state-owned sectors*** – Increased private sector investment thanks to an improved business climate through better financial transparency will help generate attractive jobs in Honduras;
- ***Local commercial banks*** – Improving the quality of corporate financial statements will enable banks to better manage their credit risk and rely less systematically on sureties, which tend to constrain the development of credit;
- ***Honduran accountants and auditors*** – With a professional body of significant stature and an internationally recognized professional certificate, accountants and auditors in Honduras will see their image improve and will be in a position to increase the value—both actual and perceived—of their services on the local market. Moreover, the recognition of a local certification in the US can open significant new business opportunities for Honduran accountants and auditors;
- ***The public sector*** – Reinforcing accounting and auditing practices in the corporate sector would support the Government's efforts to improve tax collection.

ANNEXES

Annex 1: Overview of A&A Law

The passing of the A&A Law was a significant first step in reforming Honduras's financial reporting framework, especially as the Law recognizes and implements a number of important principles, among them:

- ***Adoption of IFRS and ISA***, to provide the corporate sector with a high quality financial reporting and auditing framework;
- ***Provision of an appropriate legal backing*** to financial reporting and auditing standards to support their adoption;
- ***Establishment of an ad hoc standard-setting body***, focused specifically on setting financial reporting and auditing standards; and
- ***Inclusion of a wide group of in-country stakeholders***, not just government or the accounting profession, within the A&A standard-setting body.

A number of significant weaknesses and gaps in the law may preclude its effective implementation and enforcement including the following:

- ***The 2008 deadline for adoption appears overly ambitious, as the existing capacity of preparers and auditors of financial statements to apply IFRS and ISA properly is insufficient.*** The Technical Board, however, is aware of this issue, and they have expressed their intent to seek an amendment to the Law so as to allow for a longer transition and preparation period.
- ***The law does not adequately specify to which types of public sector entities it applies.*** The law broadly states that it applies to “relevant parts of the public administration, regardless of the level of autonomy or level of government (i.e., local, state, etc.). As a result, it is unclear whether IFRS are the reporting framework for the public sector as a whole, or only for certain types of public bodies, such as state-owned enterprises, autonomous agencies (*autarquías*), etc.
- ***The scope of application in the private sector is too broad and presents an onerous requirement for SMEs.*** The revenue threshold for exempting companies is too low and applies only to retailers.
- ***The law does not explain the adoption process for IFRS and ISA, nor does it institute a process for the standard-setting/adoption process.*** The law states that financial statements need to be prepared in accordance with IFRS, as adopted by the Technical Board. It also allows the Technical Board to make amendments to the standards, as needed. However, no implementing legislation has been issued to detail the adoption process.
- ***The law states that Honduran GAAP will continue to apply after 2008.*** Art. 22 states that once the requirement to apply IFRS and ISA come into force in 2008, existing Honduran GAAP will continue to apply. It is unclear whether the intent is to

have Honduran GAAP apply on a transitional basis or if local standards will co-exist in parallel with international standards. This needs to be clarified.⁵⁷

- ***The Law does not explicitly require groups of companies to prepare consolidated financial statements.*** While IFRS requires consolidation for companies with subsidiaries, the lack of such a requirement in the law represents a serious shortcoming in the regulatory framework, as non-consolidated financials provide an incomplete view of a company's financial performance and position. Thus, the lack of a provision for groups of companies to present both consolidated and non-consolidated statements is a significant omission that will need to be addressed for the application of IFRS to be successful.

In addition, there are a number of weaknesses in the law regarding the Technical Board and its accounting and auditing standard-setting and enforcement roles. Among them:

- ***The law does not identify a source of recurrent, sustainable funding for the Technical Board.*** The seven institutions that were accorded statutory membership in the Technical Board in 2004 were required to make an initial grant of HNL 20,000 each, equivalent to US\$1,000, which represents modest, almost symbolic, contributions.⁵⁸ The A&A Law states that additional funds may be provided to the Technical Board by its members, or by other public or private sector entities, including international financial institutions; however, it does not provide a framework for sustained funding.
- ***The law does not provide for a permanent facility or technical staff for the Technical Board, which limits its ability to operate effectively.*** The law only mentions pro bono members, and does not call for permanent technical staff, support staff or offices.
- ***Technical Board's enforcement role:*** Some parts of the A&A Law state that the Technical Board is responsible only for adopting international standards and issuing guidance on their implementation. However, other parts of the Law state the Technical Board is also entrusted with guaranteeing effective compliance with the provisions of the A&A Law. The A&A Law must clearly set out the Technical Board's responsibilities, and adjust its structure and funding accordingly.
- ***Implementation guidance for IFRS and ISA:*** The Technical Board is responsible for defining the implementation and application of IFRS and ISA; however, this is a task that requires ongoing resources – both human and financial. For the short to medium term, the technical assistance project funded by the Multilateral Investment Fund (Para. 44) can support the main effort to disseminate IFRS and train teachers, practitioners and relevant civil servants. However, once the project is completed, it will be important to provide the Technical Board with the means of funding its operations, thereby ensuring the sustainability of the progress brought about by the TA project.

⁵⁷ Other clarifications are in order for this paragraph. For example, it states that ISA will apply to the preparation of financial statements when in fact they are standards that apply to the audit, not preparation, of financial statements.

⁵⁸ Accounting and Auditing Law (2004), Article 8.

- ***Other issues:*** Finally, a number of other issues need to be clarified, including: to whom the Technical Board is accountable; whether the Technical Board will formally endorse standards individually or if they will adopt the entire body of standards at once; and how often will standards be updated (i.e., on a set schedule – on a yearly basis, for example – or on a constant basis throughout the year, as new standards and amendments are issued by the respective international standard setters.

Annex 2: Overview of the "First 15 Honduran Accounting Principles"

| No. | Title | Comments |
|-----|---|--|
| 1 | Basic principles of Accounting | Broadly in line with the IASB Framework |
| 2 | Accounts Receivable | Includes provisions mostly covered in the Framework or IAS 1 |
| 3 | Property Plant and Equipment | Broadly in line with the IAS 16. Requires disclosure of finance leases and includes some provisions on impairment of assets |
| 4 | Cash | Includes provisions mostly covered in IASs 1 and 7 |
| 5 | Changes in Accounting Policies or Estimates | Broadly in line with an old version of IAS 8. Most changes in accounting policies recognized prospectively |
| 6 | Accounting policies | Has similar provisions as IAS 1.108-114 although less precisely defined |
| 7 | Inventories | Broadly in line with IAS 2. LIFO permitted however |
| 8 | Disclosures in the financial statements | Mirrors some of the disclosures required by a number of individual IFRSs and IASs, with a significantly lower degree of depth |
| 9 | Accounting for common stock | Has similar provisions as IAS 1.76, 96-97 and IAS 12.81(i), 82 (a) |
| 10 | Capitalization of interest | Broadly in line with the allowed alternative treatment of IAS 23 (recognizing borrowing costs as period expenses is not allowed). Principle no. 10 does not consider other costs than interest (e.g. finance charges within finance leases) |
| 11 | Long-term liability | Contains provisions that are in direct contradiction with IAS 1, such as the possibility to present short term liabilities as long term when an agreement to refinance on along term basis is completed after the balance sheet date and before the financial statements are authorized for issue (IAS 1.63) |
| 12 | Presentation of Operating Income | Broadly in line with older versions of IAS 1 and IAS 8. Includes the notion of extraordinary items which is no longer considered in IAS 1 |
| 13 | Cash flow statement | Broadly in line with IAS 7 |
| 14 | Short-term liability | This Principle appears mostly redundant with Principle no. 11 |
| 15 | Revenue recognition | Broadly in line with IAS 18 |

Annex 3: Overview of Significant Differences between CNBS Accounting Rules and IFRS

- a) **Loan loss provisioning** – There are two important differences between CNBS accounting rules and IFRS:
- First, as in most Latin American countries, CNBS requires banks to follow a compulsory “matrix” for assessing losses on its loan portfolio. Under IAS 39, the approach is different in that the bank itself is required to make its own assessment of the recoverable amount of the loans, based on estimated future cash flows, taking into account not only factual indicators but also judgmental elements based on the knowledge of the debtor. The impact of this difference of approaches could be significant considering that it relates to a core activity of commercial banking.⁵⁹
 - Second, the CNBS has authorized certain accounting treatments for special categories of loans (particularly in the agricultural sector). These special provisions were made in the aftermath of Hurricane Mitch and their effect will disappear over the next few years; they are part of regulatory forbearance arrangements granted by CNBS to facilitate the financial recovery of the banking sector. A decision by CNBS to mandate IFRS, while preventing accounting exemptions such as the one discussed above, would still make other approaches to regulatory forbearance possible (for instance through special provisions in the calculation of regulatory capital).
- b) **Valuation of securities investment and investments in associates** – Provisions to reflect the loss of value of securities investments are not systematically recorded as IAS 39 would require. An investment in an associate (i.e. entity in which significant influence is exercised) is carried at cost, whereas IAS 28 requires the equity method to be applied, which follows a more economic approach as the bank reflects its share in the profits or losses in the associate.
- c) **Capitalization of costs** – CNBS can authorize banks to capitalize certain costs and amortize them over several years against retained earnings. This is in contradiction with IFRS (IAS 1 and IAS 38), as it may lead to overstating the net assets of the reporting entity. In addition, financial analysts do not view the recognition of such “soft” assets favorably as they may distort the value of an entity’s net assets and its net income.
- d) **Property received as repayment of loans (“activos eventuales”)** – Under IFRS such assets are to be valued at each balance sheet date at the lower of the book value of the loan and the fair value of the assets (i.e. based on the actual conditions of the real estate market at the time they are transferred to the bank by the debtor) less costs to sell. CNBS rules differ from IFRS in that they allow other costs to be taken into

⁵⁹ The ROSC Team does not dispute the adequacy of the matrix method in the current circumstances and for supervision purposes. Nevertheless, a gradual move toward an IAS 39 approach would make sense, especially as Honduran banks develop closer ties with foreign banks and operate more and more on an international level. Moreover, implementing the principles of IAS 39 would provide CNBS with additional empirical evidence as to the sufficiency of loan loss provisions.

account in valuing the property at the moment of the transfer, do not consider costs to sell and, in the two-year period following the transfer, do not require the amounts to be adjusted for possible decreases in market values.

- e) **Commissions received on new loans and related costs** – Commissions received and costs incurred for generating loans are accounted on a cash basis under CNBS, whereas under IFRS they should be treated as component of the aggregate remuneration or cost of the loan. As a result, revenue tends to be overstated in the year the new loan is generated.
- f) **Deferred tax** – Honduran banks do not recognize deferred income taxes, which under IAS 12 reflect the effect of transactions recognized in the financial statements but not on the tax return, or vice versa. This means that, for instance, revaluations of assets are recognized gross of their income tax effect, thereby overstating the net economic effect of such revaluation.
- g) **Disclosures** – The CNBS Accounting Standards require a much lower level of disclosure in the notes to the financial statements than IFRS requires, especially with regard to financial statements (e.g. risk management policies, fair value of financial instruments, exposure to various natures of risk, credit and otherwise). Insufficient disclosures limit investors' and other financial statements users' ability to properly interpret the financial statements and therefore to make adequately informed decisions.

Annex 4: Accounting Standards as Practiced in Honduras

These findings are based on a review of 26 Honduran annual financial statements. Since corporate financial statements are not publicly available—except for banks and insurance companies which are required to publish them on a newspaper—the ROSC Team approached 50-odd large Honduran companies, through a local private organization, requesting that they provide, on a confidential basis, copies of their most recent audited financial statements. 19 non-financial companies provided such information.⁶⁰ In addition, the 2005 audited financial statements of four financial institutions and three insurance companies (published) were reviewed.

The financial statements were reviewed per the requirements of IFRS, in an effort to gauge some of the specific areas of difficulty companies may have in the transition from Honduran GAAP to IFRS. As the sample included some of the largest local companies, which would be best equipped to apply IFRS, it is likely that smaller companies would have even greater difficulty in complying with IFRS requirements.

The most common departures from IFRS observed through the review included:

- *Agriculture* – None of the companies included in the sample which operate in the agro-business observed IAS 41.
- *Employee benefits* – A significant number of companies had recognized a provision for the future dismissal of employees. Under IAS 19, such provision could not be recognized in the absence of an obligation vis-à-vis these employees to pay any dismissal indemnification as at the balance sheet date.
- *Financial instruments* – Most companies declare that they value all investment securities at historical cost whereas under IAS 39 some of these should be measured at their fair value. In addition, none of the companies applied the recognition, measurement, disclosure and presentation provisions of IFRS relating to derivatives.
- *Impairment of assets* – Very few of the companies indicated that they applied the concept of impairment of assets as provided in IAS 36. This means that their assets and therefore their net financial position may be overstated.
- *Income taxes* – None of the companies applied the concept of deferred tax as required by IAS 12. This difference has a particularly significant impact in the case of companies that revaluated their property, plant and equipment for accounting purposes, since in effect their balance sheet would not reflect the corresponding deferred tax liability, thereby overstating the level of equity.
- *Intangible assets* – In three cases, the company had capitalized costs that it would have had to treat as period expenses under IAS 38.
- *Disclosures in the notes to the financial statements* – Accounting policies were not described with sufficient clarity and precision in the notes. In addition, few

⁶⁰ Most financial statements were as of December 31, 2005. The sample included five companies in the agro-business, five in manufacturing, two in the utilities sector and six in industrial services and trade.

companies had made the required disclosures on contingencies, terms and conditions of debt, segment information, and exposure to foreign exchange risk. Moreover, some of the disclosures on related parties required by IAS 24 were often omitted, especially the identification of those parties, management compensation, and details of the transactions entered into with those parties. Finally, a number of companies prepared their financial statements in a currency different from the Lempira, but did not provide the corresponding explanations and disclosures are required by IAS 21.

- *Differences with IFRS* – CNBS regulations require that banks and insurance companies disclose the main differences with IFRS. The review showed that such disclosures are incomplete and do not include any quantification of the differences which makes this information of limited usefulness in practice.