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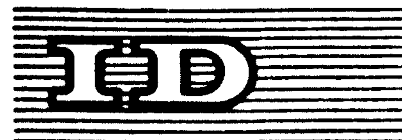

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ACCOUNTING AND AUDITING FOR DEVELOPMENT BANKS
AN OPPORTUNITY FOR DEVELOPMENT OF BETTER ACCOUNTING

This material has been prepared as a background paper for the Workshop on the basis of information supplied by Mr. G. Dewey Arnold, Jr. from Price, Waterhouse and Co (USA). The aim is to present factual information describing the accounting provisions as a basis for discussion of the subjects to be considered by participants. The views and opinions expressed in this paper are based on the author's original paper and do not necessarily reflect the views of the secretariat of UNIDO. This document has been reproduced without formal editing.

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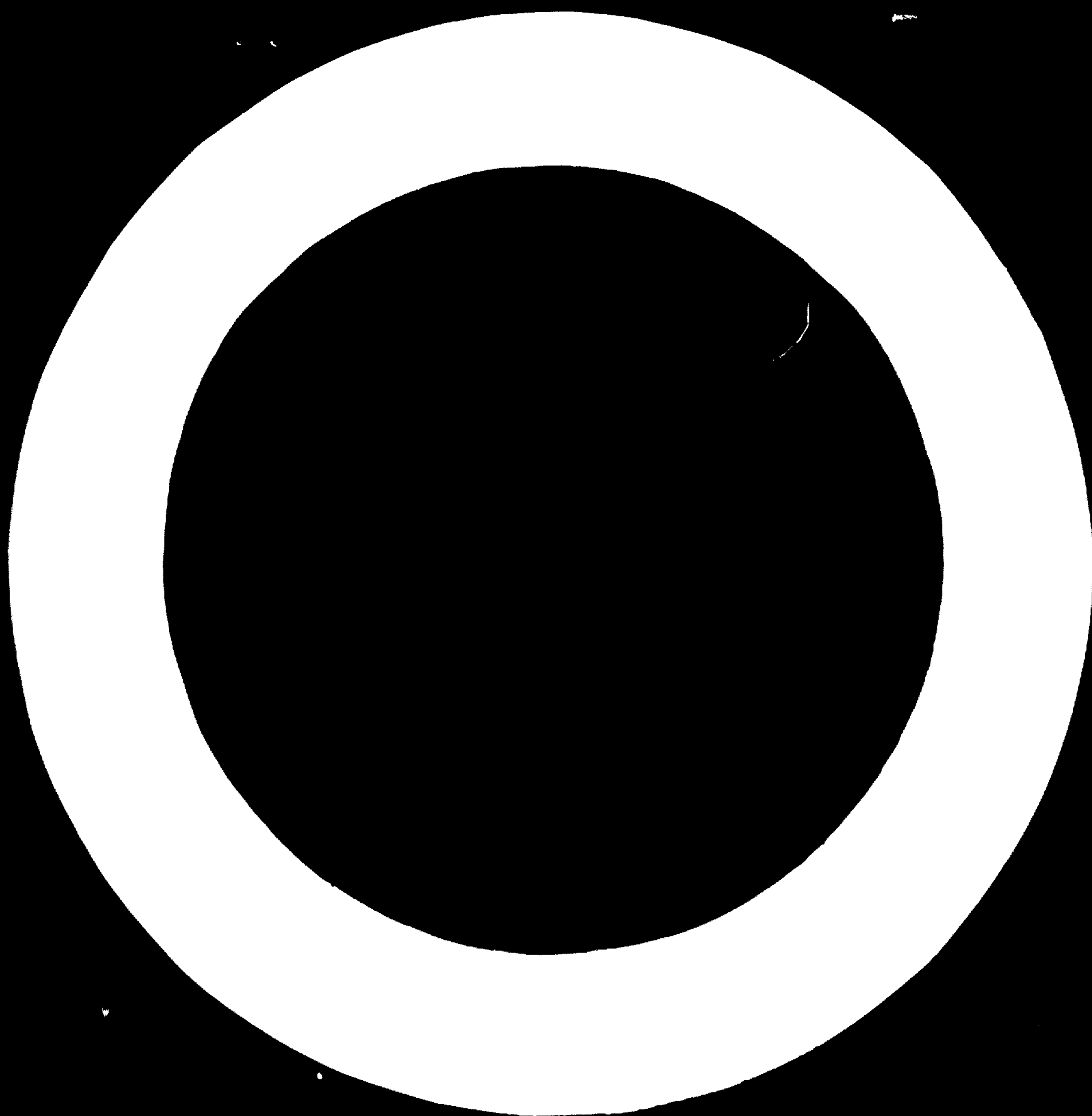


ACCOUNTING AND AUDITING FOR DEVELOPMENT BANKS

AN OPPORTUNITY FOR DEVELOPMENT OF BETTER ACCOUNTING

There is a strong correlation in the world today between the existence of a strong accounting profession and high auditing standards and a high level of economic and capital market development. While the accountant himself cannot act as the prime mover in the development of capital markets, he assists institutions and others concerned with this development by encouraging sound business practices, by helping to develop public confidence in the concept of absentee ownership by providing reliable and meaningful financial information required by the investing public.

There is a very important relationship between the work of institutions such as the development finance companies and the development of sound business and accounting practices and a strong accounting profession that can serve the needs of investors. A strong accounting profession cannot exist in a vacuum. There must be a climate which encourages private investment, sound business practices and investor requirements for reliable financial information to create the demand for high level professional accounting and auditing services.

Today, we will explore in greater detail the relationship of the professional accountant and the development finance company and how they can be of mutual assistance in furthering the economic development of the private section. In addition, we will explore some of the accounting problems of development finance companies and some problems involved in the interpretation of financial statements by investors.

A brief sketch of the historical background of developme finance companies will be helpful in focusing on the goals and objectives of these institutions.

Development Banks similar in many respects to those wh some of you represent today emerged in Europe during the mid-nin century. These institutions, sprung up to fill the great needs fo long-term capital and equity financing created by the emergence large business enterprise and the onslaught of the industrial rev tion. These institutions, although motivated primarily by the des for profit, acted as a catalyst in mobilizing capital from institu and individuals and applying it effectively to the promotion of n industrial enterprise. By investing in and promoting equity investments in new industrial enterprises these institutions contributed significantly to the development of capital markets. "These ban were designed at one stroke to relieve the shortages of capital, entrepeneurship and managerial and technical skills which face countries seeking to develop rapidly." (1) This is precisely the objective of most privately-owned industrial development banks of today.

During the first half of this century, many development institutions were created to serve specific needs or economic sec and were primarily concerned with alleviating problems caused by depression and social upheaval. Although these institutions did r their contributions to development, they were primarily concerned rebuilding and reorganization of existing large industry. Whereas

(1) William Diamond, "Development Banks," the Johns Hopkins Press, 1957, p 26.

the small and the new business may have the greatest need for equity and long-term borrowings, the instability and uncertainty of these new businesses tends to keep the suppliers of such funds involved in more secure areas of investment. Yet, "it is the small firm and the new one that must be dealt with in underdeveloped countries."(1)

The International Bank for Reconstruction and Development, known as the World Bank, was conceived by the allied nations during World War II as an institution to cope with the problems of the postwar period. The founders believed that the capital requirements in the postwar era would be so great that private investment itself, without some form of government guarantee, would be unable to accomplish the task of industrial reconstruction and long-term economic development. Although the immediate goal of the Bank was the rebuilding of the devastated industries of Europe, the long term goal was to promote the economic development of all member governments, particularly the underdeveloped countries. The Bank's purpose is to mobilize private capital for international investment purposes and it relies on private capital to finance the bulk of its lending operation. The unique feature of the Bank that aids it in mobilizing this private capital is that the risks of exchange loss fall not on the private investor but are shared by the member governments.

With the advent of the Marshall Plan which assumed the massive burden of European Reconstruction, the Bank directed its attention to the task of economic development. In 1956 the International Finance Corporation (IFC) was created as an affiliate of the World Bank.

(1) William Diamond, Development Banks, The Johns Hopkins Press 1957, p 39.

While the Bank makes loans to member governments and others with a member government's guarantee, the IFC deals directly with the private sector and does not require government guarantee of its loans or equity commitments. The Bank and IFC have provided a valuable source of long term debt and equity financing to numerous development finance companies throughout the world. They function on an international level to accomplish the same objectives that development finance companies seek to attain on a national level.

The accounting problems of development finance companies are not different from those of other industrial or commercial enterprises and no specific "banking expertise" would be required for top level accounting personnel. Accounting departments of a development finance company should be staffed with competent personnel with prior industrial or commercial experience. Top level accounting personnel should have a knowledge and appreciation for internationally recognized accounting principles and reporting standards.

Although there are no unique accounting problems of development finance companies there are certain key accounting and reporting controls and areas requiring special attention. These would include current and accurate investment records, disbursement controls, a system for billing and collection of principal and interest charges and the prompt reporting of deliquencies, a policy for handling potential gains and losses on currency revaluations, and a policy of financial reporting to shareholders and the public.

Investment records

It is essential for a development finance company to maintain current and accurate records of loan and equity investments including the cost, interest rates and payment dates, amortization schedules and other pertinent provisions of investment agreements. Where equity securities are publicly traded, their market values together with management's appraisal of the value of non-traded investments should be incorporated in reports to management for use in assessing the potential gain or loss on the entire portfolio.

Disbursement controls

Where the development finance company provides long-term loans for the construction or major expansion of an industrial enterprise it may desire as part of its overall investment supervision process to require borrowers to submit documentary evidence of the receipt of goods and services which are to be paid out of the loan proceeds. The goods and services to be financed by the loan would be specified in the loan agreement. Often, payments are made directly to the supplier. Such a system of controls enables the development finance company to keep informed of the progress of construction and monitor this progress against the original construction and financial plan. In addition, it gives assurances that loan proceeds are used only for their intended purpose and provides an early warning system for cost overruns that could endanger the project's financial plan. A disbursement control system of this nature would include provision for reporting to management of any cost overruns or discrepancies

between the original project plan and requests for disbursement of loan funds. If the company is engaged in short term financing of working capital requirements this type of control would generally not be employed.

Payment controls

It is essential that accurate and reliable records be maintained to provide for the timely billing of principal and interest payments due from borrowers and the prompt reporting and follow up of amounts not received when due. Management should be quickly informed of any defaults in order to take appropriate action. Defaults may be indicative of basic problems in the operation of the portfolio company, but they may also be a reflection of temporary cash shortages that will be overcome with time. The amount and frequency of defaults must also be considered by management in establishing a value for their portfolio and making provision for possible investment losses. In addition to controls over interest, dividends on equity investments should be recorded when declared to provide a means of control over their collection when due and payable.

Exposure to losses on currency revaluations

If a development finance company has borrowed foreign exchange, it must develop a procedure to provide for possible losses on currency revaluation and to account for gains and losses that may be incurred. The methods and accounting treatment adopted would depend on the particular provisions of the foreign exchange loan. Some development finance companies are able to obtain governmental assumption of the risks of exchange loss. Others pass on the risk

to their own borrowers. In some cases the development finance company may itself assume the risk.

Control of expenditures

Major expenses of a development finance company will normally be the cost of personnel and interest on indebtedness. Personnel costs should be controlled through a budget which is linked to the level of investment activity. Interest expense is subject to exact calculation.

Financial reporting practices

Although loans and other financial assistance from government and international development institutions may be expected to continue for some time, the private development finance company should design its policies and reporting practices to facilitate its eventual entry into the capital market, foreign or domestic, at some later date. To the extent consistent with statutory requirements, the financial reporting of a development finance company should adhere to internationally recognized reporting and disclosure standards. Development companies on an international level that have borrowed funds in the public capital markets of various countries include the World Bank, Inter-American Development Bank and the Asian Development Bank.

Accounting has a great contribution to make throughout the entire course of the investment process in helping to achieve the goals of development banks in promoting economic growth and development through the mobilization of capital for production purposes.

The needs for factual information from its portfolio companies are extremely important to the development finance company. This process of obtaining, reviewing and assessing financial information of the portfolio company begins with the original request for financing and continues until it has developed into a self-sustaining institution. At that point, the development finance company would seek to sell or otherwise dispose of its investment on favorable terms so that the investment process may begin again.

Appraisal process

Before an investment agreement is entered into there is normally a very thorough appraisal made of all technical aspects of the project including the financial plans and forecasts. At this stage of the investment cycle, the development finance company works very closely with the company management in reviewing, assessing and improving the project and financial plan. The development finance company should have ample opportunity to review their client's business practices and procedures, including the accounting and reporting system; and to encourage or require their clients to adopt adequate systems and procedures to generate information and reports that will be required for informed management decisions and periodic assessments of the project's status. The correction of potential problems at the appraisal stage is one of the best ways in which the development finance company can insure the eventual success of the project. In the process of appraisal and review of the financial plan, the accountant's role is that of advisor and consultant both to those responsible for the investment appraisal and to management of the prospective client.

Supervision process

Of great importance to the eventual success of a venture capital undertaking is the role of the development finance company in maintaining close contacts with the client. The investment officer must keep abreast of technical and financial problems as they occur so that he can mobilize the combined talents and experience of his entire organization to advise management. The formal structure for maintaining this close contact usually includes a system of disbursement controls to insure that the loan proceeds are paid only upon the delivery of goods or services specified in the loan agreement. In addition, periodic financial statements and reports supplemented by annual audited financial statements are received and reviewed for indications of potential problems and compared to original management projections. Adverse trends or significant variations from projections would be noted for discussion with management of the portfolio company. A major supervision effort is usually made by inspection teams or consultants at the project site to assess the performance in construction and the operating efficiency of the business once construction is completed.

In addition to using information obtained during the supervision process for the purposes of keeping abreast of the borrower's problems, the development finance company must critically evaluate its risks as an investor and determine the need for establishing a provision for possible losses. In establishing a loss provision, management of the development finance company would consider its past

experience, the long term nature of its investment cycle, the financial position and operating results of the portfolio company, its ability to make scheduled payments of loan principal and interest, and other governmental and environmental influences. Although a development finance company does not seek to avoid or even to minimize risks, it is essential that their management be aware of their risks and exposure to loss at all times.

Disposal or reinvestment process

More is required of development finance companies than the normal investor. To be successful not only must its investments be profitable, they must eventually be marketable. Hopefully, through the efforts of the development finance company in encouraging foreign and domestic private investment, setting the example of sound investment and management policies, and contributing to the confidence of the potential investors by encouraging full and fair disclosure of reliable financial information, the ground work will have been laid for the sale of its equity investment to a broad segment of the domestic investors. One very important consideration in broadening security markets and encouraging security ownership is the business practices and ethics of the society. Where management is not held accountable for their operating results through full and fair disclosure of financial results, it is very difficult to encourage minority ownership because the minority shareholder will not trust major shareholders or know what is going on.

We have discussed the needs of investors, managers and the investing public for reliable and meaningful financial information.

The needs of management throughout the world for reliable and meaningful financial information are the same. The needs of foreign and domestic investors for reliable financial information on which to base investment decisions and review the status of investments are likewise the same. Accounting as the language of financial communication should provide the common basis for understanding between management and international investors. However, differences in accounting practice in various parts of the world are of such magnitude as to severely inhibit the communication function that financial statements are meant to perform. The existence of these differences and their effects are subjects which have drawn the increased attention of accountants in recent times.

For this discussion it is important to keep in mind that the purpose of accounting is to record, classify and summarize financial data and events in a meaningful manner to assist investors and management in assessing the results of operations and making informed business decisions. As such, accounting for management and investors would not necessarily resemble accounting prescribed by tax or other governmental regulatory authorities unless the prescribed rules were based on realistic business principles.

Differences in accounting principles and standards of reporting throughout the world exist because of historical, legal and

environmental influences. Historically, accounting principles have been transplanted from one country to another when one country invests heavily in another. U.S. accounting principles were imported during the 19th Century by Britian's Chartered Accountants who were sent to keep watch over the substantial British investments in the United States. Subsequently, differences arose between American and British accounting principles due to environmental and other influences.

A second cause of diverse accounting practice results from the varying legal traditions of countries. Those European and Latin American countries which were influenced by the Napoleonic Code often have similar commercial codes and statutes that prescribe recordkeeping requirements. Tax legislation has also had a significant effect on accounting principles particularly in those countries where the accounting records must be maintained in accordance with provisions of the Tax Code.

In some countries the tax law will allow a deduction for doubtful accounts until the total provision equals 10% of accounts receivable. These provisions are allowed,even though the provision is excessive, as long as they are recorded on the accounting record. Naturally they are always claimed with the result that profits may be understated.

In Sweden the tax law allows an inventory reduction by as much as 60% of the average inventory of the preceeding two years. If there was a severe reduction in inventory from one year to the next

it is possible to report a negative inventory balance.(1)

Environmental influences are a third significant contributing factor in the development of accounting principles. U.S. accounting principles and reporting standards have been deeply influenced by the fact that our capital markets serve the needs of a great many small investors. In other developed countries the capital markets mainly serve large institutions and a few wealthy investors. As a result, the amount of information and financial disclosure can vary greatly between, for example, the U.S. and Western Europe. Accounting principals in many European countries have been deeply influenced by their history of recurring cycles of rampant inflation and severe depression. In these countries conservatism in financial reporting is approved by the business community and accounti is characterized by the development of hidden reserves for the purpose of stabilizing income. These accountants would argue that the only way to measure the profitability of a company is to assess its results for its entire life and that measurement for a period of time such as one year is a fruitless exercise. Accountants in the U.S., however, believe that income from operations can be reasonably measured during the course of one operating cycle of the business, usually a one year period. Severe conservatism is considered as inappropriate as unrestrained optimism.

It is interesting to examine some of the differences that do exist in practice and to contemplate the effects of each set of practic if applied to the same company in preparing financial statements.

(1) See Professional Accounting in 25 Countries AICPA.

Valuation of fixed assets(1)

Accountants in the U.S. subscribe to the concept of recording fixed assets at cost and the allocation of that cost against earnings of the company over the economic or useful life of the asset. Accountants in the U.K. favor the historical cost basis but do not prohibit the use of values based on independent appraisals. Dutch accountants often favor valuing fixed assets on the basis of replacement value. In Brazil, the cost of fixed assets may be revalued based upon inflation coefficients established by the government.

Valuation of inventories(1)

In the Netherlands although the "lower of cost or market" basis for stating inventories is more acceptable, the practice of stating inventories at less than this amount is not uncommon. Inventory cost usually includes overhead, but they may be omitted. In Japan, inventories are stated by most companies at cost, but may be recorded at "lower of cost or market."

In connection with any discussion on inventory valuation it is important to note that in addition to the different practices described above that there are also various acceptable methods of determining cost and varying definitions of the term "market."

(1)See Professional Accounting in 25 countries.AICPA.

Consolidation of financial statements of parent and subsidiary companies(1

In Brazil, it is not common for corporations to present consolidated financial statements. In India, while consolidated financial statements are generally not prepared, the Companies Act requires that financial statements of the holding company be accompanied by financial statements of each of its subsidiaries. Disclosure must be made of intercompany dealings. In the United States, consolidated financial statements are required when one corporation owns or controls other companies.

The differences that exist in accounting practice throughout the world can generally be classified as arising from differences of opinion as to the best practice or to the adoption of unrealistic accounting practice such as those prescribed by tax or other governmental regulatory agencies without any basis in reality.

A further obstacle in the path of true and meaningful communication of financial data is the well entrenched tradition of business secrecy that prevails in many areas of the world. In developing countries this often results from the concentration of economic wealth and business know how in the hands of a few wealthy family units. In some developed countries, the bulk of capital is obtained from a few wealthy investors or institutions who can obtain information direct from management and the need for a full and fair disclosure of information is considered inappropriate.

(1)See Professional Accounting in 25 countries.AICPA.

Arthur K. Watson said, speaking before the Eighth International Congress of Accountants, that "There is, we all know, a fine line between what a business can reveal publicly for the good of its public and its nation and the kind of financial information it reveals which will boomerang, which a competitor will use to telling advantage. I can't draw the line but I do know it is a long way removed from where businessmen in many nations feel it is. There aren't many secrets in American business and we're the healthier for it. I wish it were true all over the world. Secrecy or simply the lack of good financial information hurts businesses in many ways. It creates suspicion in the minds of labor and the general public. It confuses national economic policy for the policy is based on misleading or incomplete information."

Because the uneven development of accounting and availability of reliable financial information inhibits the mobility of capital and the investment process, it is important for accountants and investment institutions to search for ways to promote a more even development of accounting and raise the standard of financial reporting on both a national and international level.

Many accountants concerned with the international practice of accounting are deeply troubled by the extreme differences in practice throughout the world. Some have called for the establishment of uniform international standards of accounting. This may indeed be a very desirable long range goal, but something of a more practical and immediate nature is required. One of my partners has suggested that relief would be provided by the establishment of minimum

consolidation requirements and disclosure requirements which would apply, by agreement among the capital supplying nations, to all cases where capital is sought by any entity outside its country of domicile. In the final analysis, there are not so many different accounting principles in existence that, assuming adequate disclosure and acceptable consolidation practice, trained accountants outside the country of issuance of financial statements would be unable to comprehend them and recast them in a more familiar mold. In other words, accountants would continue to keep their books and prepare their financial statements in accordance with practices that are normal in their respective jurisdictions. However, if the financial statements were to be used in connection with the raising of capital outside the jurisdiction, then certain agreed consolidation practices would have to be followed and certain information (principally as to methods of valuation) would have to be disclosed.

International financial institutions must cope with this problem of interpreting the financial statements of companies in which they have invested. Some prescribe the form and content of financial statements and the accounting principles to be followed. Others recognize that substantial differences in accounting practice exist throughout the world and do not wish to impose their specific preferences on the companies concerned. However, they do specify that disclosure of variances from their prescribed accounting principles be included in reports submitted to them under the terms of their

investment agreements. One international investor has specified the following as examples of areas where disclosure is required. (1)

All significant nonrecurring or extraordinary items of income and expense and other significant items which could have an effect on the comparability of net income to the prior period should be identified.

Subsidiary companies should be consolidated with the financial statements of the parent company. In the event consolidated statements are not prepared, it is essential to have the operating statements of the parent company and all subsidiary companies prepared clearly identifying all intercompany balances as well as intercompany profits.

It is acceptable practice in many countries to understate assets and overstate liabilities or to equalize income from year to year by transferring funds to and from reserve accounts. Disclosure is required of the effect of such practices on the financial position and operating results.

When assets are valued on a basis other than historical cost, disclosure is required of the basis of valuation and the method of amortizing the cost or value of the property to income over its useful life.

(1) Accounting and Financial Reporting, International Finance Corporation, 1964.

Disclosure is required of the accounting treatment with regard to provision for losses on foreign exchange and of the basis of translating from one currency to another.

While we have discussed some differences in accounting practices among various countries of the world, for this is important to institutions seeking to obtain capital from foreign and international investors, it is important to realize that the differences in international practices are a reflection of the different practices existing on a national level.

Personnel at development finance companies who are responsible for the review of financial statements should be familiar with the "generally accepted accounting principles" in their country and be knowledgeable of how the use of one principle versus another affects the financial statements. In the preceding sections, we have discussed certain aspects of accounting that are essential knowledge for the investor in interpreting and understanding financial information. The accounting profession must strive to improve the reliability of financial information and its usefulness, through the elimination of differences in accounting practices or by the full disclosure of the effects of different practices measured against some agreed upon standard. Development banks and similar investment institutions can participate, even lead, in this mutually beneficial goal in numerous ways during the course of its investment cycle. In addition to contributing to the reliability and usefulness of financial statements,

this would encourage the use of sound business practice and promote the free and full disclosure of financial information to the potential private investor, all of which are important factors in economic development and the broadening of capital markets.

Development finance companies can assist in accomplishing these goals by:

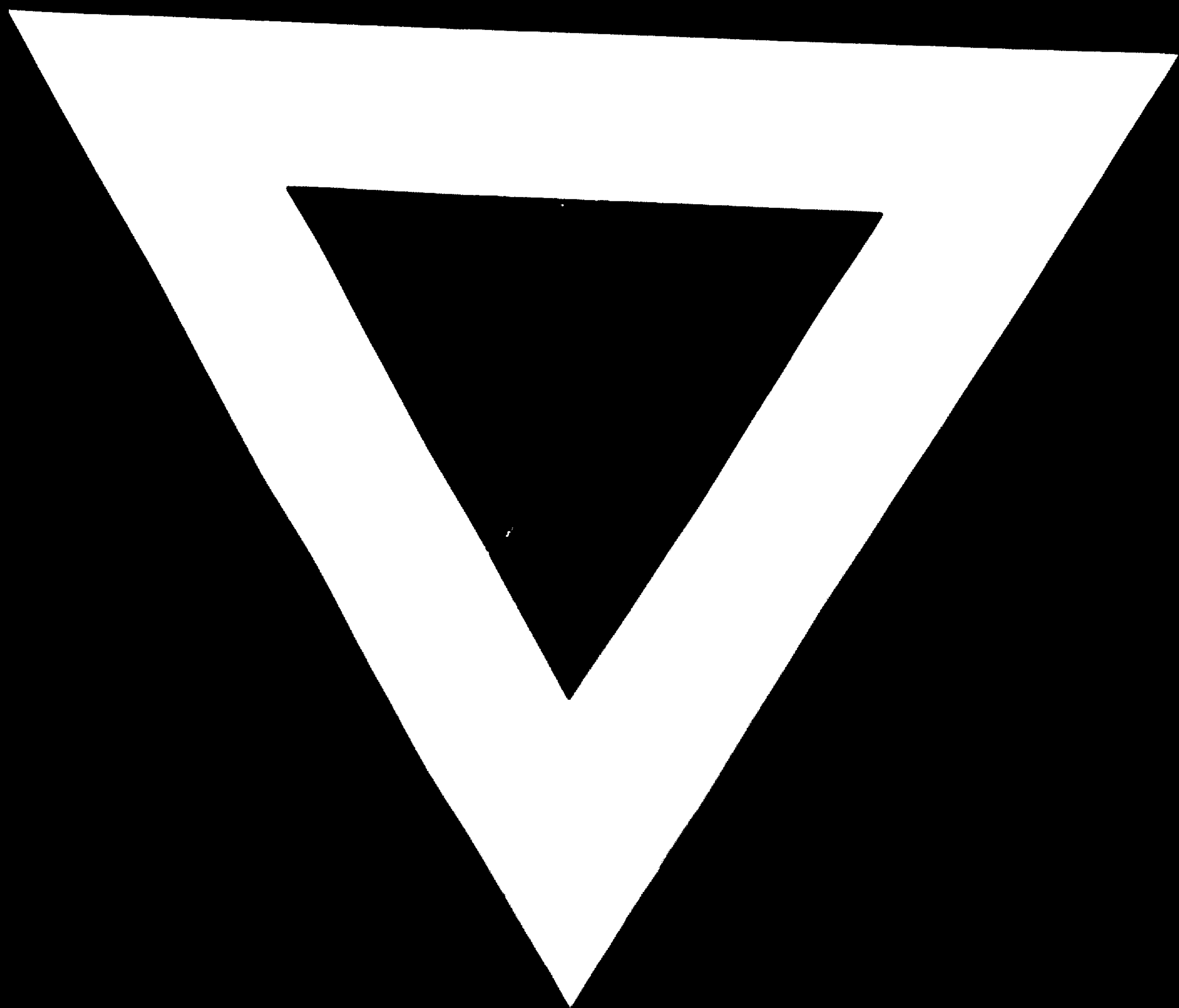
Setting the example for other industries in the country by observing sound accounting principles in its own operations, and by the presentation of meaningful financial reports to its shareholders and the public.

Second, by encouraging its portfolio companies to observe sound accounting and reporting practices.

Third, by supporting independent auditors that adhere to high standards. One development finance company, seeking to upgrade accounting practices in its country, assisted in the formation of a firm of independent auditors who agreed to follow international accounting and auditing standards. The firm was soon successful and has helped to set a higher standard of practice within the country(1), and

Fourth, by strengthening accounting and business education within the country and supporting the establishment of professional accounting societies and organizations.

(1)See Development Finance Companies: Aspects of Policy and Operations p. 35 Edited by William Diamond



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