

## CNV SEEKS AUDITING TRANSPARENCY

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Probably inspired by the auditing problems that caused the enactment of the Sabarnes-Oxley Act, the National Securities Commission (*Comisión Nacional de Valores*) (“**CNV**”) has created a system to control the external auditing of companies subject to the CNV’s control (the “**Companies**”). The CNV (i) published on April 28, 2003, the Rules on External Auditing (the “**Abrogated Rules**”), and (ii) on December 2, 2003, the Amendment to the Rules on External Auditing (the “**Rules**”). The purpose of the Rules, according to article 1, is to avoid conflicts of interest between the persons who perform auditing activities, which according to article 2, must be firms of independent public accountants (the “**Firms**”) and Companies.<sup>1</sup> For the achievement of their purpose the Rules regulate the conditions and requirements (i) that Firms must comply with when auditing financial statements of Companies, and (ii) that audit reports (the “**Reports**”) must meet pursuant to the Capital Markets Law (*Ley de Mercado de Capitales*). The CNV tries to establish a thorough control over Firms, placing special emphasis on the prevention of conflicts of interest. This shall be the main concern of this article.

### **CNV’s control over Auditors and accountants. Registration requirements.**

The first requirement imposed by the Rules is that, as indicated above, auditing activities must be performed by Firms. Accordingly, it follows that individuals working independently cannot perform external auditing for Companies.<sup>2</sup> However, the Rules do not regulate whether Firms must be of a civil or of a commercial nature, nor do they establish the specific type of Firm incorporation.<sup>3</sup>

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<sup>1</sup> This was also the purpose of the Abrogated Rules.

<sup>2</sup> Please note that the Abrogated Rules also established that auditing activities could not be performed by individuals acting on their own. However, the Abrogated Rules were differently worded, making emphasis both on individual accountants and Firms, as opposed to the Rules, which place their emphasis on Firms and regulate individuals only by means of their connection to Firms. The Abrogated Rules provided that accountants who performed auditing activities for Companies had to be partners, junior partners or employees of audit firms. This emphasis only on Firms, rather than on both Firms and individual accountants, is one of the main characteristics of the Rules and, as we shall point out throughout this article, can be seen in various aspects of the regulation.

<sup>3</sup> In this sense, the Rules are less rigid than the Abrogated Rules because the Abrogated Rules required audit firms to be incorporated as “civil associations” or partnerships in accordance with the Civil Code (as opposed to a company incorporated in accordance with the Commercial Code). Such civil associations, if registered before the Public Registry of their jurisdiction, are considered to have become “juridical persons”, that is, they are entities that are existent in and of themselves, independently of the individual partners that may be

As a second requirement, Article 3 of the Rules mandates that Firms must be duly registered before the CNV, for which they must submit certain information. First, Firms have to provide the CNV with the names of (i) their controlling partners, (ii) their partners who are public accountants, and (iii) the persons who subscribe the Reports (the “**Subscribing Accountants**”). No independent registration of the Subscribing Accountants is required by the Rules,<sup>4</sup> which does not mean that no control is exercised by the CNV over Subscribing Accountants, but rather that such control, at least with respect to external auditing, is indirect since information regarding Subscribing Accountants is provided by the Firms, instead of by the Subscribing Accountants themselves. For example, Firms must notify the CNV if an Organization of Public Accountants (*Colegio Profesional de Contadores Públicos*) (the “**Organization of Accountants**”) sanctions a Subscribing Accountant.<sup>5</sup> Second, Firms must submit a declaration stating that the information provided is true and that the CNV is authorized to verify it. Finally, other information, such as the document of incorporation and by-laws and a declaration stating that the Firm complies with an internal quality control system (pursuant to applicable rules), is also required. However, further control (*i.e.* by renewal of registration with the CNV), is not provided for under the Rules.<sup>6</sup>

Third, Article 2 of the Rules establishes that Firms and Companies must execute agreements to rule their relationship. Such agreements must (i) regulate the responsibilities, obligations and rights of each party thereto; and (ii) be submitted to the CNV within the 15 days following their execution, jointly with a declaration stating that no conflict of interests, as defined in the Rules, exists.

An interesting issue is that the Rules do not require that Firms should submit their financial statements to the CNV for their review.<sup>7</sup>

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members thereof. They have their own assets, their own liabilities, their own capital, their own net worth or “patrimony” (*patrimonio*) and their own legal personality.

<sup>4</sup> The Abrogated Rules did provide for a separate registration for Subscribing Accountants, thus creating a double sphere of control –by directly controlling individuals and Firms.

<sup>5</sup> This obligation to notify also existed under the Abrogated Rules. However, in our opinion, the drafting of the Abrogated Rules was confusing. Article 9 bound Auditors to notify the CNV of any suspension or cancellation imposed by the Organization of Accountants on “*the persons which article 3 of the present Rules refers to*”. However, on the one hand, Article 3 of the Abrogated Rules regulated the inscription of Firms – only referring to individuals under number 3 thereof, by requiring that certain information regarding partners and Subscribing Accountants be provided to the CNV for the Firm’s inscription; and, on the other, Article 4 directly regulated Subscribing Accountants –ordering their registration at the CNV. Obviously, sanctions of the Organization of Accountants are imposed in the head of individuals, rather than on Firms. Accordingly, the obligation to inform the CNV of sanctions should have been drafted by reference either to Article 4 or to Article 3, number 3. This inconsistency was corrected by the Rules, which create an obligation to notify when sanctions are imposed “*on the persons which article 3, number 3, of the present Rules refers to*”.

<sup>6</sup> Article 6 of the Abrogated Rules required registration to be renewed every three years.

<sup>7</sup> Please note that Article 7 of the Abrogated Rules did require that the Auditors’ financial statements be submitted annually to the CNV.

## Conflicts of interests

As indicated above, the Rules pay special attention to prevention of conflicts of interest, a subject which is addressed both directly and indirectly. The direct approach is a casuistic one. The Rules create under article 14 the following set of prohibitions:

1. Firms may not be shareholders of Companies audited by them or of their affiliate persons. Likewise, Companies or their affiliate persons may not own shares in their auditing Firm. The criteria for defining an affiliate person is determined by control, that is, for a person to qualify as such it must either control or be controlled by the Firms or the Company, as applicable, independently of other factors.

2. Certain employees or related persons of Companies or affiliate persons may not perform external auditing for such Companies, for as long as they are employed by or related to it. Among these persons are directors, internal auditors, executive directors, finance and accounting executives.

3. Partners of Firms may not be related (up to fourth grade consanguinity and second grade affinity) to directors or controlling shareholders of the audited Company.<sup>8</sup>

The Rules also address the conflicts of interest issue by means of an indirect approach. That is, they refer to characteristics that, in our opinion, are very much linked to this problem (*i.e.* independence and objectiveness). For example, article 6 of the Rules requires that the quality of external auditing be controlled by audit firms, binding audit firms to pursue certain goals, among which is that of ensuring that external auditors act with independence and objectiveness, and that auditing activities are also performed with such criteria.

In our opinion, the Rules place more emphasis on independence than on any other element. For instance, article 5 provides that accountants must maintain an independent, objective and capable position. Yet, no definition of “objective” or “capable” is given, while a “non-independent position” is defined as one in which a conflict of interest exists. A definition of “non-independence” with respect to audit firms is also established by the Rules under article 15, which states that Firms are not independent of the Company if directors and partners of Firms, or persons related to such Firms: (i) have a professional service agreement, of personal nature, with the Company or an affiliate; or (ii) owe the equivalent of one hundred “minimum urban salaries” (around \$ 12,870 at the official exchange rate) or more,

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<sup>8</sup> The Abrogated Rules referred to “external auditors”, instead of to “partners” of the firms. Evidently, the Abrogated Rules were more restrictive than the Rules, since the reference to external auditors could include Subscribing Accountants. However, under the Rules, Subscribing Accountants would only be prevented from auditing a Company if they are also partners of the Firm.

to the audited Company or to related persons (mortgage loans for acquisition of main homes do not qualify for these purposes).<sup>9</sup>

As we stated above “objectiveness”, although also addressed, is not given the same share of importance as “independence”. An example of this is that no definition of “objectiveness” is given throughout the Rules. Nevertheless, the issue seems to be addressed by articles 7 and 13 of the Rules, which deal with the fact that all audit reports must be based on sufficient evidence to support them and which impose (i) on Firms, the obligation to obtain this evidence by performing and evaluating such tests as are necessary to have a sound basis for expressing opinions; and (ii) on Companies, the obligation to submit to Firms all the information which is necessary and sufficient for the latter to interpret and comprehend the Company’s financial and equity related situation. Therefore, by requiring that Reports be based on sound evidence, the Rules are ensuring objectiveness in the approach of Firms, since they must issue the Reports based only on facts.

### **Other issues**

Despite the fact that the Rules’ emphasis is on conflicts of interest and related issues, other matters are also addressed by the Rules. In fact, the CNV regulates subjects such as the keeping of documents, information and papers; and confidentiality; among others.

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<sup>9</sup> This aspect was more strictly regulated under the Abrogated Rules. First, the professional service agreement was not circumscribed to an agreement of personal nature. Second, the professional service agreement and the debt could not be contracted either with a shareholder who owned more than 3% of the Company.