DISCLOSURE AND ACCOUNTING IN A GLOBAL MARKET: LOOKING TO THE FUTURE

By Lynn E. Turner[1]

THE GROWTH IN INTERNATIONAL BUSINESS

In today's global economy, many businesses of all sizes operate and conduct business on an international basis. World trade has grown as businesses have extended their operations beyond their own national borders, aided by technological advances in communication and data transmission, and the reduction of national barriers to commerce, trade and travel. Companies have learned that to be successful, they must be able to compete in international markets for both customers and capital.

During the last decade we also saw the privatization of large sectors of governments, such as telecommunication, utilities and transportation. In less developed countries, such industries and infrastructure within their economies continue to require further development.

Globalization and privatization have created an enormous need and appetite for the capital necessary to fund these undertakings. They have also created, when the risks were appropriate, an eagerness on the part of investors to take part in the resulting global investing opportunities.

At the same time businesses were expanding internationally, the global financial landscape has been undergoing a significant transformation. The world's financial markets have become increasing tied to one another. Financial service firms as well as the capital markets have been building the infrastructure necessary to link the capital markets on a global basis. Events since 1996 such as the Asian and Russian financial crisis, Long Term Capital Management, and the recent events of September 11th, have all shown that our economies have become increasingly dependent and tied to one another. A major event affecting the financial markets in one part of the world, may very likely affect the markets and investors around the globe. This has caused some to criticize the quality of international financial reporting and the role a lack of transparency played in some of the crisis involving the international markets.

---

[1] An issues paper prepared by Lynn E. Turner, Professor and Director of The Center for Quality Financial Reporting, College of Business, Colorado State University and former Chief Accountant, U.S. Securities and Exchange Commission, for a Major Issues Conference: "Securities Regulation in the Global Internet Economy, presented by the Securities and Exchange Commission Historical Society in cooperation with the United States Securities and Exchange Commission, November 14-15, 2001. Professor David S. Ruder, former Chairman of the Securities and Exchange Commission has written a companion article entitled: "Worldwide Convergence in Accounting, Auditing, and Independence Standards" (Hereafter "Ruder paper")

The ability for markets to be efficient and thereby attract capital sufficient to provide the necessary liquidity and depth is dependent in part on their ability to provide investors with high quality transparent information on a consistent and timely basis. That information must be sufficiently credible to investors that they believe it is reliable and are willing to invest based on it. Markets that have experienced events where the credibility of financial information was in question have experienced a flight of capital to safer havens. In addition, as was recently experienced by the Neuer Market, companies may leave or avoid markets where their reputation is affected by a lack of credible financial reporting.[2]

THE INCREASING IMPORTANCE OF THE U.S. MARKETS TO INTERNATIONAL BUSINESS AND ECONOMIES

The public capital markets in the United States have been the largest source of equity capital for funding economic growth in business in the U.S. and internationally and for privatization of governmental entities. At the end of 2000, the total global market capitalization of domestic listed companies on all exchanges was an aggregate of $28 trillion dollars. $14.3 trillion of this or 51% of the worldwide capitalization was invested in companies listed on either the New York Stock Exchange or the Nasdaq Stock Market. The Tokyo, London and Germany exchanges accounted for an aggregate market capitalization of $6.1 trillion of the remaining capitalization.[3]

As corporations and borrowers have expanded into new international markets for their products, they have looked beyond their home country borders for capital. An increasing number of foreign companies routinely raise or borrow capital in U.S. financial markets, and U.S. investors have shown interest in investing in foreign enterprises.

Over the last fifteen years, the number of foreign companies listing in the U.S. capital markets has increased steadily. In 1986 there were 322 foreign registrants. In subsequent years, the number has grown as follows:

1990	434
1995	744
2000	1310

At the end of 2000, these foreign registrants included companies incorporated in 59 countries throughout the world. The U.S. capital markets and investors have provided capital for a wide variety of companies, in many industries and in many

[2] See The Financial Times, June 14, 2001, ***Anglo-Saxons help reluctant German groups to open up: Changes in accounting methods alter results disclosure says Uta Harnsichfeger***.

[3] New York Stock Exchange Quick Facts at http://www.nyse.com.marketinfo/marketcapitalization.html

countries. The summary of foreign companies registered and reporting with the Securities and Exchange Commission (SEC) as of December 31, 2000 are as follows: [4]

	Number of Companies	Percentage Of Total
Canada	481	36.7%
United Kingdom	143	10.9
Israel	101	7.7
Mexico	42	3.2
Netherlands	42	3.2
France	35	2.7
Brazil	34	2.6
Australia	32	2.4
Bermuda	32	2.4
Japan	27	2.1
Chile	26	2.0
Germany	26	2.0
Other countries (9) with 10 To 25 companies	142	10.9
Other countries with 9 or Fewer companies	147	11.2
Total	1310	100.0

The above companies are listed on the New York Stock Exchange (417), the American Stock Exchange (48), the Nasdaq Stock Market-National Market System (360), the NASDAQ Stock market-Small Cap Market (64) and the Over-the-Counter Market (421). An analysis of the accounting principles followed in the financial statements the companies file with the SEC shows that approximately 872 use home country generally accepted accounting principles (GAAP), 365 use U.S. GAAP, 49 use standards promulgated by the International Accounting Standards Committee (IASC) standards, and the remaining 24 use some other type of accounting principles (e.g., those of another country).[5]

The growth in foreign company listings has been indicative of the strength and attractiveness of the U.S. capital market to those companies. It is also indicative of the desire of foreign issuers to compete for access to the capital of those markets, as well as investors desire to provide them with the capital. Without a doubt, the U.S. capital markets provide foreign companies many benefits such as capital at a lower cost, a higher level of liquidity, and a source of stock that can be readily used in acquisitions.

---

[4] U.S. Securities and Exchange Commission, Foreign Companies Registered and Reporting with the U.S. Securities and Exchange Commission, December 31, 2000. Office of International Corporate Finance, Division of Corporation Finance.

[5] The International Accounting Standards Committee was restructured during 1998 to 2000 and commenced operations as the International Accounting Standards Board (IASB) in 2001. Standards of the IASC are commonly referred to as International Accounting Standards (IAS) and those of the IASB are referred to as International Financial Reporting Standards (IFRS).

MEETING THE CHALLENGES AND OPPORTUNITIES FOR THE MARKETS AND INVESTORS

The SEC has explored ways to permit foreign issuers to compete with U.S. domiciled companies for access to the U.S. capital markets. At the same time the SEC has worked to ensure U.S. investors will continue to have access to high quality financial information. As a result, the SEC has taken a number of steps to further facilitate the access of foreign companies to the U.S. capital markets including among other activities:

- Chairmen and members of the Commission have actively worked with the stock exchanges to encourage foreign companies to access the U.S. capital markets and list with the exchanges.

- The SEC has adopted international disclosure standards endorsed by the International Organization of Securities Commissions (IOSCO).[6]

- The SEC has also permitted companies to register with the SEC using accounting principles accepted in their home country in their basic financial statements provided they disclose in the footnotes to those financial statements an audited reconciliation of those numbers to what the numbers would be using U.S. GAAP with a few limited exceptions.

- The SEC has permitted foreign companies to undertake initial public offerings with fewer years of audited financial statements or with financial statements audited by an auditor whose independence must be established for only the most recent years. Both of these positions have eased the public requirements for foreign registrants that would otherwise be applied to their U.S. counterparts.

- The SEC has permitted foreign filers to provide less current and timely information by exempting them from having to comply with requirements that U.S. companies must meet for filing on a quarterly basis, financial statements and Management's Discussion and Analysis (MD&A) as well as certain annual proxy disclosures such as those related to audit committees.[7]

---

[6] Securities and Exchange Commission Release Nos. 33-7745: 34-41936: International Series Release No. 1205, International Disclosure Standards, published in the Federal Register October 5, 1999.
[7] See for example Securities and Exchange Commission Release Nos. 34-422266; File No. 7-22-99, Audit Committee Disclosure, December 22, 1999 in which the Commission stated:

A. Foreign Private Issuers

We proposed to exclude from the new requirements foreign private issuers with a class of securities registered under Section 12 of the Exchange Act or that file reports under Section 15(d) of the Exchange Act. Foreign private issuers currently are exempt from the proxy rules, are not required to file Quarterly

- The SEC staff often work closely with foreign companies in preparing for a registration allowing them to file “drafts” of their registrations on a “private” basis and receive the staff’s comments on the drafts before more formal filings are made that become public. U.S. companies are not afforded this accommodation.

Notwithstanding the above efforts of the SEC to make it easier for foreign companies to rise capital in the U.S. markets, other significant issues may result in companies choosing other venues for sources of capital. Some of these may also cause private companies in the U.S. to avoid going public. They include a desire to:

- Avoid the transparent disclosures required by public markets including financial statement disclosures, proxy disclosures such as those about officer’s compensation, and discussions about trends in the business and its operating results.
- Keep information from competitors that may otherwise have to be disclosed if a company were to trade publicly.
- Avoid the potential for securities litigation.
- Avoid the short term earnings focus of analysts and the markets.
- Maintain corporate governance structures that are not conducive to attracting capital in the public markets.

ENSURING INVESTOR PROTECTION

The SEC has taken reasonable steps to ensure investors receive reliable, transparent financial information while providing the types of accommodations cited above. The SEC has required that audits be conducted in accordance with U.S. Generally Accepted Auditing Standards (GAAS). The SEC has also continued to require auditors to comply with the applicable SEC independence requirements for auditors.[8]The result has been that foreign issuers may list in the U.S. exchange market

---

Reports on Form 10-Q or 10-QSB, and are subject to different corporate governance regimes in their home countries. Accordingly, we do not believe it is appropriate to extend the new requirements to foreign private issuers at this time. The Commission, however, is continuing to consider how the periodic reporting requirements for domestic companies should apply to foreign private issuers. (footnotes omitted)

[8] Securities and Exchange Commission Release Nos. 33-7919; 34-43602;IC-24744;IA-1911;FR-56; File No. S7-AH91; Revision of the Commission’s Auditor Independence Requirements; November 21,2000. In this release the Commission noted that some encouraged it to adopt a “conceptual approach” put forward by the European accounting profession but in deciding to continue to require auditors of foreign registrants to comply with the SEC’s rules noted:

while submitting financial statements prepared in accordance with accounting standards permitted in their home country, IASC accounting standards, or U.S. GAAP, so long as a reconciliation is made to U.S. GAAP, and so long as the financial statement audits are conducted according to U.S. auditing standards, including auditor independence standards. Thus U.S. disclosure standards and enforcement of those standards has centered on high quality accounting standards, audit performance, and acceptable auditor independence standards. This is consistent with the following statement of the SEC on April 11, 1996:

> "The Commission supports the IASC's objective to develop, as expeditiously as possible, accounting standards that could be used for preparing financial statements used in cross-border offerings. From the Commission's perspective, there are ***three*** key elements to this program and the Commission's acceptance of its results:
>
> - The standards must include a core set of accounting pronouncements that constitutes a comprehensive, generally accepted basis of accounting;
> - The standards must be of high quality – they must result in comparability and transparency, and they must provide for full disclosure; and
> - The standards ***must be*** rigorously interpreted and applied." (emphasis supplied)[9]

In the SEC's Concept Release on International Accounting Standards, the SEC noted that accounting standards need to be of high quality, but as noted above and equally important, they must be rigorously interpreted and applied. ***Standards that are not followed in essence do not result in standards at all***. As a result, the SEC went on to set forth the elements that need to exist in the global accounting infrastructure to ensure standards are followed as written and intended. [10]

"We understand that many regulators do not agree with the conceptual approach, and several foreign countries prohibit certain non-audit services though standards vary from country to country. Standards vary for a number of reasons, including that in some countries, audits are conducted by statutory auditors who are directly responsible to shareholders and in some cases audits may be conducted for other than financial reporting purposes.

We believe that our final rules combine important and useful elements of both approaches…The four factors provide guiding principles for the Commission, similar to what a 'conceptual approach' would provide. (footnotes omitted)".

The release also references a letter from Phillipe Danjou, Chief Accountant of the COB, to Lynn Turner in which he states "I can assure you that many regulators in Europe (mainly continental Europe) do not agree with the FEE's [conceptual] approach and have made their views known to the European Commission…" See also Letter from Michael Prada. President, COB, to Marilyn Pendergast, Chairman, Ethics Committee, IFAC (September 15, 2000) stating "The proposed change from a prescriptive approach to a framework approach is flawed by the absence of a clear definition of an auditor's unique role and position." These letters are available at the SEC website

[9] SEC Statement Regarding International Accounting Standards, April 11, 1996.

[10] Securities and Exchange Commission Release Nos. 33-7801;34-42430; International Series Release No. 1215; File No. S7-04-00, International Accounting Standards. (Hereafter, "Concept Relase") See Ruder paper p.2

As international financing activities have grown, the SEC has ensured the quality of information provided to investors by foreign registrants. This has been accomplished to a great extent through its review and comment process. That process results in the SEC staff identifying circumstances when it believes filers have not complied with the applicable home country or IASB pronouncements.[12] At the same time the accounting profession has also taken steps to improve the quality of the enforcement of the standards. For example, at the urging of the SEC staff, the SEC Practice Section (SECPS) of the American Institute of Certified Public Accountants (AICPA) adopted membership rules enhancing the quality controls over reviews of filings by foreign companies with the SEC.

However, the SEC will in all likelihood not be capable of being the sole regulator who enforces the implementation of international accounting and auditing standards. The ultimate acceptance of such international standards by their ultimate customer, the investing public and capital markets, will be dependent on their rigorous implementation and application on a global basis. That will take, without a question, the cooperation among:

- The regulator's of the world's capital markets, including the SEC.
- The international and national accounting standard setters working in close cooperation with the regulators.
- The international and national auditing standard setters working in close cooperation with the regulators.
- The support of major international financial institutions such as the World Bank and International Monetary Fund who are stakeholders in quality financial reporting and enhanced international transparency.
- The support of governments around the globe who may well have to adopt changes in laws and regulations to support enhanced accounting standards, rigorous audits, and provide the regulators of the capital markets and accounting profession, appropriate enforcement capabilities.

---

[11]

[12] See speeches of the staff for examples of situations in which foreign registrants were not in compliance with applicable GAAP and were required to correct their accounting including International Reporting Issues, Craig C. Olinger, Deputy Chief Accountant, Division of Corporation Finance, December 6, 2000; International Reporting Issues, Travis Gilmer, Professional Accounting Fellow, Office of the Chief Accountant, December 6, 2000; and International Reporting Issues, Donald J. Gannon, Professional Accounting Fellow, Office of the Chief Accountant, December 8, 1999. In the speech by Mr. Olinger, he notes that there had been at least 40 restatements of financial statements or U.S. GAAP reconciliations in just the previous two years. It has been the SEC staff practice that when such issues arise, they do periodically consult on a no-name basis with the FASB or its staff and national offices of major accounting firms to obtain their viewpoints. The author's experience has been that often the FASB staff and/or the national office views are consistent with those of the SEC staff.

Enforcement capabilities and actions of regulators and governments around the world differ significantly. The self discipline and regulation by the accounting profession also varies greatly on a global basis. Some regulators review filings for compliance with the applicable disclosure and accounting standards. Others do not and in fact may not have the statutory authority to do so. The SEC has an enforcement division that undertakes to enforce the applicable rules and regulations. Other organizations such as the European Commission (EC) and national securities regulators do not currently have such capabilities or statutory authority. For example, during his tenure as Chief Accountant, the author was asked by a G-7 country accounting standard setter if the SEC would be willing to enforce their accounting standards as there were no other substantive enforcement mechanisms in place for these standards.

THE CHALLENGE OF ACHIEVING HIGH QUALITY FINANCIAL REPORTING ON AN INTERNATIONAL BASIS

Many have stated the need for achieving convergence on an international basis on a single set of high quality accounting standards for use in cross-border filings.[13] The SEC has worked in close cooperation with other members of IOSCO to achieve this goal. However, to actually achieve high quality standards that result in transparent standards that consistently reflect the economics of the reporting enterprise, whose principles are applied in spirit as well as written, and that are enforced so as to provide investors and the markets with confidence in the financial information, it will take more than just the development of quality accounting standards. It will also require that preparers, accounting and auditing standard setters, regulators and governments focus on the following issues:

Interpretation as well as development and implementation of accounting standards based on a goal of achieving transparency for investors and the world's capital markets.

Performance of independent audits which will require:

- The development of high quality international auditing standards in sufficient detail to provide guidance that will result in rigorous audits and reasonable assurance with respect to the reported results;
- Timely training and education on the applicable accounting and auditing standards.
- Quality control standards and processes within accounting firms that audit foreign companies who do cross-border filings;
- Active monitoring, oversight and discipline of audit firms and their personnel; and

---

[13] For example see the May 23, 2000 comment letter of the European Commission Director General to the SEC responding to the SEC Concept Release on International Accounting Standards,

- Independence standards for auditors that prescribe and prevent conflicts that reasonable investors would believe impair the auditor's independence.

Effective regulatory schemes by securities regulators and/or governments that provide enforcement of the applicable accounting, disclosure and auditing standards and discipline for those market participants who chose to not to comply with the appropriate standards, laws and regulations.[14]

It is critical that all market participants cooperate in working on the objectives outlined above. For example, if a country's laws require auditors to follow national standards that are of lower quality, or result in lower quality audits, the goals outlined above cannot be achieved without the government changing its laws and regulations. Likewise, audit firms and the accounting profession must adopt standards that are developed based on a mission of how can the investing public and capital markets best be served. Firms can take steps to upgrade the quality of their audits to a more consistent and higher quality approach on a global basis so that investors clearly understand the quality of the product they are receiving when they read the auditors report on a set of financial statements, regardless of the jurisdiction in which they are prepared. Likewise, regulators must come to grips with issues they face in ensuring compliance with standards applicable to cross-border offerings. Failure to do so in a timely fashion can only result in either a lack of investor confidence in the financial information they receive, which in turn increases the cost of capital and decreases efficiency in the markets, or a delay in the adoption on a global basis of international accounting standards for cross-border filings.

[14] See also SEC Concept Release, Supra n.10, page 6.

TOWARDS CONVERGENCE OF INTERNATIONAL ACCOUNTING STANDARDS

The SEC was given the authority by Congress to establish generally accepted accounting principles to be used by all companies, both foreign and domestic, who register with it and trade their securities in the U.S. capital markets. However, the Commission early on decided to look to the private sector accounting standard setting bodies for the development of accounting standards. Since1938, the Financial Accounting Standards Board (FASB), an independent private organization, and its predecessors have created the GAAP that are accepted by the SEC for use in corporate financial statements filed with it.[15] But the SEC has retained its authority to establish accounting standards when it believed private sector standards did not provide adequate protection for investors.[16]

The growth in the number of foreign issuers seeking access to the U.S. capital markets has raised the interest in the use of international accounting standards for cross-border filings with the SEC. The acceptance by the SEC of such standards would lessen the burden of those foreign companies who use international accounting standards from having to obtain the information necessary for preparing the reconciliation from IASB standards to U.S. GAAP. It is also important to note that the EC has presented a proposal for a regulation that would require all European Union (EU) companies listed on a regulated market to prepare consolidated accounts in accordance with International Accounting Standards (IAS).[17] .

The IASC was formed in 1973 by the International Federation of Accountants (IFAC), a group of private accounting organizations, for the purpose of promulgating IAS.[18] Until 2001, the IASC's business was conducted by a board of sixteen voting delegations and five non-voting observers with the privilege of the floor. The delegations were drawn from the accounting profession and preparers of financial statements, were part-time volunteers and met approximately four times a year.

In 1990, IOSCO endorsed the development of internationally acceptable accounting standards for use in cross-border filings. By 1994, IOSCO had completed a review of the IASC standards and through this process identified a number of standards

---

[15] See Securities and Exchange Commission Accounting Series Release No. 4, Administrative Policy on Financial Statements, April 25, 1938; Securities and Exchange Commission Release No. 150, Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards, December 20, 1973.

[16] For example, the SEC has issued amendments to its Regulation S-X, Accounting Series and Financial Reporting Releases over the years providing guidance on such issues as consolidated financial statements, redeemable preferred stock, income taxes, lease accounting and disclosure, capitalization of interest and software development costs, and accounting by oil and gas producers. In addition, the SEC staff periodically issues Staff Accounting Bulletins (SABs) that are not rules of the Commission, but which do provide companies and their auditors, especially smaller firms, with the staff's interpretations of the accounting standards and rules.

[17] See http://europa.eu.int/comm/internal_market/en/company/account/news/ias.htm for "Financial reporting; Commission proposes requirement for listed companies to use International Accounting Standards by 2005."

[18] IFAC is a private accounting organization of 153 professional institutes in 113 countries.

that required improvement before IOSCO would consider endorsement of IASC standards for use in cross-border filings. In 1995, the IASC and IOSCO agreed to a work program, commonly referred to as the "core standards" project.[19] Upon completion of the core standards project in 1999 by the IASC, IOSCO undertook another review of those standards. As a result of that review, in May 2000, IOSCO recommended that its members accept the IAS, as supplemented by additional requirements for reconciliation, interpretation, or disclosures where necessary to address any outstanding issues. The SEC's current rules and reconciliation process is consistent with IOSCO's resolution.

During the late 1990's, a Strategy Working Party (SWP) undertook to restructure the IASC into an improved and new structure for creating accounting standards. A number of interested parties, including the SEC and other securities regulators, worked closely with the SWP to develop a more effective board whose members were to be chosen based on their technical competence as opposed to geographical location. In addition, the structure that emerged also ensured the board members would be independent and free of potential conflicts with their serving the public interests. The new structure also provided for a new Standards Advisory Council (SAC) and the continuation of the boards interpretive body, the Standing Interpretations Committee (SIC). The new International Accounting Standards Board (IASB) held its first technical session in April, 2001. One of the key features of the new IASB is that it emphasizes cooperation with national accounting standard setters in creating "International Financial Reporting Standards" (IFRS).

Convergence was one of the crucial aspects of the SWP's proposal. In its December 1998 Discussion Paper, the SWP stated that it believed that "IASC's short-term aim should be for national accounting standards and International Accounting Standards to converge around high-quality solutions" and that:"IASC's aim in the longer term should be for global uniformity – a single set of high-quality accounting standards for all listed and other economically significant business enterprises around the world."[20]

The SWP's December 1998 Discussion Paper emphasized the need for convergence of accounting standards. By working closely with the national standard setters, it is hoped that the efforts of the IASB and those national standard setters will result in a "best of breed" set of standards and common viewpoints on what constitutes standards that will provide consistent, transparent financial reporting to investors that reflects the economic reality of the financial transactions. In turn this may very well increase the likelihood that national standard setters and the IASB would adopt similar, if not the same, accounting standards. Of course, there may be some countries where the national standard setter must appropriately reflect laws and business practices in their final standards.

---

[19] For a discussion of the IASC and IOSCO development of the work program as set forth in two June 17, 1994 letters from IOSCO to the Chairman of the IASC, Mr. Eiichi Shiratori, see the October 1997 Report on Promoting Global Preeminence of American Securities Markets in the public filing room of the Securities and Exchange Commission.

[20] Shaping IASC for the Future, A Discussion Paper issued for comment by the Strategy Working Party of the International Accounting Standards Committee, p. 57 (International Accounting Standards Committee, December 1998)

A lot of attention has been paid to whether the SEC would accept IASB standards in lieu of its reconciliation to U.S. GAAP requirements. The comment letters the SEC received on its Concept Release were, quite expectedly, divided as to their response based on where the respondent was located. U.S respondents in general believed that IASB standards are not yet of sufficient quality and effective enforcement mechanism does not exist to ensure their proper implementation and application. For example, IBM stated:

> "We do not believe that IAS ensures the same quality reporting that U.S. GAAP ensures, and strongly believe that IAS are not acceptable accounting standards for companies filing on the U.S. exchanges….IAS lack an enforcement mechanism. At times, certain enterprises that have asserted that their financial statements are in compliance with IAS have been found not to be in compliance."[21]

McDonald's Corporation stated:

> "…we do not believe that foreign private issuers should be allowed to file financial statements prepared solely under IAS as they exist today because we do not believe current IAS are of a high enough quality to ensure that U.S. investors have the appropriate information to making proper investing decisions. Therefore, if financial statements were allowed to be prepared under current IAS, it may place more investors at risk and create a competitive disadvantage to companies who file financial statements prepared under U.S. GAAP."

The vast majority of U.S. respondents expressed concerns related to the IAS permitting the use of alternative accounting principles, a lack of the necessary supporting infrastructure and a lack of effective discipline. However, most European respondents expressed a belief that the SEC should withdraw its reconciliation requirement and permit the use of IAS standards in filings with the SEC.

A notable comment was made by the AICPA which has been an active participant and supporter of the IASC. In its comment letter the AICPA stated "With the convergence of IAS and national regimes around high quality standards, fewer reconciling items will exist over time and, at a future date, reconciliation will become unnecessary. By convergence, we mean a movement toward higher quality standards from all jurisdictions, not simply a movement toward IAS or only toward U.S. GAAP or some other existing regime." With the new IASB establishing liaisons with the major national accounting standard setters, it appears that the accounting profession is moving in the direction suggested by the AICPA. A continuation of these efforts will result in the elimination of differences in accounting principles through a private sector initiative of the IASB and national standard setters. This in turn would eliminate the need for reconciliation for filings with the SEC.

[21] Others expressing similar viewpoints included the Business Round Table and Pfizer.

One recent hurdle that has been placed in front of the IASB gaining acceptance of its standards is the newly formed European Commission European Financial Reporting Advisory Group of its Technical Expert Group.[22] The EC has stated: The establishment of an endorsement mechanism at the EU level is necessary because it is not possible politically, nor legally, to delegate accounting standard setting unconditionally and irrevocably to a private organization over which the EU has no influence…The endorsement mechanism will also examine whether the standards adopted by the IASC conform with EU public policy concerns." [23] It is widely known that the staff of the EC preferred a restructured IASB whose members were chosen based on geography. This endorsement mechanism allows the EC to gain input from its member states and use that information in deciding whether to accept IASB standards, and apparently influence the IASB decision-making. However, the EC has not published any criteria by which it will evaluate prospective standards of the IASB. If the EC uses this endorsement mechanism in a heavy-handed fashion or to sway the deliberations and final standards of the IASB, it likely will result in other regulators considering how they will interact with the IASB.

ISSUE

> Are the IASB and national standard setters likely to be successful in achieving convergence around a set of high quality, "best of breed" International Financial Reporting Standards? Should the private standard setters or SEC undertake to eliminate reconciling differences? Should each regulator, including IOSCO, adopt an endorsement mechanism?

INTERPRETATION OF INTERNATIONAL ACCOUNTING STANDARDS

It is one thing to write an accounting standard. It is quite another thing to have to interpret it and apply the guidance in the standard to the billions of actual transactions that occur in the business world. This is especially true if the standard provides "broad general principles" to be followed without further implementation guidance.[24]

---

[22] For additional information concerning this organization, see http://europa.eu.int/comm/internal_market/en/company/account/news/creationeteg.htm.

[23] Proposal for a Regulation of the European Parliament and of the Council on the application of International Accounting Standards, Commission of the European Communities, COM(2001) 80 final, Explanatory Memorandum p. 4 (February 13, 200l) (hereafter EC Proposal) see also EU Press Release IP/01/…at www.iasc.org.uk (26 June 2001). More details regarding this proposal are contained in the Ruder paper.

[24]

[25] Id.

[26] Id.

[27] Id. at 5

[28] Id. at 5

[29] EU Press Release IP/01/… at www.iasc.org.uk (26 June 2001***).***

[21] It has not been uncommon in the U.S. that a preparer would insist on an accounting treatment while noting there is nothing in an accounting standard that expressly prohibits the proposed accounting. The

Accordingly, companies who follow IFRS's standards, as well as their auditors and regulators, will have to interpret them.

In the United States, the FASB and its Emerging Issues Task Force (EITF) interprets U.S. GAAP. The FASB does not approve the guidance adopted by the EITF and the EITF is not required to adopt the most transparent accounting from among the alternatives considered. However, the FASB may take formal action and reverse a consensus of the EITF but has only done so once. [25] The SEC Chief Accountant is an observer to the EITF and has the right of the floor. Periodically when the staff has considered it appropriate, the Chief Accountant has objected to a proposed or final consensus of the EITF being applicable to public companies. The SEC and its staff also exercise their statutory authority when necessary and interpret GAAP. Often registrants may request the staff's interpretation of an accounting standard, especially if they are trying to expedite a filing.

At the IASB, the IFRS are interpreted by the SIC. A SIC interpretation must be approved by the IASB prior to its adoption; a process some believe is superior to that of the FASB. In addition, as the IFRS are expected to be broader principles based standards with less interpretive guidance than is typically provided in U.S. GAAP, interpretations of the standards will also be done by preparers and their auditors.

The SEC and banking regulators will also be interpreting international accounting standards. The SEC has the statutory authority and mandate to ensure investors are adequately protected through the disclosures and financials information they receive. The International Accounting Standards Survey 2000 written by David Cairns, the former Secretary General of the IASC, cites numerous examples of companies who disclose they are using IAS but who are not in compliance with the standards. [26] Accordingly, it is expected the SEC staff will review the financial statements filed with it in order to make sure that the accounting standards used have been properly applied

ISSUE

SEC staff has also observed similar explanations by foreign registrants. This makes enforcement of principle based standards much more difficult for an auditor. It has also resulted in diversity in practice and a lack of comparability in reporting for similar transactions by registrants.

[24] It has not been uncommon in the U.S. that a preparer would insist on an accounting treatment while noting there is nothing in an accounting standard that expressly prohibits the proposed accounting. The SEC staff has also observed similar explanations by foreign registrants. This makes enforcement of principle based standards much more difficult for an auditor. It has also resulted in diversity in practice and a lack of comparability in reporting for similar transactions by registrants.

[22] The FASB staff issued FASB Technical Bulletin No. 90-1, Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts which nullified the EITF's consensus on Issue No. 89-17.

[25] The FASB staff issued FASB Technical Bulletin No. 90-1, Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts which nullified the EITF's consensus on Issue No. 89-17. See footnote 11 for references to staff cites.

[26] International Accounting Standards Survey 2000, David Cairns at www.cairns.co.uk/survey-introduction.asp

With interpretations being made by at various interpretative bodies, preparers, auditors and regulators, a challenge exists with respect to ensuring convergence with interpretation of the standards. High quality standards require consistent, comparable financial reporting by companies for similar types of transactions. Accordingly, the issue arises with respect to what appropriate steps can and should be taken to ensure that interpretive bodies, preparers, auditors and securities regulators will interpret and apply IFRS and U.S. GAAP in a consistent and effective manner.

PERFORMANCE OF EFFECTIVE AUDITS

Performance of an effective audit that provides investors with reasonable assurance that the financial statements ***and*** disclosures have been prepared in compliance with the applicable accounting standards requires the establishment of a supporting infrastructure. Elements of such an infrastructure must include:

- Effective, independent and high quality accounting and auditing standard setters;
- High quality auditing standards;
- Audit firms with effective quality controls worldwide;
- Profession-wide quality assurance; and
- Active regulatory oversight. [27]

EFFECTIVE AUDITING PROCEDURES ARE NECESSARY FOR ENFORCEMENT OF ACCOUNTING STANDARDS

Audits are considered an integral part of the capital markets system, including for foreign registrants, as they provide investors confidence that an independent third party, separate and distinct from management who prepares the financial statements, has examined the numbers and found them to be presented in accordance with the accounting principles applied. Accordingly, auditing is an important and critical part of ensuring effective financial disclosure.

The international audit firms are composed of national firms that have entered into international affiliations and have typically created an international entity that shares costs in marketing the firm on a global basis, as well as working to ensure consistency in the delivery of services to the firms' global clients. However, these structures also affect the governance of the firms, as well as their ability to establish and enforce global auditing, quality control and independence standards.

---

[24] SEC Concept Release, page 3.
[27] SEC Concept Release, Supra n.10, page 3

Auditing has a critical role in minimizing the risk of fraudulent financial reports. Competent and rigorous auditing is also needed to prevent a lack of comparability in financial reporting. As noted above in the 1999 and 2000 were surveys conducted by David Cairns, former Secretary-General of the IASC, numerous instances of companies purporting to follow international accounting standards but in fact not complying fully with such standards, while at the same time receiving a "clean" report from their auditor.[28] The Commission staff's own review of foreign issuer filings has indicated that many interpretation and compliance problems exist, necessitating restatement of primary financial statements even before reconciliation to U.S. GAAP. [29]

TRAINING AND EDUCATION

As set forth above, the number of companies utilizing IASB standards in the U.S. capital markets, as compared to those using home country or U.S. GAAP are relatively small. Many of the core standards developed by the former IASC have effective dates that are also fairly recent. [30] As a result, many preparers, auditors and regulators lack the knowledge of these standards that may be required to implement them in a quality fashion. As a result, the major international accounting firms have been building up their technical resources in Europe, in anticipation of the EC's move to international standards. However, the conversion of thousands of European companies to these standards, which entails a tremendous learning curve, changes in information systems and training of accounting staff in companies and auditing staff in accounting firms is without a doubt, a daunting task.

ISSUE

What steps have been taken and what must yet be done to educate preparer's, auditors and regulators with respect to IAS's and IFRS's? Are sufficient resources available to accomplish the education and training necessary to ensure these standards are properly implemented when first applied?

DEVELOPMENT OF GLOBAL AUDIT QUALITY CONTROL AND MONITORING SYSTEMS

At the urging of Congress and the SEC, the AICPA and U.S. auditing firms established the Public Oversight Board (POB), the AICPA Division for Firms, the SECPS and SECPS Executive Committee in approximately 1977. Within the structure of the SECPS, the accounting profession has established membership requirements and quality control and monitoring systems for the performance of audits. In the 1980's,

[25] Cairns, supra, n.23
[28] Cairns, Supra n.26
[26] International Accounting Standards Survey 2000, David Cairns
[29] Id.
[27] SEC Concept Release, See Appendix B for the effective date of the standards issued as part of the core project. Thirteen of the 31 standards had effective dates of January 1999 through January 2001.
[30] SEC Concept Release, See Appendix B for the effective date of the standards issued as part of the core project. Thirteen of the 31 standards had effective dates of January 1999 through January 2001.

the AICPA created the Quality Control Inquiry Committee to consider if in cases of alleged audit failures, there is information that would suggest the audit process should be improved. The SEC actively oversees the work of the SECPS and the POB.

However, these quality control and monitoring systems have been mainly focused on the audit procedures and work performed in the United States. As large international companies such as IBM, Coca Cola and General Motors became more global, an increasing percentage of the audit has been performed by affiliates of the U.S audit firm. This has resulted in an increasing part of the audit being outside the reach of the quality controls established here in the U.S.[31] In some instances, a question has been raised as to whether inappropriate financial reporting has been directed to that segment of the business outside the U.S. In addition, the growth in the number of foreign registrants has also increased the number of audits that are not subject to the type of quality controls and monitoring systems that ensure the quality of audits performed in the U.S.

The Panel on Audit Effectiveness issued its report on August 31, 2000.[32] Staff of the Panel met with the members of IOSCO's Working Party No. 1 and subsequent to the issuance of the report, an auditing subcommittee of WP No. 1 has been formed. That report made a number of important recommendations including:

- Establishment of a global-self-regulatory structure to monitor and report on the activities of individual country self-regulatory organizations. The report notes the primary goal of this oversight body is to serve the public interest and that it should be established through a mechanism that "ensures its independence and viability."

- There should be comprehensive annual reports by the oversight body to the public.

- Audit firms should "Implement uniform audit methodologies throughout the world that use international auditing standards as the base ***minimum (emphasis supplied and footnote omitted)***.

- A key element of quality assurance should be external reviews of the quality controls of audit firms over their accounting and auditing practices.

The accounting profession has initiated projects to respond to concerns about the quality of international audits. Perhaps the most progressive action taken to date has been that taken in the United Kingdom. The U.K. Department of Trade and Industry has established a regulatory system for audits that includes (1) an oversight body (The Foundation), (2) an audit review board, (3) an auditing practices board to set auditing

---

[31] The U.S. Quality controls and peer review procedures related to international audits typically focus on the instructions the U.S. firm provides to its international affiliates.

[32] The Panel on Audit Effectiveness, Report and Recommendations, August 31, 2000. The report is available at www.pobauditpanel.org.

standards, (4) an ethics standards board, and (5) an investigations and discipline board.[33] This proposal is currently in the process of being implemented in the U.K.

IFAC and audit firms performing international audits have undertaken projects to improve the quality of audits. These projects include the improvement of international auditing standards through IFAC's International Auditing Practice Committee (IAPC) , the establishment of a proposed Forum of Firms (the Forum) and the Transnational Auditors Committee of the Forum (its executive committee), and a proposed Public Oversight Board (IFAC POB).[34] These projects are still under development and the ultimate impact they will have on the quality of international audits remains to be seen. One proposal, that a firm on firm peer review system be established, is proposed for completion on an international basis, including engagement reviews, by no later than 2005.[35]

IFAC proposes to establish the operating procedures for the IFAC Public Oversight Board (IFAC POB) in its proposed charter. The draft charter notes the IFAC POB will be a seven member Board of independent highly respected individuals charged with the responsibility of overseeing the public interest activities of IFAC, particularly the setting of auditing standards, compliance by member bodies, and the quality assurance, compliance and other self-regulatory processes of IFAC, including oversight of the system of Quality Assurance Review under TAC. The charter establishes a system of self regulation that is missing several of the components of the system proposed by the Panel on Audit Effectiveness and that are part of both the U.S. and U.K systems. These include the rights of the proposed POB to carry out investigations it deems necessary, to discipline members and to appoint members or chairs of those committees of the profession under its oversight. In addition, the proposed funding for the IFAC POB is ***significantl***y less than that provided to the U.S. POB which raises questions regarding its future ability to function in a meaningful manner.[36] Finally, while the IFAC POB is to operate independently of IFAC, the final decision on the POB's initial members rests with IFAC.

The SEC's 2000 Annual Report sets forth critical elements and characteristics that are needed for an international public oversight organization to be effective. It states that "Among these elements are the following:

- The selection of the initial members of the oversight organization, including a chairman, should only be finalized after seeking and receiving consideration

[33] Department of Trade and Industry, A Framework of Independent Regulation for the Accountancy Profession, November, 1998 available at http://www.dti.gov.uk/cld/framework/index.htm
[34] See http://www.ifac.org/News/LatestReleases for IFAC's Request for Comment on Proposals for Establishment of the IFAC Public Oversight Board and IFA Forum of firms. This includes links to the draft constitution and operating procedures of the Forum of Firms.
[35] Request for Comment on Proposals for Establishment of the IFAC Public Oversight Board and IFAC Forum of Firms, IFAC News and Events, October 18, 2001, www.ifac.org
[36] The initial annual budget for 2001 as proposed is not to exceed $1 million and increase to $2.5 million for 2004 and subsequent years. The U.S. POB has a budget of approximately $5 million.

from international organizations representing the public interest, including securities regulators;

- The members of the oversight organization should be public interest representatives without ties to the accounting profession;
- The funding for the organization's operations should be structured in such a manner that the organization can be independent in fact and in appearance; and
- Other characteristics noted by the staff include details relating to membership and review processes, reporting to the public and other matters."[37]

It will be important that the securities regulators and accounting profession around the globe reach an agreement on an appropriate and meaningful structure for the establishment of quality control systems, monitoring and discipline. The accounting profession has taken initial steps which are an improvement over the current system in many countries, but which are of lesser quality than those in some of the more developed countries. In addition, the proposed system does not provide for active ongoing oversight by the respective securities regulators, a key component of the U.S. system.

ISSUE

What should be the role of the profession, the role of the public and the role of regulators in the development of the necessary quality controls and monitoring systems for the performance of international audits?

ENHANCEMENTS TO THE AUDITING STANDARDS-SETTER

Over the last fifteen years, developments toward the improvement of auditing practices have also been occurring in the area of international auditing standards, though not with the same resources and level of intensity that has been devoted to accounting standards. Since the 1970's, IFAChas developed and issued a body of International Auditing Standards (ISAs). However, much of the content in these standards is in the form of guidelines and general principles for consideration, rather than in the form of specific requirements.

[37] Securities and Exchange Commission Annual Report 2000, pages 89-90.
[38] IFAC is a private accounting organization of 153 professional institutes in 113 countries.

On July 27, 1987, the staff of the SEC issued a report to Congress on "Internationalization of the Securities Markets". This report included coverage of the standards and status pertaining to audits of foreign issuers in the U.S. securities markets, noted that auditing standards differed among nations, and stated that "while accounting principles can be reconciled, auditing standards cannot." [39] The report further went on to state that, for foreign issuers registering in the U.S. capital markets, steps are taken by the SEC "to provide assurance that the examinations of financial statements by foreign auditors are as extensive and complete as those conducted by U.S. auditors."[40]

Harmonization of international auditing practices was also recognized as an issue in the 1987 Report. The report noted that "by July 1, 1987, the International Audit Practices Committee of the International Federation of Accountants had issued guidelines on professional ethics, pre-qualification education and training and twenty-four auditing guidelines plus three exposure drafts. Although the IFAC's auditing guidelines are impressive, they are not coordinated in the manner of the auditing standards generally accepted in the United States." In particular, it was noted that "IFAC international auditing standards cite audit procedures as examples of what an auditor may do, while, in contrast, they are required procedures under U.S. GAAS in appropriate circumstances." [41]

IFAC has recently established an International Auditing Practices Committee (IAPC) Review Task Force for the purpose of conducting a comprehensive review of the membership, organization, and processes of the IPAC. That Task Force published a proposal with recommendations for changes in the IPAC on July 18, 2001[42] and recommends IFAC and the IAPC adopt a number of changes, including:

1. Selection of members on based on professional competence.
2. Enlargement of the committee from 14 to 15 members, and including one public interest representative.
3. Greater interaction with national standard-setting bodies.
4. Improved due process with open meetings and published drafts
5. Strengthen the role of the Planning Committee
6. Removing ambiguity created by the IAPC's "black lettering.

[39] SEC Report to Congress on Internationalization of the Securities Markets, July 27, 1987
[40] Id.
[41] Id.
[42] Review of the Operations of the IFAC International Auditing Practice Committee", IAPC Review Task Force, International Federation of Accountants, www.IASC.org (July 18, 2001)

The accounting profession should reach out to securities regulators, including IOSCO and the SEC, and enable them to participate in a meaningful and effective manner in the oversight of audit standard setting. While the Task Force recommendations note they do not intend the IFAC POB or securities regulators to manage the process, they must both be given unrestricted oversight of the audit standard setting process and the resulting product if it is to gain market acceptance. Audit and quality control standards that do not provide sufficient detail to ensure effective audits that protect investors, will result in a lack of market credibility in the auditing process.

ISSUE

> In light of concerns over the quality of international audits, should the SEC continue to require the use of U.S. GAAS until further improvements are made to international auditing standards?

ACTIVE REGULATORY ENFORCEMENT MECHANISM

The SEC is one of the few, if not the only securities regulator, whose staff reviews filings on a selected basis to ensure compliance with the applicable disclosure standards, and that has an enforcement division that can undertake legal actions when necessary. In many countries such regulatory oversight does not exist and the securities regulator may not have the statutory legal authority to take enforcement actions when a company or its auditors violate financial reporting or auditing rules.[43] During the Asian markets crisis of 1997-98, it was noted that some of the Asian market regulators had very limited, if any real enforcement powers with respect to the performance of audits.

The SEC has also acknowledged the limitations of its own ability to gain access to necessary files and information when cases under investigation involve a registrant with foreign operations that have been audited by a foreign affiliate of a U.S. firm.[44] For example the SEC has noted the difficulty it has had in obtaining access to the work papers of foreign auditors or foreign affiliates of U.S. auditors. This has also been an issue for banking regulators. In such cases, the SEC has the potential to use a domestic compulsory mechanism, or memorandum of understandings or similar arrangements with non-U.S. regulators.

The U.K.'s new framework for the regulation of the accounting profession includes a proposed Investigations and Discipline Board. In the United States, the SEC and AICPA Ethics Executive Committee fill such a role. However, the SEC has noted in

[43] For example, the EC does not have the regulatory oversight and enforcement mechanisms the SEC does and the securities commissions in its member states do not all have such enforcement authority or oversight of the accounting profession.
[44] SEC Concept Release, Supra n.10, pages 17-18.

its annual report that the AICPA may not always take disciplinary action when the SEC has determined to do so.

ISSUE

What should and can be done to improve the regulatory oversight of international securities regulators and disciplinary mechanisms?

AUDITOR INDEPENDENCE

The SEC's new auditor independence requirements were adopted in November of 2000 after much public debate, numerous public hearings, and over 3000 comment letters from investors, the accounting profession, foreign and domestic regulators and many others. [45] The final rules that were adopted mirrored in many instances, previously existing rules of the AICPA and SECPS. [46]

Other countries also have requirements that establish rules governing the independence of auditors. In some of these countries, consulting services permitted in the U.S. are prescribed while other services prescribed by the SEC's rules may be permitted. In some foreign countries, accounting firms have established affiliated entities that provide services, such as legal services, that might be otherwise prescribed if they are performed directly by the auditing firm. There may also be varying degrees with respect to the actual enforcement of the rules. The SEC and its staff have expressed reservations with respect to the existence or effectiveness of quality controls that ensure the foreign affiliates of U.S. audit firms are complying with the applicable independence audit requirements.

In April of 2001 the Ethics Committee of IFAC proposed a draft entitled: "Independence - Proposed Changes to the Code of Ethics for Professional Accountants"[47] In contrast to the SEC's independence rules, the draft in many cases relies upon the auditing firm to assess whether a particular threat to the auditor's independence based on the auditors determination (rather than the investors) calls for an action to preserve independence. Accordingly, the auditor serves as one's own enforcer of the rules, rather than utilizing a separate enforcement mechanism.

Some securities regulators have expressed concern over the IFAC proposal. The President of the Commission des Operations de Bourse in a letter to IFAC stated:

> "However, we are particularly concerned with what seems to be a fundamental flaw in the basis of the argument: the proposed code is

[45] Revision of the Commission's Auditor Independence Requirements , Release Nos. 33-7919 and 34-40602, Nov.21,2000 at p2
[46] The question is often referred to as to the "appearance" of an auditor's independence and has been a cornerstone of the accounting profession's and SEC's rules and interpretations for many years.
[47] www.ifac.org, hereafter "the IFAC Independence Code" Additional comments regarding the IFAC proposal appear in the Ruder paper.

based on the assumption that a very wide range of non-assurance services can be provided by accountants to their clients….This conveys the impression that the audit of financial statements is just an ordinary business service as any other engagement…

We hold a different view. We believe that public accountants should make a clear choice with respect to their role to a given client: they should either elect to be the company's auditor or to be a multi-disciplinary consultant. To mingle the two roles would only lead to confusion in the public mind and weaken the confidence placed in the function of the independent auditor, the very foundation of reliable capital markets."[48]

Many U.S. investor's who testified at the SEC's public hearings or commented on the SEC's rule proposal on auditor's independence, felt the SEC should have taken a far more aggressive approach in the final rule. In the area of independence, the SEC faces substantial differences in practice elsewhere. It will have to decide whether to accept independence attitudes in other countries or continue with its recently adopted standards.

ISSUE

The basic issue that arises is whether securities regulators should accept international auditor independence requirements based on a standard of the appearance of independence to the reasonable investor or based on a determination by the auditor.

Conclusion

Quality financial reporting is critical to the efficient operations of the world's capital markets. Since its inception, the SEC has been a leader in ensuring investors have been provided with such information in the past.

But with the increasing expansion of all market participants beyond their national borders, the challenges of continuing to maintain quality and transparency in financial reporting has increased. Those challenges include protecting investors and international capital markets in an environment of exploding technology and fierce global competition.

These challenges require the coordinated effort of public companies, auditors, standard setters, regulators and governments. They cannot be met by just one or two of these groups. It is critically important that they all closely coordinate their efforts and devise and execute the changes needed for future success. These are changes that need to be made in a timely fashion, with input from the public, and with appropriate due

[48] Letter dated September 15, 2000 from Michel PRADA, President of the French Commission des Operations de Bourse to the Chairman of the IFAC Ethics Committee.

process. With such an approach, it is hopeful that a quality product will be developed that ensures the continued success of the world's capital markets. That success in turn should result in companies having access to capital that is so important to the global economy.