U.S. Securities and Exchange Commission

Speech by SEC Commissioner: Remarks Before the Institute for International Bankers Annual Conference

by

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U.S. Securities and Exchange Commission

Washington, DC
March 13, 2006

I wish to thank the Institute for International Bankers for inviting me to speak. Today I would like to spend some time discussing the status of the U.S.-E.U. dialogue and, specifically, the prospect of convergence of U.S. and E.U. accounting standards. In particular, I would like to discuss the adoption of International Financial Reporting Standards, or IFRS, as the single accounting standard in the E.U., starting with the requirement that European listed companies report using IFRS in 2005. I would also like to discuss the principles underlying the "roadmap" by which the Commission is considering accepting IFRS as a primary accounting system without requiring reconciliation to U.S. GAAP. Before I do, I must remind you that my remarks represent my own views, and not necessarily those of the Commission, my fellow Commissioners, or the staff.[1]

I often say, both in public statements and private discussions, that our regulatory challenges, and some of the most dynamic areas needing supervision, not only cross jurisdictional lines between U.S. regulatory regimes but also cross boundaries between regulated and non-regulated entities and across national boundaries as well. Advances in communications and information technology and the freedom of choice they bring to investors by providing an easy ability to access markets located many miles away, have allowed cross-border and global investment to flourish. Also, countries always desire strong, stable, and liquid capital markets to fuel economic growth, and such strength and liquidity rely in part on comprehensive quality accounting standards. Recognizing that regulation has global implications and knowing that embracing a common set of high quality accounting standards bolsters investor understanding and confidence, regulators have increasingly coordinated to achieve, where possible, some regulatory convergence. One area where coordination has yielded great results is auditor regulation, where the Commission and the PCAOB and their European counterparts have worked diligently together to reduce regulatory overlap and divergence.

There are many ways in which harmonizing two broadly-used accounting standards would benefit investors and the capital markets. Financial statements prepared using a common set of accounting standards help investors better understand and compare investment opportunities. Investor confidence in financial reporting is also likely to be stronger if the accounting standards used have been subjected to appropriate due process and have gained wide acceptance in practice. Further, in situations in which differing accounting standards are used — for example, as is the case in the United States where financial reporting under U.S. GAAP is the norm but the SEC also accepts financial reports from foreign private issuers using either IFRS or national accounting standards accompanied by a reconciliation to U.S. GAAP — investor confidence is likely greater if the differences between the standards are readily understandable and few in number. Embracing a common set of accounting standards would also lower costs for issuers.

There are clear downsides as well to not pursuing a common set of accounting standards. Specifically, if a company's financial statements are prepared using accounting standards which are viewed skeptically or with which the investor is unfamiliar, then investors may not be able to fully understand a company's prospects and thus may insist on a risk premium for an investment in that company. And, at the extreme, if as a result of companies using weak or incomplete accounting standards it becomes excessively time-consuming or difficult for investors to distinguish good investment opportunities from bad ones, investors may choose instead to invest in what they consider to be safer opportunities.

For all these reasons, I think nothing could be more important to global markets than to have one or two widely-used and accepted accounting standards whose minimal differences are acknowledged and well-understood. And the opportunity to forge such a harmonization of standards appears to be well at hand.

The E.U. is now attempting to forge a single capital market across 25 different countries with widely varying financial cultures, legal traditions, and disclosure standards. Accounting standards are just one part of a much larger project. The E.U. has been working diligently towards a unified financial market. Issuers, for their part, understandably are seeking certainty, and would like to know that they can report using IFRS without needing to reconcile with U.S. GAAP. Ideally, convergence of IFRS and U.S. GAAP principles would allow the United States and other markets to capitalize on the benefits of a single set of globally accepted accounting standards because such convergence will reduce differences between IFRS and U.S. GAAP, while at the same time taking both to a higher quality level.

As you know, accounting standards in the U.S. have a long history, of over 70 years. In this time U.S. GAAP has been tested and refined as markets have grown and evolved. U.S. GAAP currently is used by more than half the world's issuers and has been applied to a wide range of industries. Its strengths and weaknesses are well understood. It has been our experience that investor confidence in financial reporting standards and the capital markets they serve is stronger if the accounting standard has been subject to an appropriate and robust vetting process by those closest to, and most experienced in, these issues. Further, a true standard must be widely accepted in practice, by issuers, investors, auditors, and other market participants.

IFRS is also a comprehensive framework of quality accounting standards. In light of the E.U.'s recent adoption of IFRS, it now is on the way to being widely used. Nonetheless, IFRS has had a relatively brief history of application and interpretation, and it is still unclear whether IFRS will be interpreted consistently in the jurisdictions that have adopted it. It is because of this uncertainty and the brief history of its application, that the SEC staff has asked for time to assess the consistency and faithfulness of IFRS interpretation and application.

This is a critical moment for IFRS, and I know our international counterparts alike will be closely reviewing the filings for consistency of application by issuers and accounting professionals. As with any new standard, there will be issues of interpretation even within the E.U. markets. With respect to the roadmap crafted by the Commission's former Chief Accountant, Don Nicolaisen, Commission staff will be reviewing IFRS application in filings that it receives with a view toward determining whether reconciliation to U.S. GAAP is needed in the future.

Our current approach with respect to domestic and foreign issuer financial statements is that domestic companies prepare their financial statements under U.S. GAAP. Foreign private issuers reconcile to U.S. GAAP the financial statements they file with the SEC if those financial statements are prepared pursuant to another basis of accounting, whether that is IFRS or national accounting standards. Foreign private issuers, of course, also have the option to prepare their financial statements under U.S. GAAP and some do, in fact, report on this basis.

This treatment of foreign issuer financials took shape in 1982, when the Commission adopted a distinct set of registration statement forms for foreign private issuers. At the same time, the Commission decided to more closely align disclosures between domestic and foreign private issuers. The Commission created what are the SEC's current U.S. GAAP reconciliation requirements: "Item 17 reconciliations," a quantitative reconciliation without certain U.S. GAAP disclosures, and "Item 18 reconciliations," a quantitative reconciliation with all U.S. GAAP disclosures.

How the Commission arrived at a reconciliation requirement is rooted in two fundamental policy considerations. One is consistency, that is, the investing public in the United States needs the same type of basic information disclosed for an investment decision regardless of whether the issuer is foreign or domestic. This view suggests that foreign registrants be subject to exactly the same requirements as domestic ones. The other policy consideration is that it is in the public interest to permit U.S. investors the opportunity to invest in a broad array of securities, including foreign securities. This suggests that the Commission avoid overly burdensome requirements on foreign issuers. According to this reasoning, the public interest would be better served by encouraging foreign issuers to register their securities with the Commission.

These same considerations are at the heart of the determination of a reconciliation requirement. Thus the roadmap focuses on whether foreign private issuer financials prepared under IFRS, without reconciliation to U.S. GAAP, will achieve the goal of opening our markets further while remaining consistent with the objective of providing disclosure of comparable quality, transparency, and usefulness.

What is essential for convergence, and ultimately for the issue of reconciliation to be comfortably determined, is that each set of accounting standards must be complete. Each must produce financial statements of high quality, each set of standards must enjoy wide acceptance and use, the standards must be reasonably comparable to each other, and investors must be capable of understanding the nature of differences between the two sets of standards.

The IASB and FASB have undertaken a joint standard setting effort and the differences between IFRS and U.S. GAAP are being reduced. That is occurring in part by choosing the better standard where differences exist and in part by joint cooperation in new standard setting initiatives. I believe convergence requires movement by both the IASB and the FASB and that the priorities and proposed solutions should be proffered from these independent entities.

With respect to the roadmap, I am heartened that Chairman Cox and Commissioner McCreevy recently affirmed their commitment to eliminating the need for reconciliation requirements. Chairman Cox reiterated that achieving this goal depends on various factors, including the effective implementation of IFRS in practice. Chairman Cox and Commissioner McCreevy highlighted the need for enhanced cooperation, dialogue and information-sharing among regulators, such as the SEC and the members of CESR, regarding the implementation of IFRS. Chairman Cox and Commissioner McCreevy also discussed the efforts of the IASB and the FASB to converge IFRS and U.S. GAAP. Chairman Cox emphasized that a particular degree of convergence would not be required for eliminating reconciliation. Rather, the Chairman would expect an effective process for converging IFRS and U.S. GAAP as demonstrated by measurable progress in addressing priority issues.

I could not agree more with the emphasis the Chairman has placed on substance over form. I think it is clear that we at the Commission do not expect full or even a particular threshold of convergence before we are willing to eliminate the reconciliation requirement. What we must keep in mind in making such determinations is whether U.S. investors are able to understand financial statements prepared under IFRS. While convergence between IFRS and U.S. GAAP will certainly help us all in reaching that goal, it is also possible for U.S. investors to understand financial statements prepared using a rigorously applied system of IFRS, even if there remain differences between IFRS and U.S. GAAP.

So, while there is no bright-line test of convergence for eliminating the reconciliation requirement, the Commission likely will expect a rigorous process for converging IFRS and U.S. GAAP to be in place. This will help make sure that, going forward, both sets of accounting standards will continue to converge. The best mark of the effectiveness of such a process is through the results it generates, such as resolving the differing approaches to recognition and measurement of fundamental inputs such as net income and equity.

I must note that the role of accounting firms, issuers, and regulators in this task should not be underestimated. The challenge of crafting a high-quality set of accounting standards is daunting, but perhaps more daunting is the challenge of effectively implementing that set of standards across a large number of issuers in varying jurisdictions and varying industries. It is an undertaking that must be done with care and diligence. Unless IFRS is applied and interpreted consistently across companies and countries, IFRS will not achieve a single accounting standard status. As for the Commission, we look forward to continuing our dialogue with our European counterparts to achieve what will be a significant boon to investors and to the capital markets around the world.

Thank you.

Endnotes

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[1] The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publications or statements by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission, any other Commissioner, or the staff.

http://www.sec.gov/news/speech/spch031306aln_iib.htm
