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PROMOTION OF INTERNATIONAL CAPITAL FLOW THROUGH ACCOUNTING STANDARDS

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON
FINANCIAL SERVICES

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PROMOTION OF INTERNATIONAL CAPITAL FLOW THROUGH ACCOUNTING STANDARDS

THURSDAY, JUNE 7, 2001

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, DC.

The subcommittee met, at 10:00 a.m., in room 2128, Rayburn House Office Building, Hon. Richard H. Baker, [chairman of the subcommittee], presiding.

Present: Chairman Baker; Representatives Shays, Cox, Gillmor, Royce, Oxley, Ose, Kanjorski, Bentsen, J. Maloney of Connecticut, Hooley, Mascara, LaFalce, Sherman, Inslee, Moore, Lucas, Shows, Israel, and Ross.

Chairman BAKER. I'd like to call this hearing of the Capital Markets Subcommittee to order. I am informed that we will have a journal vote or a vote at approximately 10:30. Mr. Kanjorski, the Ranking Member, is on his way, but I thought we would convene the hearing this morning in an effort to get the opening statements on the record prior to breaking for whatever vote is required on the floor.

With that advisory, I do expect Mr. Kanjorski's arrival momentarily.

Today, we have under consideration accounting issues which are new to this Committee's jurisdiction this year. Financial accounting and transparency are vitally important for all investors, practitioners, regulators and others who have interest in the market's conduct.

We begin today by reviewing the efforts to harmonize international accounting standards, given the nature of the changing world economy.

Transparency regarding the financial condition of a company is a key component in an investment decision. Accounting standards are intended to serve investors by imposing a framework for financial reporting so that all investors may evaluate and compare on a common platform.

The United States capital markets are the deepest and most complex in the world. And while there are very legitimate concerns about the rules, the markets consider the Generally Accepted Accounting Principles, or GAAP, the most comprehensive standards in the world.

Of course, these standards are only used by companies filing financial statements domestically. The globalization of markets and

new technology now more than ever allow investors to diversify portfolios and seek opportunities both here and abroad.

Additionally, U.S. companies are able now to find capital in growing sources from those outside the country. However, without harmonization of accounting standards, investors face uncertainties. We must carefully scrutinize this process so that the field is made level across national borders and that standards are effective and meaningful to the investors whether here or abroad.

This does not merely mean reconciliation of foreign standards to GAAP. There is the hope that the international effort to harmonize will take the best ideas of all national standards and do away with those principles which unduly burden issuers or do not provide meaningful information to investors.

Most importantly, this effort should be responsive to the needs of investors worldwide and should consider the types and manner of disclosure most appropriate.

It is a pleasure today to welcome Chairman Volcker here. I will have a formal introduction at a later moment. But to have his prestige brought to bear on this important matter in his new capacity is indeed an important addition to this process.

[The prepared statement of Hon. Richard H. Baker can be found on page 42 in the appendix.]

With that opening statement, I'd like to turn to Mr. LaFalce for his words.

Mr. LaFalce.

Mr. LAFALCE. Thank you very much, Mr. Chairman. Chairman Volcker, it is always a pleasure to have you before us. We can always learn treasures and gems when you come. And Mr. Chairman Baker, I can't tell you how very pleased I am that you are having this hearing. We had a dialogue in your office about a month or two ago about the importance of accounting, and I'm glad you're chairing this Committee, and I know you're going to be looking into this issue the way it should be.

I believe it's very important to harmonize international accounting standards. Yet I'm also concerned that in the process we do not undercut the generally strong standards we have in the United States. These standards and the strength of our accounting and auditing professions play a fundamental role in protecting investors and maintaining the integrity of our capital markets.

I'd also like to take the opportunity to thank Chairman Volcker for his efforts to improve the international accounting standard-setting process. I believe these efforts will make an important contribution to the integrity and transparency of both our markets and those abroad.

Accounting issues have recently begun to catch the attention of the media, and I'm delighted at that. It's difficult now not to notice daily reports of financial fraud and restatements of financials by major corporations, not just small corporations, but major corporations. And I'm extremely concerned about this. In fact, "outraged" may be a much better word.

The SEC, particularly its Chief Accountant, has also been expressing concerns about various accounting issues and practices involving the accounting profession and corporate management. And I hope they will step up their enforcement efforts. But most impor-

tantly, I hope we give them the resources necessary to do that. That ball is in our court.

Today's hearing obligates me to express my strong conviction that our Committee and the Congress must not take the strength and integrity of our own accounting system for granted. And most importantly, we have to make it clear that harmonizing international accounting is not an excuse to lower U.S. accounting standards.

In other words, standardizing accounting practices around the globe cannot be a race to the bottom. Investors, shareholders and increasingly global capital markets all benefit from access to the highest quality information.

Now this aspect of accounting on which we're having a hearing today should be only the beginning of a tremendous Committee focus on domestic accounting issues and how the application of accounting standards is affecting the integrity of our capital markets. It's certainly an area that I personally shall be pursuing with the greatest aggressive effort I can muster.

This is particularly important in view of the tremendous growth in stock ownership throughout the country. Estimates for the most recent survey data indicate that approximately half the households in the United States now own corporate stock, either directly or indirectly, through a mutual fund, retirement account or defined contribution pension plan.

This represents over a 60 percent increase in the number of individual shareholders over just the last decade. This trend, combined with the decreasing availability of defined benefit pension plans, means that more Americans than ever are relying on the performance of their stock investments for their savings and retirement.

Twenty years ago, two-thirds of all pension plan participants were in defined benefits plans. Today, more than two-thirds are in defined contributions plans. Now, that change is profound in its implications and profound in the obligations it imposes upon us, the SEC, and so forth.

High quality accounting standards and financial reporting are essential for sound investment choices to be made. At the same time that Americans have become more reliant on the performance of their stock investments, the pressures on firms to manipulate their financial results have grown tremendously. Executive compensation is increasingly tied to market valuation of corporate stock, creating ever more pressure to meet earnings estimates to the penny. Fourteen cents rather than 15 cents could result in the stock price and market valuation of a company being pummeled.

Judging by the numbers of companies that have had to restate their financial statements after they were released, many companies have succumbed to the temptation to manipulate their results. According to the SEC, the number of restatements has more than trebled from the early 1990s, from an average of less than 50 per year to 156 last year.

More than half of the companies accused of financial fraud and shareholder class action lawsuits last year have already been forced to restate their earnings. These figures are very troubling when one notes that these are restatements of financials that had been signed off on by the firm's auditors.

Regrettably, there is increasing and disturbing evidence that the problem is widespread. An article this month by a senior editor of that ultra-liberal *Harvard Business Review* describes the insidious effects of the so-called earnings management, saying that: "the earnings game is now so commonplace that it can sometimes seem like a collective agreement to believe the unbelievable."

While many of the techniques used may be technically legal, they are economically indefensible. And the conduct of many companies may well cross the line into fraud on investors in the markets.

Further, while I would like to think that the conduct of these companies is an aberration, what may look like an ice cube is much more likely to be the tip of the iceberg, as the Chief Accountant of the SEC noted only last week. I suspect that iceberg may be gigantic.

Our Committee needs to focus seriously on the importance of accounting standards and their proper application to our capital markets. High quality financial reporting is essential to protecting investors and maintaining investor confidence. We need to ensure the high quality of financial information from all firms that compete for capital in our markets, whether they are U.S. companies or foreign corporations.

Today's hearing is a start, but only a small start in that effort. Looking forward, it's imperative that we look at all issues affecting investor protection in a balanced, objective way. This Subcommittee under the leadership of Chairman Baker and Mr. Kanjorski will be having a hearing next week on analyst independence, which we certainly should do. But if we are to do a serious analysis of the problem, the regulators must also be invited to be part of that dialogue.

And, Mr. Chairman, I understand that full Committee staff may be very reluctant to that, and I ask that you make the decision as to who should testify rather than staff. I thank the Chairman.

[The prepared statement of Hon. John J. LaFalce can be found on page 62 in the appendix.]

Chairman BAKER. Thank you, Mr. LaFalce. And for the record, you'll note substantial time was allocated to your remarks in deference to your evident strong feelings on the matter, and I assure you the hearing next week is only a minor beginning to our Committee work on the subject, and we look forward to your continued interest. Thank you, sir.

Chairman Oxley.

Mr. OXLEY. Thank you, Mr. Chairman. And today our subcommittee begins its consideration of significant issues in public accounting and investor disclosure. I want to congratulate you, Mr. Chairman, for taking the initiative in holding this hearing. And I also want to welcome the distinguished former Chairman of the Federal Reserve, Paul Volcker, who once again is playing a leading role in international finance and welcome Chairman Volcker back to the Committee.

I appreciate the work of the AICPA and the Financial Executives Institute and the willingness of their representatives from KPMG, Peat Marwick and General Electric, to testify today.

We live in a time of growing interdependence in world financial markets. However, financial reports on publicly traded companies

upon which investors and regulators depend on based on accounting practices that can vary widely by country. These differences result in a lack of comparability and reliability in financial disclosure.

Harmonizing accounting standards will benefit preparers and users of financial statements, promote international trade and investment and reduce costs for multinational companies. Investors will be better able to make informed investment decisions.

With integrated financial markets, economic crises are not deterred by national borders. By streamlining international accounting standards, we're improving our changes of detecting and preventing financial problems before they reach global proportions.

Businesses, regulators and the markets must be able to compare apples with apples when it comes to financial report. Mr. Chairman, I look forward to hearing about the work that the International Accounting Standards Board and others are doing to harmonize global rules and the benefits for investors in the capital markets.

I encourage you in further efforts to set a new benchmark for the highest quality financial reporting, and I thank the Chair and yield back the balance of my time.

[The prepared statement of Hon. Michael Oxley can be found on page 65 in the appendix.]

Chairman BAKER. Thank you, Mr. Chairman, not only for your attendance here today, but for your significant interest in this whole subject matter. It's most appreciated, Mr. Chairman. Thank you.

Ranking Member Kanjorski.

Mr. KANJORSKI. Thank you, Mr. Chairman.

First of all, Mr. Chairman, I want to congratulate you for bringing about this hearing. I look forward to Mr. Volcker's testimony. I'm going to ask unanimous consent to introduce into the record my full statement.

[The prepared statement of Hon. Paul Kanjorski can be found on page 60 in the appendix.]

Chairman BAKER. Without objection.

Mr. KANJORSKI. But, I just wanted to make one or two points. One, can the Federal Government assist financially in moving this process along faster? I think that perhaps staff and funding of expenses may be helpful. If there is something we can do, like using some of the excess funds at the SEC that can be guided toward this effort, I would like to know.

Second, I am interested to know whether or not we are developing any concept of a stick-and-carrot for those corporations and countries internationally that are hesitating or perhaps taking too long in adopting these standards. We have the IMF, the World Bank, and other institutions that, on the one hand, could be utilized to look more favorably upon those nations and those corporations that move faster in adjusting their standards, and on the other hand, have some penalty if they do not comport with the need for international standards.

But, at a meeting I had last week, I learned that there may be 10 or 15 years before world standards are able to be implemented. I am not sure that is speedy enough. With those few questions in

mind, I look forward to Mr. Volcker's statement and yield back my time.

Chairman BAKER. Thank you very much, Mr. Kanjorski.

Mr. Mascara, did you have a statement?

Mr. MASCARA. Mr. Chairman, I ask unanimous consent to have an opening statement prepared later and introduced.

Chairman BAKER. Without objection.

[The prepared statement of Hon. Frank Mascara can be found on page 64 in the appendix.]

Mr. MASCARA. Thank you.

Chairman BAKER. Mr. Maloney.

Mr. MALONEY. No thank you.

Chairman BAKER. Ms. Hooley.

Ms. HOOLEY. Thank you, Mr. Chair, and Ranking Member Kanjorski for convening this hearing today and for the witnesses that have been asked to testify. I'm constantly telling the people back home that you can't turn back the hands of time, that globalization is here to stay. And it seems to me each passing day our economy is more intertwined with the global economy than ever before.

And more and more investors from the United States are dipping their toes into the foreign markets, and more and more foreign markets and companies are listed here. I think if international markets are going to function properly, a single set of high quality international accounting standards must exist. As Mr. Kanjorski has stated, stocks aren't lottery tickets. And to make sure investors are protected, we need to create an independent system that is not only high in quality, but high in consistency. I'm looking forward to your testimony and I'm looking forward to seeing how quickly this can be done.

Thank you.

Chairman BAKER. Thank you, Ms. Hooley.

Mr. Volcker, it's apparent that we'll have a vote. It may be, however, I'm advised, slightly later than 10:30. It would be at least a 15-minute vote, which would mean Members would likely be here 5- or 10-minutes after it goes off.

Given that and to use time effectively, I'd like to proceed with your introduction and request that you proceed with your remarks.

Mr. Volcker was the Chairman of the Board of Governors of the Federal Reserve from August of 1979 to August of 1987. Initially appointed to the position by President Carter, he was reappointed in 1983 by President Reagan. He worked for the Federal Government for almost 30 years, serving under five Presidents, he retired as Chairman and Chief Executive Officer of Wolfensohn and Company in 1996.

However, in a review of your resume, Mr. Volcker, I thought the most outstanding line of its entire content, all of which is distinguished in achievement, is the fact that you claim "four brilliant grandchildren," which I quote.

We indeed welcome you back, sir, and have great regard for your insight and abilities. Welcome.

STATEMENT OF HON. PAUL VOLCKER, CHAIRMAN, INTERNATIONAL ACCOUNTING STANDARDS TRUSTEES

Mr. VOLCKER. Thank you very much, Mr. Chairman. And I might say that the oldest of those brilliant grandchildren just graduated from school here in Washington on Saturday. So we've got him through one hurdle, anyway.

I really appreciate being here. This is the first time I've been before the Committee in its new guise and enlarged guise. But it gives me an opportunity to congratulate you and the Congress, I think, on this reorganization that from my experience makes a great deal of sense. Back in the days when I had to testify before the Banking Committee and the Securities Committee on issues that obviously, overlapped.

Chairman BAKER. And could you pull the mike just a bit closer so we can hear you a little better? Just pull the whole mike to you.

Mr. VOLCKER. You have a copy of my statement, and I won't read it. It's a rather comprehensive statement on the origin of this work.

We have also distributed, I will just bring to your attention, a brief description of the new International Accounting Standards Board and Committee, notably, particularly because it's got the names of the various trustees and Board members on it and where they come from and where their background is. So you may find that of some interest.

[The information referred to can be found on page 74 in the appendix.]

Let me just make a few points here in the time that we have before the vote. I really do appreciate your initiative in these hearings, as some of your associates have said. This is not, I realize, a subject that makes for big headlines, and it doesn't make the political blood run, but I do think it's a very important subject that we need to be better informed about and understand what both the advantages are, the potential is, and what the problems are. I am greatly encouraged by the interest that Members here have expressed.

The fact of the matter is that the need for international accounting standards is one reflection of what is really the inexorable, inevitable globalization of finance that Ms. Hooley just referred to. I think the internationalization of finance has great potential benefits, but there have been enough events recently to show that it's also filled with very considerable hazards and uncertainties.

And in a most general sense, it seems to me the venture that we have launched here to create some high quality and internationally accepted standards is a response to what's going on in the world. And I want to emphasize both parts of that, because we won't have done our job if they're not, a: of high quality; but, b: internationally accepted. So we have to combine those two criteria if we are indeed to maximize the benefits of international finance and minimize the hazards. It is just simply a building block for an efficient international financial system, and obviously of great significance to the United States in that respect.

Now let me just make a very few points. The idea of an international accounting standards committee is not new. A Committee has been around for a long time, but the effort that I chair as trustee or Chairman of the trustees of the Committee really reflects a

ground-up revision and restructuring of the old international committee, which it basically abolished. They adopted a new constitution. That's what we're talking about.

And this was really done as a result of an international effort by regulators, by professionals, and by affected businesspeople working together in something called a Strategy Working Party to develop a new framework.

And you will recognize that this administrative framework in many ways follows the FASB precedent, because it was important to maintain the professional objectivity and competence of this group, and that was the great emphasis certainly that the American participants and others had in this effort.

What we have is a committee of trustees that I chair. The trustees are responsible for general oversight. We're, not incidentally, responsible for raising the money to finance it. And we appoint the Board members. The Board is the body that makes the standards, not the trustees. That is all delegated to the independent Board which has been appointed, and it has now begun work. It is a group of high-level professionals drawn from around the world which is reflected on the sheet of paper you have.

We have been concerned as trustees, and Sir David Tweedie, who chairs the Board is equally concerned, that we get input from all the relevant and interested parties in the best way we can do it. There is a provision for an Advisory Council, which we are in the process of appointing. It is an interesting fact that to get all the various points of view reflected, that Advisory Council has grown to considerable size. It will have close to 50 members, and it is a broadly representative body that, I think, you will find will indeed be able to provide input from a wide variety of points of view.

I am here today really somewhat to my surprise, not being a close follower of these things in the past. I am here because I was invited by the Chairman of the SEC, who chaired the effort to find a new committee and a new framework, to become the Chairman. I was surprised, because I think traditionally the United States has taken the attitude we have the best standards. That's good enough. The rest of the world can come and join us if they're interested in approaching the big American markets. And indeed, that approach has had some influence on the world.

But, I think, it is also true and it's come to be understood, I think, by the American regulators, by FASB itself, that this is a big world and the rest of the world isn't necessarily willing to agree that all wisdom lies in Norwalk, Connecticut with the FASB. We may have—and indeed, do have—the best developed standards—I think most people would agree internationally, the highest set of standards—but they still can reflect input from the rest of the world. We want a truly international standard and an improvement on the American standards, not a diminution. That's certainly our objective.

And second, I think there has been a clear recognition as I look at the picture in recent years, a recognition by the SEC and FASB itself that these are very contentious matters that in some cases have attracted political interest, and that indeed, advancing the platform to an international level may provide a more appropriate perspective than a purely national level.

So far as other attitudes are concerned, the European Commission, the European Union, has had a particular interest. They are in the process of passing European legislation that they say will demand by 2005 that European countries report according to international standards.

Now they've also reserved the right, and will appoint a body to review the international standards, or particular standards to see whether they will be acceptable in Europe. Just how that works, I don't know. But in principle, they're looking forward to international standards just as other countries are. And, I think, there is broad support in industry around the world. We have been reasonably successful in raising money to support this industry effort, and I would say rather unusually, we have had contributions from international organizations, from central banks, from regulatory bodies around the world individually, not in huge amounts, but symbolically very important to show the official support for this effort right around the world.

The second point I would make, I've already touched upon. We are dealing with inherently controversial and difficult matters upon which there are contrasting views between industry groups, very strongly contrasting views in some cases, and there are different approaches and attitudes out of national traditions, a certain amount of suspicion among various national bodies whether this is an American takeover on the part of the United States, whether this is dilution of high standards. We have to deal with those suspicions and get everybody working together.

Now I won't go over all those controversies today. Let me just mention two of them to give you some sense of it. One, it's not really a matter of substance, but of approach. I think the American approach historically has been to state a standard and then write several hundred pages explaining how to apply the standard. Some of the other countries feel it's very important to get the standard right, but the particular application will evolve in more common law tradition, a case-by-case application, putting very heavy weight on the auditing profession itself to develop. And, obviously, there will have to be some oversight of that process. But how those two different approaches get reconciled will be an interesting thing to watch.

The other point of substance, a real point of substance to which the accounting profession, I think, all around the world has to become sensitized to, is the increasing importance of intangibles in accounting statements and in balance sheet statements. And goodwill just dominates in the new economy. But even companies in the old economy so-called, you look at their equity and you look at their balance sheet and most of their equity is reflected in something called good-will. How do you evaluate good-will? It is a very large problem that has arisen in recent FASB discussions which I don't think anybody feels satisfied is fully resolved.

Now I could go on and on with other issues, but I just want to give you a flavor of what we're grappling with.

The final point I would make is really a point that touches upon Mr. LaFalce's great emphasis. Standard setting is one thing. It's very important. It's a beginning point in developing a high quality

set of accounts by individual companies. But at least as important is how those standards are enforced.

Setting them out and stating them is one thing, but individual companies are applying them, and they're applying them under the surveillance of auditors, and, I think, if we're going to have good accounting standards internationally, we have to recognize there is a very great burden on the auditing profession itself in developing its standards for enforcing the accounting standard itself.

Having said that, I think it is also clear that having a common set of standards around the world will greatly ease that job of the accounting profession itself and the auditing profession and companies in enforcing the standard. When they're not dealing with many standards, they're dealing with one. So I think the enforcement and the standard work together, but I just want to emphasize that our work is primarily on developing the standards. The enforcement will remain national. So it's an important point.

Just a word about the outlook. I am conscious of my own age, so I'm not looking forward to a 25-year project here. Let me set out a target. I hope it's not totally unrealistic. But we've had some discussion with David Tweedie, who I might say, is a Scotsman, who will lead this effort. I think that's got some symbolic value, having a nice, dour Scotsman raised in the Calvinist tradition to lead this international effort.

But, we can foresee that, say within a period of 3 years or so, we get enough commonality between the international standard and let's say GAAP so that reconciliation will become a lot easier. And, reconciliation might become easy enough so that it's easier for foreign companies to do the reconciliation and get access to American markets or vice versa.

But, you've got to think at least in a 5-year time perspective to have a complete set of international accounting standards that we and other countries and the European community with their 2005 deadline will say, OK, this is the basis for using internationally in a fairly complete way.

That may be a very optimistic outlook, but I think that's the kind of framework in which we should be thinking.

With that much, I will cease and desist and welcome your questions.

[The prepared statement of Hon. Paul Volcker can be found on page 66 in the appendix.]

Chairman BAKER. Thank you very much, sir. I very much appreciate your skill and determination being brought to this most difficult subject. I certainly recognize the difficulty of it even in the treatment of our own domestic reporting requirements and the rules that FASB has promulgated in recent years have brought about considerable discussions with derivatives treatment and other controversial matters.

So I can only imagine what it must be like internationally where nationalism enters the picture and one assumes that all intellect does not reside in the United States. So I come at this with something less than a nationalistic view, I hope with an understanding that there are perhaps different ways of achieving the same goal.

Of recent interest to me was a publication called *Value Reporting*, written by Eccles & Hertz, which got into a discussion of the

adequacy of the current reporting methodologies and what investors in the market really are looking for.

There was some discussion, for example, along the lines of Mr. LaFalce's comments, of—I hate to use the word "manipulation". "Management" perhaps is a better word, to perhaps beat the street expectations by a penny and what takes place immediately prior to that quarterly report.

The quarterly report, though, is really a historical perspective, not a forward-looking statement. Given the impact of Reg FD of recent vintage, it appears that those forward-looking statements may all too often result in litigation if the forecast is not extremely accurate.

But, the current standard as you, I think appropriately, note with regard to the calculation of good-will is only one element of the problem. For example, a customer satisfaction survey may well be a much better indicator of future sales than the last quarter with old technology which may now be brought about, in this fast-moving world, to be obsolete.

The short life of a computer: by the time I buy one and get it home, the first service call is "where did you get this old thing?" So, the world is changing so fast it seems to me that if we're taking this on, it ought not to be just a rehash of GAAP, but it ought to be with recognition that the information informed investors need is more a roadmap of the future than a historic report of past conduct.

And I think that publication, I would recommend it to Members. It's only been out now 4 or 5 months. It's with the international foundation, several prominent CPAs, domestic are involved. And it's rather a comprehensive view of the market needs and what the market currently receives.

My most important question, Mr. Volcker, is how do you see the role of this Committee being most helpful to you in your organizational responsibilities in proceeding with this topic? Would you like to see this Committee engage in some regular interchange with you and other members of the Commission to have a platform in which points of concern could be reflected on? I know you have one rather large Advisory Committee already. I don't know that you need another one. But how can we be helpful?

Mr. VOLCKER. Well, I think you have already, from my point of view, performed a very considerable service by having this hearing. And in your comments, the interest that exists and the sympathy that I hear expressed about the idea of an international standard is a very important contribution you can make. There is a danger that this gets bogged down in particular nationalistic interests, even though I don't think the substantive issues fall easily into national differences.

When you talk to industrialists, when you talk to bankers, when you talk to other people, the bankers tend to see things alike, the industrial preparers, chief financial officers tend to see things alike. Some of the users tend to see things alike internationally. And they may disagree among themselves, but it doesn't typically necessarily fall on national lines.

So I think we have to keep that understanding, and anything you can do to understand the importance of an international standard of high quality and effective enforcement is important.

Now it gets a little tricky, I think, because the Americans who participated in reorganizing this process were particularly those that wanted to be sure that these rules were made by professionals, and that they be insulated as far as possible from political pressures. And I think we want to preserve that kind of professional decisionmaking.

But, in my experience, I would say, even in my experience in the Federal Reserve, it's good for professionals to hear outside thinking once in a while as they go about their task. So I think having an occasional hearing and kind of assessing where we are and prodding us a bit would be helpful. But I don't think you want to get too much into the specifics of particular accounting issues.

Chairman BAKER. Thank you very much.

Mr. Kanjorski.

Mr. KANJORSKI. Thank you very much.

Mr. Volcker, let me address this subcommittee to something in which you did participate in a very big way by establishing the predicate for the solution of the S&L process. As we look now at Japan, isn't part of their economic difficulty related to banking and the failure for adopting acceptable banking standards? Therefore, can we really evaluate the value of their banks?

Mr. VOLCKER. It was certainly true in the S&L crisis in the United States. But as you indicate, I had some occasion to be rather closely involved with that at one point.

And I think it is also true in Japan, where there are substantial changes now going on in Japanese accounting practices.

But, you see it on two sides and it again reflects the complementarity between the standard and its enforcement. But the Japanese banks have had large equity positions which were not brought to market and accounted for in a way that lent any precision to the process historically. Now that's changing.

Their standards in evaluating loans, I think it's fair to say, were not adequately disciplined, to be kind about it. Now that's a matter of enforcement. The official enforcement of some kind of standard counts as much as the standard itself, but I think it's a combination of both.

So, yes, I think there were lapses that have led to real problems of a profound nature in Japan, and a considerable nature even in the United States, where the S&Ls had their own accounting system, which was not very adequate.

Mr. KANJORSKI. When we made those adjustments in the early 1980s, we used a concept in the United States, which I suspect was governmentally-imposed, called "supervisory good-will." Will a world accounting system deny governments the ability to take those extraordinary positions and qualify good-will as an asset in a different way because of a particular domestic difficulty?

Mr. VOLCKER. Well, you're going to exhaust my technical knowledge of accounting pretty quickly. But I do know enough to know that international practice, in a combination maybe of government and private accounting practices, treated good-will very differently in the case of mergers and acquisitions.

And that raises a question apart from what is right or wrong in some sense, which is very difficult in this area. When it's different in different jurisdictions, particular companies find themselves at a relative advantage or disadvantage in making mergers or acquisitions. And American companies in particular have complained that accounting rules in other countries have made it possible for other companies, foreign-based companies, to make acquisitions that they could not make because of the accounting treatment and the effect that it therefore had on their published earnings and so forth.

So one of the benefits, the benefits very clearly seen by some of the companies I've talked to, is leveling the playing field with respect to the treatment of good-will in mergers and acquisitions.

Mr. KANJORSKI. Whenever we have a standard imposed, whether it be by government or in the private sector, there is a cost factor. Are you conducting an economic analysis of what the international cost factor would be to the various corporations and countries to impose this new international standard?

Mr. VOLCKER. I think the fair answer to that is, I don't know of any clear study that's been made of that. We are operating on the assumption that the most important benefit is a very general benefit that is very hard to quantify: having more efficient international capital markets. Now, how do you measure that benefit?

Now the fact is there are also direct benefits that are measurable in terms of the expenses of a multinational company in conforming to accounting practices and laws in, you know, numerous jurisdictions. And, depending upon a particular company, what kind of business it's in, how long he's been in business, if you have to install that system, it's very expensive.

Some companies tell me, well, they've had them in operation for a long time, so it's a lesser expense now than it used to be, but it's an expense. It's just honest-to-goodness money in hiring accountants and bookkeepers and all that goes with keeping separate sets of accounts.

Mr. KANJORSKI. A cynic would say it is an accounting relief act?

Mr. VOLCKER. Pardon me?

Mr. KANJORSKI. A cynic would say it is an accounting relief act?

Mr. VOLCKER. Yes. This is the opposite, I guess. The existing situation is full employment for accountants. We want to divert their energies to more productive uses.

Chairman BAKER. Thank you, Mr. Kanjorski. I read somewhere that to convert from the international standard for a sophisticated corporation to GAAP, the estimated cost of conversion today is about $10 million for a large corporation, which I find extraordinary.

Chairman Oxley, please proceed as you choose if you would like to take your time now, or we'll recess and come back at your judgment.

Mr. OXLEY. I'd be glad to take 5 minutes, Mr. Chairman. Thank you.

Chairman BAKER. Certainly. Go right ahead.

Mr. OXLEY. Mr. Volcker, you had indicated in your comments that in the past at the SEC and FASB it generally historically considered our GAAP standards to be superior to the rest of the world. And you indicated, I think, in your statement that that appears to

be changing, that the internationalization of finance and the like is such, and I would heartily agree.

Is there still some feeling out abroad that perhaps we are still being too aggressive in trying to put our stamp of approval on some of these standards?

Mr. VOLCKER. I think without question. Let me make clear, I think there is truth to the proposition that we have the best and most comprehensive standards. That doesn't mean that they can't be improved and that we cannot benefit from this international effort, which I believe is the case.

But there is a feeling historically that we were rather imperialistic about this, and the carryover of that is, I think, reflected in some of this feeling in the European Union, for instance, that they want to reserve judgment. While they want international standards, will put that in community law and regulation, they also want to reserve the right to look them over on an individual basis, because there is some feeling this should not be an American takeover. There's a certain amount of emotion in that.

The counterpart is, of course, the concern in the United States that it not be a weakening of high quality. So we've got to bridge that.

I might mention one of the encouraging things to me in getting involved in this was to see the interest that FASB people themselves expressed in a most direct way of wanting to participate in the international effort—be on the International Board, to be on the advisory committees.

And we've had people who have been either current Board members or past Board members of FASB on our International Board, because they wanted to be there. Now, let me also make sure there are Europeans on the Advisory Board in some size. There are Europeans, of course, and Japanese and Australians and Canadians and so forth on the Board. So, we're going to get a variety of points of view. But we have to overcome those residual suspicions.

Mr. OXLEY. Could you explain to me how this would work, given the European Union structure? That is, once the international accounting standards were to be adopted, would that be done by the European Commission?

Mr. VOLCKER. Yes. As I understand it, this is a matter of the European Commission in this area. It's in their jurisdiction, and they are exerting that jurisdiction.

Mr. OXLEY. So, it would not be—the individual member states then would not necessarily——

Mr. VOLCKER. Well, I said the European Commission. I think this is something that would actually be approved by the European Parliament, too. I'm not sure about that. But it is a European matter, not a national matter. They will assert European jurisdiction, as I understand it.

Mr. OXLEY. And would it be your guess that that would be the first breakthrough? That is in Europe as opposed to perhaps Asia? Or do you see this entire thing coming together simultaneously?

Mr. VOLCKER. I think it all has to come together simultaneously. Given my impression, because I'm not a deep expert in this, Japan accounting in the past—as we mentioned—has been further removed from what we consider acceptable standards. But they are

in the process of moving pretty fast by their standards. But still, there are going to be big problems there in bringing them up to the international standard and international enforcement.

Mr. OXLEY. Well, is it safe to say that historically and culturally, our standards would tend to be closer to the European Union member states as opposed to Japan, for example, or some of the other Asian countries?

Mr. VOLCKER. Oh, I think that's true, yes. I used to see this just as a personal experience. I used to be a director of Nestlé, a big international company headquartered in Europe. And, I hope it's true that they had reasonable accounting standards and approached it honestly and straightforwardly.

But the management of that company felt very strongly that they shouldn't be subject to U.S. GAAP. They were a European company, and while they have a big operation in the United States, they didn't agree with some of the GAAP approaches, and I think there was a certain national feeling about it. Why should they have to conform in every respect to GAAP when they were perfectly capable of following what they thought is a reasonable Swiss standard and a more general European standard?

Now, through the years, they were following the old international standard, and they have come closer together before this effort started. But there's still a lot to get over.

Mr. OXLEY. Thank you.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Chairman Oxley. It would be my intention, Mr. Volcker, Mr. Shays has fortunately been able to make it over for a vote and can take the chair on our departure. Mr. LaFalce will be recognized for his question or comment, and then we would excuse ourselves for the vote. But there should be Members coming back just momentarily. We won't have to recess the hearing.

Mr. LaFalce.

Mr. LAFALCE. Chairman Volcker, I think I've got about 4- or 5-minutes to go over for a vote, so I'll be very, very brief. A couple of bumper sticker slogans. The second bumper sticker is Harmonize Up Rather Than Harmonize Down. And the first bumper sticker slogan is Enforce First. And I was so pleased that your comments supported the concept that, you know, standards are super important.

We've got some pretty good standards in the United States. Let's enforce those standards. And I'm most concerned that we are not adequately enforcing those standards, and I am also concerned that we do not have the regulatory resources to bring about the type of enforcement that the investor deserves.

Mr. VOLCKER. Well, I absolutely agree with that, and in relation to Mr. Baker's question earlier. And for the United States, that's within your jurisdiction.

Mr. LAFALCE. That's why I said the ball is in our court.

Mr. VOLCKER. You've got the SEC that enforces, and the SEC reports to you. So we can set the standards, but then the ball goes in your court.

Mr. LAFALCE. As I've said, the ball is in our court. And the first thing we're doing is saying let's reduce the fees.

Mr. VOLCKER. Right.

Mr. LAFALCE. The third thing is, one thing we can do, too, is make sure that before any company is listed on any U.S. exchange, they can do whatever they want overseas, but before they're listed on a U.S. exchange, let's adopt and apply and insist upon U.S. standards.

Mr. VOLCKER. Excuse me. I didn't hear the first part of that.

Mr. LAFALCE. I apologize. I just said that before any company is listed on the U.S. exchange, we ensure that they adopt——

Mr. VOLCKER. U.S. standards.

Mr. LAFALCE. Enforce the application of U.S. standards. And now I've got to go vote.

Mr. VOLCKER. Well, that's, of course, the current posture. But I would hope when we get an international standard, the international standard will be good enough.

Mr. SHAYS. [Presiding]. Thank you. Mr. Volcker, other Members are going to be coming back, so we're not going to go to the next panel. So I have some questions and maybe other Members will come back and we can kind of filibuster together if you want to.

Would you just tell me, the IAST founded in 1973, has it had much clout over the years, or has it been pretty much an advisory group?

Mr. VOLCKER. Well, I think it has had some. Now, again, you'll have to direct that question to somebody who has more historical exposure than I have. But as I have observed it a little bit, for instance, as the director of Nestle, it has had some influence.

But there's a general feeling that it was a large body, it was a part-time body. There was from our perspective anyway too much of a tendency to seek compromise for compromise sake, that the issues were not posed as sharply as they might have been, and it simply didn't have the standing or the intellectual integrity the GAAP, for instance, had.

So, yes, I think it made some progress.

Mr. SHAYS. So, now it's a smaller body, and now it's full time?

Mr. VOLCKER. Well, it's predominantly full time. Two members are part-time. The people who set this out, the authority now lies with trustees. In the constitution that we inherited, established the general framework and they decided to include two part-time, two half-time members in effect, because you might want to get somebody with particular expertise or an academic who could participate on a part-time basis, but not a full-time basis. But essentially, it's meant to be a full-time, active professional body.

Mr. SHAYS. It still needs to exert more authority over time. It still needs to become a greater force internationally.

Mr. VOLCKER. No question.

Mr. SHAYS. What would be the thorniest issues that you need to address?

Mr. VOLCKER. What?

Mr. SHAYS. The thorniest issues? What are the most difficult issues that you need to address?

Mr. VOLCKER. Well, I mentioned this one of intangibles, goodwill, which goes over a lot of different companies, different issues, mergers and acquisitions and so forth. The issue of derivatives has been one to tear people's hair out for a long time, and I'm told that

FASB has 600 pages of explanation which nobody fully understands. It's an inherently complex area, which has, you know, grown like Topsy in recent years. And, I am told, nobody is particularly happy with the present standards and their application.

An issue, which indeed from my earlier life I was very much aware of, is the general move toward mark-to-market accounting, which I find is rather euphemistically described as "fair market accounting." I guess it has a lot of logic to it, but a lot of people question whether it is applicable to all situations in all circumstances. And people feel very strongly on both sides of that issue. And it's an issue that's particularly important to the commercial banking world, to the insurance world, and some other worlds.

And stock options are another. I might say that the Congress has been rather familiar with a very specific issue, how do you account for stock options and other forms of remuneration of that sort?

Mr. SHAYS. So, some of the same things we're having to address here we're having to address internationally as well?

Mr. VOLCKER. Yes. All these issues have been addressed here, but some of them have been kind of left in limbo. There was a retreat on stock options from what FASB initially was thinking about, as you know. There's been a shift of thinking, as I understand it, on FASB on the good-will, intangibles question. They now have changed their position, but not defined just what to do.

It's a very, by the very nature of it, intangible, a little hard to evaluate.

Mr. SHAYS. The primary message that I heard from you was that politics has to stay out of the——

Mr. VOLCKER. That is the whole intent of this structure. Politics stay out of it so far as setting the standard is concerned.

Mr. SHAYS. What I don't fully understand is we're talking about an extraordinary number of different countries that have to buy in. And, so, some countries are going to buy in, some countries aren't. But you're not going to see a compromise to get a country to participate?

Mr. VOLCKER. No. The aim of this structure was to delegate the decisionmaking to a body that was some insulation from politics and that definitely could bring different points of view to bear so far as experience is concerned. It was set out rather carefully that some of these members should have auditing experience, some should have preparer's experience. They should have experience within companies. Some of them should be analysts and users of accounting information. Some should be academic.

The purpose is to make sure a variety of different professional points of view are brought to bear. But they should not be picked on the basis of nationality. Now, in fact, we have a spreading of nationalities. There are a number of Americans, a number of Europeans. There is, I guess, one Japanese, one or two from emerging countries, a Canadian and an Australian. So the countries that have been most active in this area are certainly fully represented. A relatively small number of countries have active accounting standard boards of our type.

Mr. SHAYS. Now, the International Accounting Standards Board is basically, what they determine, in my understanding, is basically going to be enforced by the national regulators in each country?

Mr. VOLCKER. Yes. Well, first of all, they presume they will be enforced by auditors themselves.

Mr. SHAYS. OK. I just said it in reverse. I was going to say national regulators and the audit firms. You want me to say audit firms and national regulators.

Mr. VOLCKER. Right.

Mr. SHAYS. OK. Do you see this working effectively?

Mr. VOLCKER. There is an effort going on as I understand in the auditing profession itself to exchange views and develop approaches and processes to add to the confidence in the auditing process itself, which, I think, is fair to say has been damaged by the kind of thing that Congressman LaFalce was talking about. The auditing firms themselves have something to worry about in terms of the integrity of their processes, and I think they're at work on them.

Mr. SHAYS. I'm new to the Committee, frankly, and I don't have a comprehension of whether audit firms around the world are similar in their approach.

Mr. VOLCKER. Well, there are five auditing firms around the world that account for a big portion of the business all over the world.

Mr. SHAYS. OK. So the auditing firms here are the major players.

Mr. VOLCKER. Well, the auditing firms here, you think of the big five American auditing firms, they're all international and pretty much all over the world in different organizational structures. Some of them are more uniform than others. Some of them are, I guess, a collection of existing firms that retain some degree of independence. Others are more centrally operated.

Mr. SHAYS. In that case, though, given that they're international in nature, if the national regulatory body of a country seems not to be as eager to comply, does the market in a sense force them to, because the auditing firms, the international firms are simply going to have a consistent standard around the world?

Mr. VOLCKER. That's the aim.

Mr. SHAYS. So the question, though, I'm saying is, so even if the national regulatory body isn't as aggressive as it should be, the hope is that the auditing firms will still set the standard?

Mr. VOLCKER. That is my understanding with the exception that if a particular country said companies domiciled in our borders has to follow a different standard, obviously, they have to follow the law. But as I said, in Europe, a big important area, they say they will adopt international standards. I think the presumption is Japan will do that. The hope is eventually the United States will do that. And it could be done either by adopting GAAP or adopting the international standard, that's good enough. That may be hypothetical out in the future, but you could say the international standard correctly audited is good enough for entry into our market.

Mr. SHAYS. Are we dealing with the European Union as a body, or do we have to deal with each specific country?

Mr. VOLCKER. I think in this area we're getting them as a body.

Mr. SHAYS. So they have, for the most part, have uniformity within the Union?

Mr. VOLCKER. They don't now, I don't think, but they are aiming for it. That's what they're saying.

Mr. SHAYS. And is it more difficult to get compliance among the more economically powerful countries as opposed to those that are trying to become players?

Mr. VOLCKER. Well, I would guess. You could talk to people who have had practical experience, but I would assume that those nations that have more effective governments generally, tradition of rule of law and due process and transparency and so forth, are going to have more effective enforcement than countries that don't have any of those, that basic infrastructure.

Mr. SHAYS. We have our Members here, so we'll continue. The gentleman from Texas can have the floor if he would like. Thank you very much, Mr. Volcker, for responding to my questions.

Mr. VOLCKER. Thank you.

Mr. SHAYS. The gentleman from Texas has the floor.

Mr. BENTSEN. Thank you, Mr. Chairman.

Mr. Volcker, always good to see you.

Mr. VOLCKER. Thank you.

Mr. BENTSEN. With respect to the international standards, how much do you think—you talked about in your testimony that standards are one thing, enforcement is another thing, which is sort of stating the obvious, but——

Mr. VOLCKER. We had quite a bit of discussion about that this morning.

Mr. BENTSEN. Right. How much do you believe that as the markets become more interdependent, how much do you believe that the more sophisticated capital markets and institutional investors will drive to the highest standard? Do you think that's a simplistic view of things? Or do you think that institutional investors will be more inclined to seek safety in high standards?

Mr. VOLCKER. Well, I wish the answer was as unambiguous as it could be. Obviously, the investor ought to go to the higher standard and be very interested in the higher standard.

The reason I waffle a little bit in my answer—I don't want to make too much of this—but, one of my mild disappointments in this effort has been to somehow see what I perceive, maybe wrongly, as less strong interest among the analysis community, among the investment community than in the preparer community or the auditing community. And I puzzle over why that is the case. And maybe I'm misreading it. But that seems to be curious.

Mr. BENTSEN. So you're not optimistic, I guess, that it would move in that direction? I ask that because we have had recently a situation where there's been an attempt—and this is a little bit like apples to oranges—but this whole concept of tax harmonization through the OECD, and the Administration, in particular Secretary O'Neill, have come out opposed to this. And it's a fairly controversial issue.

Mr. VOLCKER. Right.

Mr. BENTSEN. Some view it as an approach toward purer tax harmonization. Others see it as an approach for more income reporting harmonization. It seems to me that ultimately—and I don't think this is a bad idea—but ultimately, we're moving toward some form of accounting harmonization. If the European Union moves

forward with it, then I think the U.S. may find itself having to follow suit.

And, I mean, I gather from your statement you don't view this as a bad thing. That ultimately we should have this harmonization.

Mr. VOLCKER. No. I think that if we can make progress in international standards that a failure to follow international standards will be noted. Let's assume we make progress toward high quality international standards and it's accepted that these are good standards, that they're internationally applicable. The momentum among investors will be to insist that people use them more commonly than is now the case when there's a lot of confusion over what the best standard is. The Europeans will argue that their standard is better than the American standard. The Americans argue our standard is better.

So, you know, it's a little harder to insist upon the correct standard when you don't have agreement on what the correct standard is or the best standard or uniform standard. Whether it's the best or not, it's uniform. I think you will get more discipline. I would think you would get more discipline in the investment community, because it will stand out more if you're not following the international standard.

Mr. BENTSEN. From a practical matter, if I understand correctly now, a foreign-based corporation that sells shares in United States markets can use their home-based accounting standards, but there are certain GAAP standards that they have to comply with supplemental to whatever their audit is.

Do you believe that even if we go toward—if we don't get to a full harmonized standard, but the international standards are set forth and there's a variation between that and GAAP, do you think that we can continue with sort of a bifurcated capital market system between the United States and the European markets, or do you think the capital markets themselves will force this?

Mr. VOLCKER. Well, I think you can continue with a bifurcated, but in a different situation than exists at present. You could exist, not as good as with a clear international standard, but you could exist if it's easier to reconcile. I don't think it's easy to reconcile now, from what I'm told. So it's theoretically possible, but in practice, difficult.

If there was enough consensus, but there were two or three points upon which there was a difference that were pretty clear cut and fairly simple, you could present accounts that reconciled the two, you would have made a very big step forward.

Mr. BENTSEN. Thank you. Thank you, Mr. Chairman.

Mr. SHAYS. Thank you, Mr. Bentsen. Mr. Cox, did you have a question?

Mr. COX. Well, I apologize for having been down at the signing ceremony on the floor, and so I have just now confronted your written testimony and I'm not really prepared to address to you any complicated questions. But I want to——

Mr. VOLCKER. I'm not prepared to answer too complicated a question. So we're in the——

[Laughter.]

Mr. COX. But I want to wish you Godspeed in your role as Chairman and just emphasize what I know you take to be the impor-

tance of what you're doing. Because rather rapidly, more rapidly than most of us have been able to absorb, the world has changed around us, and the things that we were all accustomed to and the ways of doing business that we were accustomed to simply won't serve for the future, and we've got to do precisely what it is that you are focused upon. So I want to thank you for it. And beyond that, if I feel compelled, I'll have to send you a written question at some point.

Mr. VOLCKER. You know, I really appreciate your interest and the other Members of the Committee, because I think it is important. And I think the end result will be something, I'm inclined to say different than GAAP. I don't know how different it's going to be, but something that has international support instead of pure American support, and I think that's important in the world that you're talking about.

Mr. COX. If I may, Mr. Chairman. Apart from standard-setting, which is a difficult intellectual task, there is the matter of examination and enforcement, because it's easy enough for people to say or to claim that they are adhering to an international standard or to a uniform standard. But our system in the United States is superior not just because innately our standards are the right ones, but perhaps even more so because there is what we'd like to call transparency and there is a rule of law. There are consequences for failing to do what you said you did.

Mr. VOLCKER. Absolutely.

Mr. COX. What, if anything, in your role as Chairman can you do about that aspect, perhaps the larger aspect of the problem?

Mr. VOLCKER. Our mandate is confined to the standards. But, I think in reality, the uniform international standard will create pressures for better enforcement. And, I think, there's bound to be some interaction between the standard-setter and the enforcers in practice, at least I hope that will be the case.

But, we don't have any authority for enforcement. That's up to the auditors themselves in the first instance and then the national bodies to back that up or direct it. You're absolutely right in, I think, emphasizing the importance of enforcement.

Mr. COX. Thank you. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Cox.

Mr. Israel, did you have a question?

Mr. ISRAEL. Mr. Chairman, I was at a Science Committee markup and then on the floor, so at the risk of asking a question already asked, I will hold off except to thank the Chairman for leading this Subcommittee into the important issue of accounting.

Chairman BAKER. Thank you very much, Mr. Israel.

Mr. Volcker, I think you have responded to all the questions of the Committee this morning. We certainly appreciate your continued leadership in this matter, and as you feel we may be of further assistance in your task, we want to offer the Committee's services in any way you deem appropriate.

Mr. VOLCKER. I might say that we are intending to have a meeting of the trustees and the Board in Washington. I don't remember the exact dates, but you will certainly get invitations to some meetings so we can explore these issues further to the extent that you care.

Chairman BAKER. I certainly think that it would be a welcome opportunity, and I think one appearance would probably cure the Committee's interest in hearing from us again. Thank you very much, Mr. Volcker.

[Laughter.]

Chairman BAKER. At this time I'd like to invite our two participants on our next panel to come forward. Thank you.

I'm pleased this morning to have two distinguished participants in our hearing that will bring, I think, important perspectives to the necessity for an international standard. The first is Mr. Phil Ameen, Vice President and Comptroller of General Electric Company and Chairman of the Committee on Corporate Reporting of Financial Executives International, known as FEI.

We also have with us this morning Mr. Robert Elliott, who is the Immediate Past Chairman of the Board of Directors of the American Institute of Certified Public Accountants, a partner today in KPMG LLP in New York.

Gentlemen, I welcome both of you here this morning and we will make both your statements part of our official record. And welcome you here, Mr. Ameen, to begin the remarks, sir.

STATEMENT OF PHILIP AMEEN, VICE PRESIDENT AND COMPTROLLER, GENERAL ELECTRIC COMPANY; CHAIRMAN, COMMITTEE ON CORPORATE REPORTING OF FINANCIAL EXECUTIVES INTERNATIONAL, REPRESENTING THE FINANCIAL EXECUTIVES INSTITUTE

Mr. AMEEN. Thank you, Mr. Chairman. On behalf of FEI it is indeed an honor and a privilege to be here today. My official comments have been submitted to you in writing earlier, and I shall confine my remarks this morning to a brief summary of what I've already submitted, with your permission.

Three broad summary points. First of all, we believe that international accounting standards are inevitable and a good thing.

Second, I'd like to spend a moment thinking about the extreme difficulty which has already been hinted at this morning of developing accounting standards at all.

And, finally, spend a moment thinking about the status of the United States and particularly U.S. reporting companies, in a world of international standards.

First of all, the inevitability. Within the international world in which we deal, currency flows, capital flows are rapid and have no respect for borders. Thus, we already live in what is very much a global environment, both in the investment world and in the mergers and acquisitions world more pointedly.

Earlier this week, I was with one of our Italian affiliates. We were talking about some U.S. application of revenue recognition principles, and it was necessary for me to describe pretty quickly which of the seven ledgers that they are required to maintain I was interested in, that being, of course, the one necessary for reporting in the United States.

The change necessary for international companies to adopt international standards when they're issued will be dramatic, but it is also an ordinary course of events for them.

We believe at FEI that the faster we move to a high standard set of global accounting standards, the better the world is going to be, and that we should not think of this strictly from the standpoint of international companies being required to adhere to these standards, but we should think as quickly as possible about moving all reporting companies, including U.S. registrants, to these standards so that everyone trading in the U.S. markets will be talking the same language.

Second, on the issue of the difficulty of setting accounting standards, I respect your ability to talk about this issue with Chairman Volcker without getting into specifics. Accounting standards are very much like theology. Those who have a view, and it's just about everyone involved in them, believe that their view is right to the exclusion of just about every other view.

This creates an enormous amount of strain during the debates surrounding accounting standards. Oftentimes, you will see reports from preparers and reviews by analysts that dismiss an entry or an accounting result as just the accounting. My view is that we have to view that as a failure of the standards, that the responsibility of standards is to communicate the financial results, the financial position, in a clear, unambiguous fashion, and not introduce bias.

Oftentimes, the accounting standards themselves can be viewed as more or less just a deadweight tax levied on the system, and the proceeds that that tax extracts are simply a drain on the system.

Accounting standards are often set by the theologians who have a view that their answer is the one that will solve the problems in the accounting standards world. Many examples of that. Mark-to-market, or as Chairman Volcker said, fair value accounting, stock option accounting, the recent instability in consolidation of affiliates. All of these rules have changed dramatically. And our view would be that the faster we reach stability in the accounting standards, the better off we are from a reporting and from a usability of financial statements standpoint.

Finally, I think it's necessary for us to think about the diminished status of U.S. companies as international accounting standards come into being. We simply have fewer votes at the table in what has been the most complex application of standards. If standards work in the U.S., they'll work just about anywhere is a fair view from the U.S. standpoint. But, I think, we have to understand and respect that that isn't necessarily going to carry the day internationally and will not necessarily influence these standards.

Finally, just a word about what we view as the reliability of U.S. financial reporting. FEI recently published a study of restatements from 1977 through the year 2000, and it's interesting, I think, that the level of restatements indicating the reliability of financial statements is under half a percent, and on a market cap weighted basis, under a tenth of a percent of registrants during the period. We don't know what we don't know. We don't know those misstatements that haven't yet been discovered. But all in, I think we would all conclude that we have a very reliable and excellent set of reporting, enforcement and auditing in the United States.

Thank you.

[The prepared statement of Philip Ameen can be found on page 79 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Ameen.

Mr. Elliott, welcome, sir.

STATEMENT OF ROBERT ELLIOTT, PARTNER, KPMG PEAT MARWICK LLP; REPRESENTING THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. ELLIOTT. Thank you, Mr. Chairman and Members of the Subcommittee for giving us the opportunity this morning to talk about such an important issue as international accounting standards and their effect on global capital flows.

I also have submitted my statement for the record, and I will not repeat that. But, I want to emphasize a few high points.

First, I want to start by saying that accounting is a language. It's a language devised in order to describe business enterprises. And accounting standards, in effect, represent the vocabulary and the grammar of that language. Historically, each country has developed its own language. And these languages differ one from the other, and it's for good and proper reasons in the past. It depends on what the objectives have been.

In some countries, the objective has been to facilitate central control of the economy. In some countries, it's been to facilitate the banking system financing companies. In some countries, it has been to facilitate tax collection. In a few countries, mainly the United States, the United Kingdom and other advanced capital markets, it has been developed in order to serve investors in public companies.

So, naturally, the language would have developed differently along all of these lines. Now, we have these global markets that everyone in attendance here is well aware of, and the International Accounting Standards Committee has been in place for quite a while to attempt to develop a common language that could serve investors across this whole waterfront.

And, I would say, that over the period that they've been in existence, they have done a fine job of developing accounting standards. And international accounting standards are better than the local accounting standards in most countries. And if companies in those countries would use international standards, investors would be better served.

But, international accounting standards are not better than the accounting standards in every country; in particular, the United States, the United Kingdom and Canada arguably have more rigorous standards. And, therefore, to adopt at this time international accounting standards would actually result in a reduction of the quality of information available to United States investors.

In time, as Chairman Volcker put it, we hope that international accounting standards will rise to be the best in the world. But in the meantime, it's important for U.S. investors to have the benefit of the best standards in the world.

But there's a more important issue, and that is that accounting, like any language, can be either primitive and rudimentary like the language that the Neanderthals would have used, or it can be a rich, sophisticated, descriptive language like modern English.

Today's accounting language in virtually all countries was developed in order to describe industrial era enterprises, companies like the B&O Railroad, like the Packard Motor Car Company, like the National Cash Register Company, and like Montgomery Ward. These accounting principles were not developed to describe modern post-industrial companies, and they therefore do not well describe them, companies like Amazon and Cisco and Intel and Microsoft.

So it's very difficult to describe these companies given our accounting standards, just as it would be very difficult for a Neanderthal with his limited vocabulary to describe a steam engine let alone a computer.

So it's not just uniformity of accounting that's important, desirable as that is. We also have to be concerned about modernizing accounting so that it is more descriptive of the types of post-industrial enterprises that are leading the way into the development of our economy for the 21st century.

There is an element here of suppression of innovation at work. The regulators generally are very concerned with preventing and suppressing fraud, which is certainly something much to be desired. But it does leave the regulatory agencies, generally speaking, in a position of suppressing innovation and change in the way in which these things are done.

And one role that the SEC could do is to encourage innovation and let the private marketplace develop a richer language, a richer vocabulary to describe these post-industrial enterprises.

So basically, my points are that while uniformity around the world would be a good thing, it would not be a good thing if it were at the expense of having American investors deprived of the best possible information about the investments that they're making, and it would not be necessarily a good thing if it were at the expense of modernizing the accounting language to better describe modern companies, and that our regulators, including the SEC, have a role to play in encouraging the modernization of accounting.

Mr. Chairman, that completes my informal remarks. And thank you very much.

[The prepared statement of Robert Elliott can be found on page 86 in the appendix.]

Chairman BAKER. Thank you, gentlemen, both for your appearance here, and your formal statements both were very instructive and very helpful.

In coming at this, describing the accounting reporting language in whatever style we wish—richer, boring—it would seem that we have to be careful even within the English language whether it's English brogue or Southern drawl or rap music in Los Angeles, that there tends to be an inability to communicate even on that platform.

More important than that, perhaps, is the intended use of the reporting data. And I have concerns, perhaps not well founded, that much of the reporting today is based on standards developed over the past 50 years that tend to be more brick-and-mortar traditionalist views of the market participation and activity.

It would seem, for example, in the case of a concept stock, where there are few assets at all other than perhaps a patent, a new drug being developed, how does one look at that in the old style of eval-

uation and come up with anything that's relative to the real dollar value or any economic potential since it is for the purpose of the investor that this information is generated?

I would presume that management within a corporation will use this data, but management generally feels they have more insight into the activities and direction of the corporation than the mere financials and metrics can indicate.

So if it is for the purpose of the investor to understand the real risk and potential return or potential loss associated with the investment, if that's the goal, should we while we have this opportunity to reconfigure without a nationalistic bias, I would add, isn't it time, given the changing nature of the dynamic of the economic system, more appropriate to have forward-looking analysis as to corporate strategies? Where do you intend to invest?

Even social and environmental sensitivities. If you're going to build a nuclear power plant and sell shares in that activity and you're going to do it in a region which has some political sensitivity to that, those disclosures might well change the investor's view, even though management appears competent, the plan seems sound, and they have a track record of doing it well in another country.

Finally, my last observation is, I think, I understand the cost for the international firm to go from IAS back to GAAP, to come to the United States to get on the big board. What is the cost, if there is such a thing as an average, for a domestic corporation to go abroad and participate in European markets in light of the IAS standard? The figure I had gotten for a large corporate transfer from IAS to GAAP was $10 million. Is it that expensive for us to do likewise? And, if that's the case, doesn't that add some sense of urgency to simplification and unification? And, I'm going to quit, because that's just sort of a statement more than anything else. Either gentleman.

Mr. AMEEN. If I could address the last point first. For the most part when my company, General Electric, trades in European exchanges, we do so based on U.S. financial statements without translation to local financial statements. There are very few exceptions to that.

Until recently, in order to trade on the Tokyo exchange, one had to translate one's financial statements into Japanese accounting principles and into Japanese in fact. But for the most part, U.S. standards are accepted as the trading vocabulary for European markets.

Mr. ELLIOTT. Mr. Chairman, I agree with your comments about the forward-looking information. Sometimes people think that it's going to be very difficult to take these soft assets of the types you were describing—a patent or knowhow or the capacity to innovate—and put it into dollars and cents and put it into the financial statements.

But that's not the only way to address the problem. There could be supplemental disclosure about these matters that would be very informative to investors without necessarily clouding the financial statements with such soft types of numbers.

Several years ago, the AICPA had a committee known as the Jenkins Committee. Mr. Jenkins is now the Chairman of the

FASB. They suggested a more forward-looking business reporting model for American companies, and that's under consideration by the FASB now, and I'm sure it will be by the new IASB.

But it talked about more in the way of leading indicators, risks and opportunities for the company, and the types of things that you were talking about. Those would be substantial improvements in corporate reporting that would help investors.

But there is a counter to this, and that is that the more that companies reveal to investors, the more they accidentally reveal to their competitors, and there's a balance point. On one hand, the more they reveal, the lower their cost of capital, because the information risk to investors is lower. But, on the other hand, there are competitive costs. And companies must seek a balance in that, and that is really a fundamental part of the job of any accounting standard-setter—to make those balances in such a way that we have the maximum economic benefit.

Chairman BAKER. But one might also well argue that the more you disclose, the lower your cost of capital, the less you disclose, the higher the cost. And the tradeoff is competitive pressures verse the cost of capital to expand your business enterprises. Is that a fair statement?

Mr. ELLIOTT. That is precisely correct.

Chairman BAKER. Well, I think in the long haul, given the nature of the economy being an information-based economy and that change in values occurs so dramatically and quickly, I can only imagine if one had a disclosure of Bill Gates's original travel meter, which was his first product that he actually sold, and you were an investor in the travel meter corporation, what his valuations might have looked like as opposed to Microsoft.

Mr. AMEEN. Mr. Chairman, I'd just like to add an observation to what's already been said. I think it's important from a financial reporting standpoint to permit financial statements to do what they do well. What has happened, in my view, in the last—perhaps 20 years, as we've moved into a technology age, is that the pipeline of data is vastly greater than what's contained in financial statements.

The amount of data that comes from my company through the investor relations community, through the press relations community so far exceeds what's in financial statements that that becomes the principal trading information. What one would say about a company with no sales and a billion dollar market cap within the financial statements quite escapes me. However, there is a story to be told and there are unofficial, unaudited, non-financial statement means of communicating that story that seem to work reasonably well, and we should respect that communication mechanism.

Chairman BAKER. I am continually amazed that when a brick-and-mortar corporation fails to meet a seven cents earning expectation and only makes six, gets treated more harshly than a dot.com who only loses a nickel instead of ten. You can't explain that rationale to me, I don't think. Mr. Kanjorski?

Mr. KANJORSKI. The receptiveness of international standards, how culturally driven is that? It is my understanding that there are many foreign companies that really do not like to have transparency or disclosure, because they consider their business their

own business, and they may find it difficult to adopt. Is this a cultural problem or a national problem? Or is the world global market just overcoming this with abandonment?

Mr. ELLIOTT. As I had indicated, Congressman Kanjorski, a lot depends on the history in a country and why things are the way they are today. So, for example, many countries, including those in Europe, do not have a tradition of allocating capital through open capital markets, but rather through the banking system and other ways.

The systems of accountability there are developed for other purposes rather than informing investors. They might be to make the most conservative type of statements to shareholders and the banks, rather than to be transparent and so forth. And it's difficult to overcome those because those are deeply seated historical situations.

But as these companies get to the point where they need public money and they need to come to the capital markets for money, then they must step up to world class standards of transparency and accountability. So, absolutely, there is a cultural issue. And to a large extent, it comes at a national level because of the national history of each of the accounting systems.

Mr. KANJORSKI. Is this going to be a process where the large corporations and the international corporations first adopt these principles, and then the intermediate-sized companies, and then ultimately in the long term, the small businesses will adopt the standard? Is that what is going to occur, because the drive is to get into the public markets?

Mr. ELLIOTT. That is a very likely scenario, yes. I mean, to some degree, that's already happened, as one looks at the large German companies that have come into the U.S. markets by adopting U.S. standards and vastly increasing their transparency. The effect on what's disclosed by Daimler Benz when they became a U.S. registrant, the difference in their reported earnings, German principles versus U.S. principles, and the amount of transparency in that registration was quite enlightening to those who were providing capital for that company. And, I think, that's a trend that's got to continue.

Mr. KANJORSKI. In my opening statement I asked Mr. Volcker to give me some stick-and-carrot type considerations that the United States Government or the American economy could lend to this effort. Do you see any need for the United States Government to act in order to help facilitate this transition, or are we doing just what we should do in staying out of it? Or, is there a need for something that we can provide to encourage the transition?

Mr. AMEEN. In an oversight capacity with responsibility for the U.S. capital markets, I think oversight is the right approach at this point. I think that Chairman Volcker is right. The standard setters need to be left to operate independent of political pressures lest we bring political pressures from the rest of the world to bear, and that would not be the right standard-setting environment, in my view.

Mr. ELLIOTT. We should also point out that Chairman Levitt of the SEC was instrumental in the design of this system, so it's not

that the United States has had little or no influence on how it has been designed.

Mr. KANJORSKI. Very good. Mr. Chairman, I yield back the remainder of my time.

Chairman BAKER. Thank you, Mr. Kanjorski.

Mr. Cox.

Mr. COX. Thank you very much, Mr. Chairman.

Mr. Ameen, I want to ask you about one part of your written testimony that is especially frightening, I think, if you consider the implications of it. You have said that—I think you've said very politely that the due process of international standard-setting is more nuanced than its U.S. counterpart, by which I infer you mean that we don't know exactly how it's going to work.

There is, you go on, a very real risk that the economic interests of the United States, and that's something about which, if nothing else, the Congress must concern itself, will get lost in the avalanche of feedback that the new International Accounting Standards Board will face. So, in addition to not knowing precisely how the due process is going to work, one of the issues that the International Accounting Standards Board is going to face is just an enormous volume of information, and how they're going to process it and what weight they're going to give to it is anybody's guess.

Lastly, you say in this passage that it's already clear that the United States leads the way with the most innovative transactions and structures that the world has ever seen, but that the U.S. concerns will carry relatively modest weight with members of the new IASB. And, if we missed the point, you have said also it seems to me with remarkable diplomacy, "inevitably, representatives from simpler environments will be hard pressed to cast knowledgeable votes".

Do you want to tell us why we shouldn't be scared to death of what you're saying here?

Mr. AMEEN. I expressed those as concerns, not as the inevitable outcome. I think it will require particular energy on the part of the IASB members to understand transactions and economic environments with which they are not individually familiar. These are all professionals. They have been dealing in a professional environment their entire careers, and I am hopeful that they will meet the test. But, I think it's something that we need to watch very carefully. That contrasts, I think, with standard-setting in the U.S. where the substance of all feedback is coming from a very similar economic environment.

Part of what, I think, we need to be cautious of is that the complex transactions in the U.S. are presented fairly, however the standards are ultimately developed.

It is in the best interest of the international community to look at where the markets and the transactions in the U.S. are because inevitably, they will follow, given some time lag.

Mr. COX. I suppose that one of the inferences that one might draw from the concerns that you've raised is that inasmuch as the United States is the leading capital market in the world, among other things, it has the most capital, and inasmuch as we're talking about international economics and international business, which is in the end competitive, that U.S. leadership and U.S. modeling,

which is then emulated by the rest of the world, is another way to achieve similar results, or at least another, if you're an academic, potential way, another route to achieving the same end. Should we be thinking about ways to capitalize, if you will, on the U.S. native advantage here at the same time that we think about international bureaucratic political structures to accomplish the same result?

Mr. AMEEN. I think so. I think that the structure that Chairman Volcker has designed and his associates have designed is meant to be responsive to input from a wide variety of constituents and certainly constituents in the U.S. will have the obligation to communicate clearly with the Board potential perils of the path they're exposing and selecting.

And we will attempt to keep the calories behind that effort, both as FEI and as individual registrants in the U.S. That's our principal means of applying influence.

Congressman Cox, the——

Mr. COX. Mr. Elliott, I wanted to invite your comments on this. I simply started with Mr. Ameen because it was the passage from his testimony that I was quoting. Thank you.

Mr. AMEEN. Thank you. I just wanted to add that we could hypothesize that the International Accounting Standards Board goes in either of two directions, either they have the good structure and the quality of the accounting standards that they develop goes up, or we could also hypothesize that politics results in a sort of least common denominator, and they go down.

If they go up, then they will at some point be as good as, and better than, U.S. standards, and everybody around the world will be better off.

If they go down, our SEC is not going to permit companies to file under those lower standards. They will still be required to give United States investors the benefit of the higher United States standards.

So, if they go down, we're protected, and if they go up, we'll be better off. I, for one, believe that the structure that's been put in place deserves a good chance to operate, and I'm optimistic that it will result in improvements.

Mr. COX. Implicit in your comment is that the Congress should not cede any turf legislatively from the SEC to this or other international standard-setting bodies so that as a failsafe always, U.S. standards can be implemented from our own vantage point.

Mr. AMEEN. I think the status quo as it exists right now provides the level of protection necessary. The SEC is doing what it needs to do in the interest of American investors and the Congress is overseeing the SEC, and I think it's working to the advantage of our investors.

Mr. COX. That's very helpful. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Cox.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman. Let me say first off, in following up on what the Chairman had talked about of how as we move forward, how you'd value assets. I want to compliment Mr. Ameen. I agree with you.

Much to my dismay, the older I get, the more old-fashioned I find myself. And, I think that we ought to be cautious in not trying to

assign values to intangible assets that may or may not have value and should be cautious about certain exuberance that might exist in the current times.

I think I hear what both of you are saying, and particularly, Mr. Elliott, that we should allow this to go forward. But, let's be cautious that we might not come out with the best structure. And I understand your concern or your comment that even if the international standards were lesser than what we would view as appropriate and what our current laws and regulations provide for participation in American capital markets, given the growing international structure of the capital markets, there might appear to be some systemic risk that could occur where you would have a race to the bottom in other markets where larger companies, public companies would be able to use lesser standards in other markets. And, I think, we have to be concerned about that.

But I want to ask you, I'd ask Mr. Volcker this, and Mr. Ameen, you may have a better viewpoint on this, coming from a public company. Mr. Volcker was not particularly optimistic, I think, that institutional investors would necessarily demand the highest standards. That as the markets become more intertwined and international that we couldn't necessarily rely on market discipline to acquire the most appropriate or most transparent standards. I would certainly hope that would be the case. But I'd be curious of what your opinion is.

Mr. AMEEN. It's an intriguing question.

The academic research that I'm familiar with has been inconclusive at best. Where we stand now, I think, is an interesting case study—that is, regardless of what your domestic native economy's standards are, they may be used as a basis for filing in the U.S. with reconciliation to U.S. accounting principles.

Reconciliation, one can argue, is probably less than half of a complete solution, because of the robust disclosures that are required in U.S. financial statements. But at least it's a start, and it calibrates something of the difference between what you see in the financials and what they would have presented had they been presented in the U.S. One would presume that reconciled financial statements would carry with them, because of the lack of transparency and the lack of total comparability, some sort of risk premium.

I think if the markets could demonstrate clearly that the higher standards carry a lower risk premium, then the rush to U.S. or high-quality international standards would be universal. Obviously, we haven't made that case with sufficient compulsion that that's been the answer, and it's unclear to me why.

Mr. BENTSEN. I think you would excuse fraud. You're always going to have some actors that are going to be fraudulent, and those would be separate.

Mr. AMEEN. I think one has to argue that errors in financial reporting are more likely to occur in more complex standards environments. It's an unfortunate result of the complexity of the standards themselves.

We will see errors in application of derivatives accounting just because the rules are so horrendously complicated.

Mr. BENTSEN. You talk about Daimler-Benz and others, and Mr. Elliott, you as well talked about the various forms of allocation of capital.

But again, as we see the capital markets become more international, at least in more industrialized countries, are you seeing assimilation of the allocation of capital similar to the United States model and away from the more bank-funded model, or not?

Mr. AMEEN. That certainly seems to be the case.

Mr. BENTSEN. Do you think the standards might follow suit as a result of that, or is there any empirical evidence of that?

Mr. AMEEN. I have not seen evidence that the standards are necessarily following suit yet.

Mr. ELLIOTT. The investors themselves, I think, are pretty well aware of the risks that they're taking when they invest in different economies and under different standards. And while they might not, as Chairman Volcker suggested, demand to invest only under United States or very high standards, nevertheless when they invest in other places they demand a higher risk premium, which results in a higher cost of capital for those companies.

Why do overseas companies want to come to the United States to raise capital? Well, one answer is there's more capital here. But another answer is, the cost of capital is lower here. But that's not an accident. It happens because of the high standards of accounting and disclosure and enforcement in the United States.

So you can say that there is a race to the top in that sense, that companies anywhere in the world who want to tap our capital markets have to step up to our standards. So while Mr. Ameen, I think, is right that the academic evidence is not as strong as we would like in order to be able to make policy decisions, I think it's fairly clear that the more transparent a company is, and is seen by its investors as being, the lower the risk premium that they demand. And the more opaque they are, the less they tell to investors, the higher the price of capital that they pay.

Mr. BENTSEN. Thank you, Mr. Chairman.

Chairman BAKER. Mr. Bentsen, I wasn't suggesting that they value dot coms based upon what they become. But my point in making the statement was that there are significant intangibles that often give someone a more clear understanding in supporting your comment, the more transparency the better, up to the point at which it becomes competitively disadvantageous. That's my point.

Mr. Royce.

Mr. ROYCE. Yes.

Mr. Elliott, when you argue that it's a 50/50 proposition whether the input of these new constituencies will frankly increase the likelihood that the standards will be more useful, beneficial worldwide, versus the proposition that it will be the least common denominator that determines the outcome, I would just reflect—Phil Ameen has made the point in his written testimony. He used the word, inevitably.

He said, inevitably, representatives from simpler environments—environments without the transactions that test the limits of a proposed accounting standard—will be hard-pressed to cast knowledgeable votes.

It seems to me that there was another course of action here. Rather than attempt to democratize this process in a way which those interests that already had lacked the impetus to reform their own economies in a way to bring transparency, they would be given a seat at the table. And it was reflected in the testimony that I was not here for, but Chairman Volcker's testimony, in which he alludes to the past and he said, the SEC had considered U.S. GAAP to be the best in the world. In effect, they had long taken the position other countries and companies should conform if they wanted to access U.S. capital markets.

In fact, it is seen that increasing numbers of global corporations were accepting that verdict. They were conforming.

Then he went on to argue why we were going to change course, why we were going to develop this concept of developing international standards collectively. He puts it to the Asian financial crisis, and that led him and others to a different emphasis. They've made clear the importance of effective auditing internationally.

See, I'm not sure that's true. I think what it has made clear to us is that our own insistence on U.S. standards was gaining ground. I think the Asian financial crisis is probably a reflection of moral hazard, of what happened when you basically have a situation where investors feel they're going to be bailed out, and you have investment in a hot market.

And I think our rush to judgment here has led us to embrace a strategy that perhaps is not the best. I think the SEC was originally correct in their assumption. If we stuck to our guns and recognized that ours was the most innovative system in putting forward standards, that we would end up basically having the world come along.

Now, Volcker went on to say the U.S. does not have all the right answers. Well, I think we have more of the right answers than anyone else in the game. Furthermore, developing de facto global standards from Connecticut has seemed increasingly unrealistic, both politically and economically in the age of globalization. I just think he's come to the wrong conclusion.

But I'd ask for your consideration on that observation.

Mr. ELLIOTT. I think it's a very interesting observation.

Before the new structure was put in place, and we were working with the old volunteer basis in the International Accounting Standards Committee, there was a competition going on, and that competition was between international accounting standards and U.S. accounting standards. In Germany, for example, under the law it's permissible for public companies to adopt either German GAAP or U.S. GAAP, and many German companies were beginning to adopt U.S. GAAP, because it resulted in their capital cost improvements.

But also, I would say parenthetically a lot of those companies looked at Daimler-Benz, and they looked at the way that that company's internal management processes were improved once they had better accounting information at their disposal. And these companies were thinking, maybe adopting U.S. GAAP would not only give them the capital cost advantage, but would also give them better internal management information to run the company.

So, the direction seemed to be going that it was at least a reasonable horse race that U.S. GAAP would win the day against the old

IASC. I think that with the restructuring of the old IASB, which reflects Chairman Levitt's views of what would constitute a high-quality system, and with getting full-time members on there and with substantial funding and so forth, I think the horse race needs to be handicapped in a different way, and that while it's still possible that U.S. accounting principles would dominate in the end, I think the smart money would now go to the IASB as winning the game in the long run.

But it is not determined. You're absolutely right. There is a marketplace at work here, and it will be determined by the choices made by companies in different countries over the next couple of years.

Mr. ROYCE. It was interesting, because if I were to graph the capitalized value of our capital markets and then compare it to the capitalized value of the European capital markets, and then the Asian capital markets, and then Australian and African capital markets—people are voting with their feet, in a sense. I mean, the disparity is absolutely phenomenal.

Part of that is security with our laws relative to transparency and reporting. But I was going to go lastly back to Mr. Ameen. As you say in your written testimony, there is a very real risk that the economic interests of the United States will get lost in the avalanche of feedback that the new International Accounting Standards Board will face.

Let me ask you, Phil, for your view of my tack on this, and whether you think there is a possibility that, in the long run, our standards would perhaps create enough leverage, if we stuck to that position, that Asia and Europe would probably begin to cede to those rules.

Chairman BAKER. Mr. Royce, we'll have to make this your wrap-up, too, as well.

Mr. AMEEN. It's a very interesting question, and one that I do not have a clear answer to.

We recite so often, as those who are influential in shaping U.S. GAAP, that we are the best in the world, and the rest of the world should follow along behind us. We forget that our standards are far from perfect. There are many legitimate criticisms that Europeans and Asians levy at our standards that are levied internally within the U.S. at our standards.

What we have is an opportunity to work with the rest of the world on a clean sheet of paper, and achieve in fact higher-quality standards that will serve not only us, but the rest of the world, exceptionally well. I think that's the opportunity that we need to capitalize on and we need to take advantage of.

It would be almost impossible, I think, to achieve that sort of end in the U.S. This is a very dynamic process.

Mr. ROYCE. I will wrap up. But if past experience had not been that, on balance, we had been more innovative, we had been more accurate, our costs of capital had not been so much lower, then I would concur.

But I spent a lot of time in Asia and around the world. And looking at the lack of transparency and the lack of emphasis there from corporations or from governments in making the right moves, that's why I lean toward the other.

Mr. AMEEN. That's true. I think we have yet to see the effect of the pool of Europe, all of that capital and all of those resources which were separate countries heretofore. I think that's an influence that's going to be very strong in the near future.

Mr. ROYCE. Thank you. Thank you, Mr. Chairman.

Chairman BAKER. Mr. Sherman.

Mr. SHERMAN. Thank you, Mr. Chairman.

Our capital markets and accounting system are indeed the envy of the world. In large part, we got there by always insisting that we make it better and asking the tough questions, and inviting tough questions from the rest of the world as to how we could make our accounting systems better.

And there is domestic criticism. It is said that we do an outstanding job of reporting the irrelevant in a transparent manner to investors. And I want to focus on something I've studied over the years that has been ignored under generally accepted accounting principles in this country, but is a large portion of GAAP or its equivalent in Spanish, in Latin America and other countries: that is, inflation adjustments to accounting.

Now, inflation has been low enough in the United States, except in the 1980s, so that you could claim that it was ignorable. But even rates of 2 or 3 percent are relevant. And then, unless you're marking everything to dollars, if you're preparing accounting systems to be used in other currencies they have much higher inflation rates.

I'd like our witnesses to comment on whether the very well-established and detailed mechanisms for accounting for inflation have been worked out as a matter of necessity in countries that have often experienced 10, 20, 30 percent inflation in a year—whether those should be part of our domestic financial statements.

Mr. ELLIOTT. There was a time when we had inflation accounting on the books in the United States. And even with low rates, as I'm sure you're aware, over time there could be a big distortion in numbers. But those results were not highly demanded by the investment community, and we did away with them some years ago.

But when you get to the question of what are the valuable assets of post-industrial companies, they are not, in general, exceptions; the land that was bought 100 years ago, or the factory that was built 50 years ago, or the machinery that was bought 30 years ago and are most likely to be distorted by the inflationary adjustment factor.

In fact, the important assets of companies today are things like customer satisfaction, good relations with customers and vendors, capacity for innovation, research and development, the ability to leverage knowledge to create value. These are the things that are missing from the financial statements.

So we could go back and adjust the trackbed of the railroad to today's dollars, and we could spend an awful lot of resources in doing that. But it might be less of an important thing to focus on in getting better information to investors than getting them more information about the knowledge assets, the intangibles, the sort of post-industrial assets that drive modern companies.

Mr. SHERMAN. If I could interrupt, I do think though that the land and equipment is valuable, and especially on an international

basis. Yes, we'd like to think that our future is all Silicon Valley. But certainly in many developing countries, the most valuable company is the railroad or the real estate holding company rather than, you know, the leading Paraguayan software developer.

But, that does bring another issue. That is, I think the last FASB that was published before I left full-time practice of the profession was FASB 2. I'm not saying I disagreed with it so much that I left, but if memory serves me correctly—and I may have the number wrong—that was the one that said that all research and development was written off.

Mr. ELLIOTT. That was the number, right.

Mr. SHERMAN. That illustrates the problem that I see in developing our accounting standards, and that is the tension between reporting the relevant and reporting the verifiable, given the fact that if you report the verifiable, then your likelihood of being sued is considerably less, since you can go out and do a competent job and verify the verifiable, and defend any lawsuits.

We not only have the best capital markets. We have the world's most robust tort law system. I'm not saying there's a correlation.

So what I would ask is, should we revisit the idea of writing off all research and development as an expense, and producing financial statements that are identical for two companies, one of which does a successful R&D program and one of which does an unsuccessful R&D program?

Mr. ELLIOTT. I think you may not have been here when Chairman Volcker indicated that he felt that the new IASB was going to have to address the question of intangibles. And so I don't regard the write-off of research and development as a settled issue for all time for the whole world, as I infer you feel about this.

I don't believe that that was the right choice. But that was a choice that was made in the middle 1970s. Things are very different today, and they might not make that choice today.

Mr. SHERMAN. I'm sure that it was the right choice, so long as I was with an accounting firm that could have been sued for failing to correctly assess the very difficult-to-assess value or success of a research program. Now that I no longer have a stake in whether the unverifiable is part of what has to be verified, and now that I'm an investor and a consumer of these statements rather than a producer of them, I may have changed my mind.

Mr. ELLIOTT. You put your finger on a very important issue, which is the disincentive to disclosing soft information and forward-looking information because of the litigation risk.

Mr. AMEEN. Just to use my company as an example, we don't do inflation-adjusted statements. Our historical equity is about $50 billion. If we were to capitalize R&D and amortize it over, say, a 10-year period and adjust everything for inflation, that might get as high as $70- to $75-billion.

Our market cap is about half-a-trillion dollars. So there's a big gap between what we can reasonably achieve through manipulating the old historical numbers and what the market perceives our value to be. I hope the market is right.

Mr. SHERMAN. I would point out the market is going to be based on your income statement, not your balance sheet. And I would point out the things I'm talking about would affect not only your

balance sheet, which as you point out seems to be irrelevant to your stock price, but would also affect your earnings per share, which probably is relevant.

Thank you, Mr. Chairman.

Chairman BAKER. Mr. Shays.

Mr. SHAYS. Thank you, Mr. Chairman.

Mr. Sherman, almost every hearing has someone from the Fourth Congressional District or near it, and it just tells me how important issues that come before this subcommittee are to our district. I'm delighted that FASB is part of the Fourth Congressional District, and extraordinarily proud that GE is.

I'm delighted to have both of our witnesses here today, both FASB and GE, which I consider to be one of the greatest, if not the greatest, company in the country and world is in our district. Proud to have you.

I love the tension between what I see between the two of you and FASB. I get the sense, Mr. Ameen, that you are supportive of ISB, but a little more skeptical than you are, Mr. Elliott.

I would love to have both of you mention the concept of quality. You were, Mr. Elliott, describing the fact that it's great that we have compatibility and so on, but the quality of that matters a great deal. I'd like you to define quality, if both of you would, to me.

Mr. ELLIOTT. You raise, obviously, a very difficult and esoteric question, Congressman Shays, as to how you would define quality of accounting statements and accounting standards.

I would define it in terms of the ability that it has to permit investors to assess the potential returns on their investments, and that the higher the correlation between what the company discloses and their ability to make those predictions, the higher the quality.

Specifically, that gets around two questions. One is the range of information that's disclosed, and how relevant it is. Congressman Sherman was talking about the tradeoffs between reliability or auditability and relevance. But part of the quality is to focus on relevance to investors, and part of it, of course, is to focus on the reliability of the information—that is, is it honest? Is it a fair statement of what it purports to be?

So both reliability and relevance are components. But another component you would have to bring up is timeliness. Excellent information delivered 6 months late would not be high quality, so you really have to balance relevance, reliability and timeliness to get to the most high-quality information.

Mr. SHAYS. But you view that, obviously, as of greater importance than just uniformity.

Mr. ELLIOTT. Uniformity is important, but not at the expense of quality. That's my position, yes.

Mr. AMEEN. Mr. Shays, just to put another dimension on the quality question: the measure of quality that we use in my company and a number of companies throughout the U.S. is a 6-sigma measure, which is a measure which quantifies the amount of defects permitted by a particular system. 6-sigma is almost unachievably precise.

One of the dimensions of accounting standards that has become apparent to us in the last couple of years, and that is increasingly

of concern, is that it is clear that the higher the complexity of an accounting standard, the less capable systems are of applying that standard precisely. I mentioned earlier the derivatives standard. I think there are other examples of extraordinarily complex rule sets that we very much would like to apply as they were intended. But the number of decisions necessitated by those rule sets means that errors will occur. I think that's very unfortunate.

Mr. SHAYS. Do companies like yours, and do you in particular, tend to view FASB as almost being academicians? In other words, a sense that you're out in the real world fighting the battle, and they're out sitting on the sideline, kind of seeing the world as they'd like it to be?

Mr. AMEEN. I'm not sure academic is the characterization. I think there is a certain insensitivity to costs of application of complex standards. It's an interesting issue. It's an interesting tension, yes.

Mr. SHAYS. When you say the so-called flight to quality can ruin economies and companies, and lay waste to the best global strategies, Mr. Elliott, I felt you had a very eloquent statement; and, Mr. Ameen, you had a very provocative statement. That's provocative to me. I don't understand it.

Mr. AMEEN. The flight to quality——

Mr. SHAYS. Can ruin economies and companies; not cause them problems, but ruin them. And the concept of going to quality ruining something is an interesting concept.

Mr. AMEEN. Capital flight would have that kind of consequence. And I think that's the sort of thing that you need to be very concerned about, absolutely.

Mr. SHAYS. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Shays.

Gentlemen, I want to express our appreciation to both of you for your responsiveness and your time today. It's been a great help to the subcommittee.

I think everyone here is torn between wanting to have international markets where capital flows freely, and not creating regulatory circumstances which lead to 6-sigma events. Given those two contrasting perspectives, we have a difficult role—and also being advised by Chairman Volcker not to politicize these activities, but members do have strongly held opinions about what is in the investors' best interest.

We will—next week, for example—have a hearing on how analysts are making their recommendations to investors in the market, which directly relates to the question of the quality of reporting that they get access to. These are indeed complex issues, but have extraordinary impact potentially on the formation of capital and the growth of business, not only here, but internationally.

We thank you for your comments, and I'm certain there will be Members who wish to follow up with written questions at a later time. We will certainly make your written statements part of the official record. We thank you for your participation.

I am also in receipt of a statement from the Association of Investment Management and Research with regard to the SEC concept release on international accounting standards. Without objection, I would make that a part of the official record here today.

[The information can be found on page 43 in the appendix.]

Chairman BAKER. Unless there's further comment from anyone else, our hearing stands adjourned. Thank you very much.

[Whereupon, at 12:15 p.m., the hearing was adjourned.]

A P P E N D I X

June 7, 2001

Opening Statement
Richard H. Baker
Chairman
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
International Accounting Standards Hearing
Thursday, June 07, 2001

Today, we are exercising for the first time the Committee's new jurisdiction over accounting issues. Financial accounting and transparency are vitally important for investors, practitioners, and regulators and it is my intention to actively pursue this jurisdictional responsibility. We begin by reviewing efforts to harmonize international accounting standards.

Transparency regarding the financial condition of a company is a key component in investment decisions. Accounting standards are intended to serve investors by imposing a framework for financial reporting so that investors can evaluate and compare companies using a common language.

The United States capital markets are the deepest and most complex in the world. While there are very legitimate concerns about some of the rules, the markets consider U.S. General Accepted Accounting Principles, or G.A.A.P., the most comprehensive accounting standards in the world. Of course these standards are only used by companies filing financial statements here in our country.

The globalization of capital markets and new technology now more than ever allow U.S. investors to diversify portfolios and seek lucrative opportunities both here and overseas. Additionally, U.S. companies are able to find capital to grow from sources outside the country. However, without harmonization of accounting standards from country to country, investors face uncertainty when evaluating investment opportunities and companies face costly compliance with varying accounting standards when filing financial disclosures.

We must be careful in scrutinizing this process so that the playing field is made level across national borders and that the standards are effective and meaningful to the investing public. This does not merely mean the reconciliation of foreign standards to G.A.A.P. The hope is that the international effort to harmonize accounting standards takes the best ideas of the different national standards boards and is willing to do away with those accounting principles that unduly burden issuers and increase the cost of capital. Most importantly, this effort should be responsive first and foremost to the needs of investors and should consider the types and manner or disclosure they deem most significant.

I would like to welcome former Chairman of the Federal Reserve Board, the Honorable Paul Volker and commend him for his efforts in this area as the current Chairman of the International Accounting Standards Trustees. I look forward to hearing about their important work.

I would also like to thank the members of our second panel for their willingness to testify here today. Bob Elliot, a partner at KPMG here on behalf of the AICPA, and Philip Ameen, the Controller of General Electric here on behalf of the Financial Executives Institute, have both been very active participants in the harmonization effort as well.

I look forward to the testimony and support the important goal of establishing common accounting standards of the highest quality to facilitate the flow of good information to investors.

June 5, 2000

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: Concept Release: *International Accounting Standards* (File No. S7-04-00)

Dear Mr. Katz:

The Global Financial Reporting Advocacy Committee (GFRAC) of the Association for Investment Management and Research (AIMR)[1] is pleased to respond to the U.S. Securities and Exchange Commission's Concept Release on *International Accounting Standards*. The GFRAC is a standing committee of AIMR charged with representing the views of investors to and maintaining liaison with bodies that set financial accounting and reporting standards in a global context, particularly the International Accounting Standards Committee. The committee is also charged with responding to requests for comment from national standard setters and regulators on international financial reporting issues. The committee is developing a position paper on the quality of International Accounting Standards and their acceptability as a reporting regime for financial analysis and valuation of cross-border securities listings. The committee's work on this position paper forms the basis for their comments on the Commission's concept release.

The GFRAC is currently comprised of AIMR members from the United States, the United Kingdom, Canada, Malaysia, and Hong Kong. They have familiarity with various accounting standards and financial reporting regimes and are well versed in the issues addressed by the Commission's concept release.

Scope of Comment

The primary objective of GFRAC in fulfilling its charge by AIMR is to promote efficiency and transparency in global financial markets through development, maintenance and use of high quality financial reporting and disclosure standards. Such standards cannot stand alone. To be effective, financial reporting and disclosure standards must be part of a financial reporting and disclosure system or infrastructure that ensures these standards are properly and consistently applied. We believe that such a system must have the following five elements:

1. Well-specified and understandable financial reporting and disclosure standards;
2. Ethical, trained preparers;
3. Ethical, trained and independent auditors;
4. Effective regulatory oversight and enforcement,

including the threat of litigation, economic and criminal penalties for fraud and non-compliance; and
5. Shareholder and investor responsibility and involvement in corporate governance.

We believe that only a comprehensive and integrated financial reporting system that includes high quality accounting standards can produce financial statements that are comprehensive, neutral, timely, and most importantly, relevant and reliable.

A majority of the Committee believes that IAS standards meet the requirements set forth in element (1) above and this letter presents our reasons for that view. We wish to be extremely clear, however, that in forming our views on the suitability of IAS for use by foreign issuers in the U.S. capital markets, we assume that the quality of financial statement preparation, auditing, regulatory oversight and enforcement, and corporate governance will be of the same level and caliber as currently exists for U.S. registrants. We understand that this is a significant, and perhaps unrealistic, assumption. However, in order to be fair and impartial in our assessment of IAS, we must provide these standards with a level playing field *vis a vis* U.S. GAAP. Therefore, our conclusions are predicated on the following four assumptions being true:

1. The financial statements of foreign issuers will be subject to the Commission's additional financial reporting and disclosure requirements.
2. The Commission will enforce compliance with IAS and those additional requirements.
3. The Commission will require that auditors comply with U.S. Generally Accepted Auditing Standards in determining whether an issuer's financial statements are in compliance with IAS.
4. Investors will be afforded the same level of involvement in corporate governance as they have with domestic issuers.

We believe that accounting standards are only one piece of an integrated financial reporting system. These standards can only be effective when combined with consistent interpretation and enforcement by high quality, independent audits, and regulatory enforcement with consequences for lack of compliance. We firmly believe that clear and consistent interpretation of the standards cannot rest solely with the standard setter, whether it be the Financial Accounting Standards Board (FASB) or the International Accounting Standards Committee (IASC), but must also be the responsibility of the independent auditors when addressing practice questions. With respect to enforcement, no private-sector standard setter, including the FASB, enforces its own standards. Only regulators have that power. The Commission must commit to enforce compliance with IAS standards with the same diligence and attention with which in enforces U.S.

GAAP.

We are emphasizing these assumptions because we are concerned that many who criticize IAS have confounded these various elements of a comprehensive financial reporting and disclosure system. Even the most "perfect" accounting standards, if they should exist, would be of little use to investors if they were expected to stand alone without the other elements of the reporting system in place and fully operational.

Dissenting View

One member of the GFRAC disagrees with this view. He strongly believes that the IAS (as of June 5, 2000) cannot be regarded as a set of "high quality" standards for the following reasons:

1. IAS often contain too many acceptable alternatives.
2. IAS does not provide adequate disclosures and implementation guidance.
3. Some IAS are perfunctory (e.g., accounting for leases).
4. Too many IAS have not yet been applied.

He believes that these deficiencies make it impossible to conclude that IAS can be consistently applied and are capable of rigorous interpretation. He is also alarmed by the absence of any comprehensive discussion of plans to achieve acceptable levels of compliance by preparers and enforcement by auditors and regulators. Because he believes that (1) it is not possible to conclude that IAS are of acceptable "high quality' and (2) there is not enough evidence that adequate compliance or enforcement exists today, he dissents from the views expressed in the remainder of this letter.

Non-GAAP Elements of Financial Reporting and Disclosure System

As noted above, the GFRAC believes that it may not be realistic to assume that the non-GAAP elements of the financial reporting and disclosure system surrounding IAS are of comparable quality to those surrounding U.S. GAAP. Elements (2) and (3) of the financial reporting and disclosure system described above, for example, relate to the responsibilities of issuers and auditors respectively. The GFRAC believes that these elements have two important characteristics in common: ethics and training. In addition, auditors must be independent from their clients. We believe that there is considerable work to be done in all three areas.

Training on IAS can be achieved in a variety of ways. We do not believe that it should take very long for preparers and auditors to be adequately trained. Some of us have seen evidence that the global accounting firms have already begun to address this issue. We believe that acceptance of IAS will of necessity

expedite this process.

Ethics and independence are more problematic. The Independence Standards Board was initiated to address these issues with respect to those who audit U.S. financial statements. We believe that, given both cultural and legal differences that exist in an international context, it is reasonable for investors to be more concerned about compliance with both the spirit and letter of IAS.

Therefore, although we believe that independent auditors make significant contributions to effective enforcement, the true burden of enforcement of IAS will rest with the Commission and its staff. We understand that the most important issue for the Commission will be to have adequate numbers of trained staff to undertake this responsibility. Once adequate staff is in place the Commission must review IAS financial statements with as much, if not more, care as they currently do U.S. GAAP financial statements. When non-compliance or fraud is detected, the Commission must use all of the remedial actions available including threats of litigation, punitive damages, and criminal proceedings.

Finally, shareholders and investors must accept responsibility and be afforded the opportunity to participate in corporate governance to insure that the companies in which they invest provide them with sufficient, reliable, and relevant information. And to penalize those companies who fail to do so with reduced share prices and increased cost of capital.

Comments on Convergence of Accounting Standards

The GFRAC strongly supports the IASC's mandate and its efforts to procure convergence of international accounting standards and practices to one high quality standard. As noted by the FAPC in *Financial Reporting*, globalization and increased correlation of international capital markets heightens the need for high quality, complete, accessible, and understandable financial statements that provide comparability across companies regardless of the country of domicile. Financial analysis and investment decision-making has for some time focused on analyzing and comparing companies in global industries, not merely domestic. Therefore, improved transparency and comparability of financial information will (1) provide the better companies with additional sources of capital at lower cost and (2) provide investors with additional investment opportunities and the ability to assess them appropriately.

By design, IAS are not as detailed or comprehensive as U.S. GAAP. Rather than providing detailed rules, IAS focus on the principles that when followed appropriately will provide the same quality and quantity of information in financial statements. Current IAS GAAP has benefited greatly from both the Improvements Project and the development of the

other standards that comprised the IOSCO work program. The interpretations and the guidance that have been and continues to be provided by the IASC Standard Interpreting Committee (SIC) is critical to providing the consistency of interpretation that is provided in the U.S. by the Emerging Issues Task Force (EITF).

If IAS are considered as part of the Commission's financial reporting system, the GFRAC generally supports allowing foreign issuers to file their primary financial statements with the Commission using IAS. We believe the core standards provide as high quality and comprehensive a framework for financial reporting as U.S. GAAP and are suitable for use in the financial statements of foreign issuers in the United States. We believe that allowing foreign issuers to prepare their primary financial statements using IAS when they file these statements with the Commission will have three significant benefits :

- More companies will be encouraged to adopt IAS which will ultimately reduce the number of different "GAAPs" with which U.S. investors (and the Commission's staff) must be familiar.
- The resulting common use of IAS GAAP under a high quality auditing and enforcement regime will result in further improvements to IAS.
- Acceptance will provide a test, on a limited basis, of the market implications of using IAS.

Though the GFRAC recommends that the SEC allow foreign issuers to file statements based on IAS GAAP, this recommendation is not without trepidation. Our concerns stem primarily from the experience we have had analyzing financial statements currently prepared using IAS. First, a number of key standards have effective dates in 2000 and 2001 and there is no experience on whether the standards are being applied appropriately or consistently. Second, even for standards that are effective, we have seen inconsistent interpretation by the audit profession and a singular lack of enforcement. Some of these problems may be due to lack of knowledge and experience by both auditors and regulators. But continuance of such a situation is unacceptable to us.

Adequate and consistent enforcement is critical to the acceptance and survival of the IAS. Since there is no global regulatory body charged with enforcing the IASs, this task will be the responsibility of separate national regulators and independent auditors. Both will need ample training on the IASs themselves and on cultural issues that may interfere with the correct application of the standards. If the Commission should accept IAS, it will be its responsibility to ensure its staff has sufficient knowledge and expertise to perform the enforcement role effectively.

Standard-by-Standard Evaluation of IAS

The GFRAC is in the process of completing a

standard-by-standard evaluation of IAS. In performing this evaluation, we did not believe that simple comparison to the U.S. GAAP requirements would be sufficient to determine whether the standard was of high quality. Rather, we felt that it is also necessary to compare the standards to an ideal set of criteria. In doing so we are employing the criteria outlined in *Criteria Employed by the AIMR Financial Accounting Policy Committee* [FAPC] *in Evaluating Financial Accounting Standards*[2]. In this paper, the FAPC provided eight criteria that they considered most critical to the promulgation of high quality accounting standards. The GFRAC believes that the FAPC's criteria provides an important framework for analysis and we are relying on them in performing our evaluation of International Accounting Standards (IAS). These criteria are:

1. *A new standard should improve the information that is available to investment decision makers.*
2. *The information that results from applying a new standard should be relevant to the investment evaluation process.*
3. *Certain financial information is better presented outside the audited financial statements, and should not be included in the scope of a financial accounting standard.*
4. *The information that results from applying a new standard should fit the double-entry accounting model or should enhance understanding of the data contained in the model.*
5. *Economic phenomena that are similar or equivalent should be depicted as such in financial statements. That depiction ought to conform to underlying economic reality.*
6. *Current values usually are more useful than historic amounts, subject to reliability of their measurement.*
7. *Extensive disclosures usually must be required as an integral part of a new accounting standard. Disclosures are necessary:*
    1. *To overcome the deficiencies of a mixed-attribute accounting model; and*
    2. *To help users understand the effects and implications of management's accounting choices. Disclosures are not, however, a substitute for measurement and recognition.*
8. *"Smoothing" and "normalization" is a function of analysis, not financial reporting.*

Although our evaluation of all the IAS standards is not complete[3], a consensus has emerged on a sufficient number of standards for us to respond to the *Concept Release*.

The remainder of our comments address the specific questions the Commission raised in its concept release. Answers to most of the questions are implicit in the substance of our comments reflected below.

Specific Comments

▶ *Comprehensive Accounting Framework Addressing Fundamental Issues*

The GFRAC believes that IAS provide a comprehensive accounting framework. These standards address the basic and fundamental accounting issues that are encountered in a broad range of industries. Our standard by standard evaluation addresses the strengths and weaknesses of individual standards both with respect to our "ideal" standard and with respect to U.S. GAAP.

▶ *Reconciliation to U.S. GAAP*

Although the GFRAC does not hold the U.S. GAAP reconciliation in high regard, the committee could not agree that it should be eliminated. There was agreement among Committee members that, if the reconciliation in retained in the short term, it should not be viewed as a permanent part of the Commission's requirements.

In evaluating the usefulness of the reconciliation, the committee identified its shortcomings. It imposes an additional and costly reporting burden on foreign issuers. It cannot be used to construct a U.S. GAAP income statement and there is not sufficient information to construct a U.S. GAAP balance sheet. We are also concerned that issuers manage the reconciliation as much as they might manage reported earnings. We are not convinced that reconciled net income is the income that would be reported if the issuer had prepared its financial statements using U.S. GAAP. This is not to say that any additional information cannot be useful. (See comments under *Quality and Usefulness of U.S. GAAP Reconciliation*.) However, we believe the benefits of accepting IAS outweigh this limited usefulness.

One difficulty arises when there is no equivalent IAS for a U.S. GAAP standard. Absent specific guidance by the Commission, we believe that companies would tend to choose between U.S. GAAP or a national GAAP standard, if one exists. Since we support maintaining the reconciliation requirement where issuers prepare financial statements using national accounting standards, we recommend that, in cases where an issuer who prepared IAS financial statements but applied a national standard rather than U.S. GAAP when no IAS existed, reconciliation requirement should be maintained.

▶ *Important Differences between IAS and U.S. GAAP*

As noted above, the GFRAC is in the process of evaluating IAS on a standard-by-standard basis. Nevertheless, we have already identified several differences that we consider important in evaluating

the overall quality of IAS. We considered the following to be shortcomings in IAS:

(1) Accounting alternatives
(2) Restriction on use of multiple inventory valuation methods
(3) Capitalization of development costs
(4) Consolidation policy
(5) Lack of implementation guidelines

Conversely, we believe the following aspects of IAS provide better information that US GAAP:

(1) Revaluation of fixed assets
(2) Business combinations
(3) Segment disclosures

Although we have enumerated several differences between IAS and U.S. GAAP, we would like to remind the Commission that "accounting standards" are always in a state of flux. Sometimes, the FASB takes the initiative to improve accounting for a particular issue. At other times, we have seen the IASC take the initiative. This is the case with accounting for business combinations. The IASC limited the "pooling of interests" exception to only those situations where no acquirer could be identified. The FASB is now taking this one step further and eliminating the exception altogether. We hope that the IASC will reopen this issue in the near future as well.

Accounting for financial assets and liabilities is another example where different standard setters continue and expand the debate initiated by another standard setter. The FASB introduced the concept of recognizing certain financial assets and liabilities at fair value. The IASC produced a discussion document that recommended that all financial assets and liabilities be accounted for at fair value. These efforts have culminated in the formation of the Joint Working Group of Standard Setters to address these issues and make recommendations for standards in this area.

In the final analysis, however, we concluded that investors would not be disadvantaged by using IAS financial statements. We believe that if users suspect the quality of the data provided that they will assess issuers a higher cost of capital. The market will penalize those companies that make questionable accounting choices or omit adequate disclosures. We believe that IAS provide users with sufficient information to separate "good" issuers from "bad" issuers in that regard and make valuation decisions accordingly.

▶ *Competitive Disadvantage for U.S. Companies*

The GFRAC does not believe that U.S. companies would be disadvantaged if foreign issuers are allowed to use IAS. On the contrary, we believe that there is a general belief by most users that U.S. GAAP provides better information, even if that is not the case.

Therefore, we suspect that, if a U.S. company sought permission to prepare its financial statements under IAS, investors would assume this was a change to lower quality earnings and value them under that impression.

▶ *Sufficiency of Guidance and Interpretation*

The GFRAC found the questions related to implementation guidance, consistent application and rigorous interpretation difficult to address. Many of the more complex standards have not yet been implemented. Other recently issued and implemented standards have not been "stress tested" and the effectiveness of existing guidance and consistency of application can only be evaluated with time.

We believe that the IASC's Standing Interpretation Committee has acted in a timely manner to address issues and has provided guidance and interpretation where necessary. In addition, the IASC convened a working group to address questions related to IAS 39, *Financial Instruments: Recognition and Measurement*. This group has already issued a series of questions and answers for public comment. We believe that these mechanisms should provide the same level of guidance and interpretation provided by the FASB, EITF and Derivatives Implementation Group in the U.S.

▶ *Effectiveness of the Standing Interpretations Committee(SIC)*

Although the GFRAC believes that the SIC is effective within it mandate to rely on existing standards to support interpretations, its effectiveness could be improved if it had the same latitude to set standards as the EITF.

▶ *IASC Restructuring*

The GFRAC does not believe that it is necessary for the Commission to condition its acceptance of IAS on the new structure. We believe that the IASC is committed to the new structure and that once the transition is complete, it will be better able to develop well-specified and understandable accounting standards.

▶ *Auditor Certification*

Trained, ethical and independent auditors are critical to a sound financial reporting infrastructure. Although we recognize that there may be cultural issues that make this difficult, if not impossible, in some jurisdictions, the GFRAC believes that auditors who certify financial statements are in compliance with IAS must be subject to the same quality control requirements as those who certify U.S. GAAP statements, if those statements are filed with the Commission. If not, the Commission's enforcement task would be exacerbated. We believe that this

should be the case regardless of the accounting standards used as the basis for financial statements filed with the Commission.

▶ *Existing Variation in Practices and Interpretations*

The GFRAC is only aware of variations in practice due to the issues being addressed by the SIC. However, the SIC can only provide "legal" interpretations of the standards. It cannot ensure that preparers and auditors comply with the interpretation, any more than it can do so with respect to the basic standards. We are aware that the global accounting firms have instituted either centralized practice departments with respect to IAS interpretations or have global committees to insure that there is consistent interpretations and to identify issues that should be addressed by the SIC.

National regulators must take a greater role in enforcement of the standards. Although we do not see the Commission as the "regulator of last resort," we believe that if the Commission accepts IAS, it will become the *de facto* enforcer of the standards. We also believe that the Commission can have influence over auditors, particularly the global accounting firms, to provide consistent interpretation and application of IAS.

▶ *Commission's Ability to Take Effective Enforcement Actions*

The GFRAC does not see how accepting IAS could have a negative effect on the Commission's ability to take effective enforcement actions. We are not aware of the Commission undertaking an enforcement action against a foreign issuer for failure to comply with foreign GAAP or for preparing an incorrect reconciliation. Therefore, we believe that if a majority of foreign issuers report under IAS rather than a national GAAP the Commission can only become more effective in detecting financial reporting irregularities and fraud. We believe that if more foreign issuers file IAS financial statements then the Commission's staff will develop the sufficient expertise in IAS to perform effective reviews. It would seem to us that the efficiency and effectiveness that would come with this increased expertise would enhance the Commission's ability to take effective enforcement actions rather than decrease it.

▶ *Quality and Usefulness of the U.S. GAAP Reconciliation*

The majority of GFRAC members believe that the US GAAP reconciliation has limited usefulness. These members prefer high quality primary financial statements to poor quality primary statements with a reconciliation.

We believe that investors do not generally take the time to convert the reconciliation into a useful income

statement. Even if investors could use the information to prepare a relatively complete U.S. GAAP income statement, there is not sufficient information to prepare a U.S. GAAP balance sheet. In addition to an income statement, a balance sheet is needed in order to do ratio analysis including calculation of such items as inventory or receivables turnover or an analysis of fixed assets.

Some analysts do use the reconciliation in their analysis of companies in a global sector. The use is not necessarily to restate companies to U.S. GAAP, however. A series of reports by Morgan Stanley, *Apples to Apples*, provides some insight into how this information may be used. It is important to note that these reports do not recommend restating reported financial information to U.S. GAAP, IAS GAAP or to any other national GAAP. All information provided in the financial statements, including the reconciliation, is used to restate information to a "common" GAAP. In fact, even if all companies report using U.S. GAAP, financial information might be restated if possible to a consistent and more analytically useful number. We believe the limited usefulness of this information does not warrant retention of the reconciliation requirement for issuers preparing IAS financial statements.

Those on the committee who support retaining the reconciliation requirement believe that analysis of the information it provides is best used to assess the validity of management's accounting choices. We believe that the importance of the reconciliation increases when the financial statements are weak.

Some GFRAC members noted that there were contradicting academic studies on the usefulness of the information in the reconciliation.

▶ *Requirements for the Reconciliation*

The GFRAC agreed that requirements to provide a reconciliation should not depend on the type of securities to be registered or the type of company seeking registration. Nor are we supportive of providing a "bottom line" number if only a partial reconciliation were required. Such a number would be meaningless since it would not be based on any GAAP.

Concluding Remarks

The majority of the GFRAC believe that IAS are of sufficient quality to be accepted by the Commission for use by foreign registrants without reconciliation given that the other elements of the financial reporting and disclosure system are comparable to those in the current system of domestic registrants. We believe there are three benefits to accepting the core standards which should be reiterated here. First, acceptance will encourage more companies to adopt IAS. Second, acceptance will foster further improvement of the standards. Finally, acceptance will test the market implications of using IAS.

The dissenting member of the Committee is willing to support these conclusions only if the reconciliation requirement is retained. However, the majority of the committee disagrees with retention of the reconciliation requirement. They believe that if the reconciliation is retained any tests of the market implications of IAS will be confounded by the availability of US GAAP information.

The Global Financial Reporting Advocacy Committee appreciates the opportunity to express its views on the Concept Release, *International Accounting Standards*. If the Commission or its staff have questions or seek amplification of our views, we would be pleased to answer any questions or provide any additional information you might request.

Sincerely,

Trevor W. Nysetvold, CFA Chair Global Financial Reporting Advocacy Committee	Patricia Doran Walters, CFA Vice President, Advocacy AIMR

Members of the AIMR Global Financial Reporting Advocacy Committee :

Low Kwong Chong	Malaysia
Robin J. G. Fox, CFA	Hong Kong
Trevor W. Nysetvold, CFA, *Chair*	Canada/United States
Nazir S. V. Rahemtulla, CA	Canada
Kenrick R. M. Ramlochan, CFA	United Kingdom
Gary S. Schieneman	United States
Ashwinpaul C. (Tony) Sondhi	United States

Cc: International Accounting Standards Committee
Patricia A. McConnell
David Damant
Rolf Rundfelt
Toshihiko Amano
AIMR Distribution List
Michael S. Caccese, Senior Vice President, General Counsel & Secretary, AIMR
Maria J.A. Clark, Associate, AIMR

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[1] The Association for Investment Management and Research (AIMR) is a global, not-for-profit organization of over 42,000 investment professionals in 95 countries. Through its headquarters in Charlottesville, VA, and more than 94 Member Societies and Chapters throughout the world, AIMR provides global leadership in investment education, professional standards, and

advocacy programs.

[2] This paper was prepared by Peter Knutson, PhD, CPA, and Gabrielle U. Napolitano, CFA, former Chair and Chair, respectively, of the FAPC to be presented at the 1997 Financial Reporting Issues Conference of the American Accounting Association and the Financial Accounting Standards Board.

[3] A copy of the complete analysis will be provided to the Commission when it becomes available.

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London **STOCK EXCHANGE**

London EC2N 1HP
Telephone 020 7797 1000
www.londonstockexchange.com

8 June 2001

Congressman Richard Baker
Chairman
Capital Markets Subcommittee
House Committee on Financial Services
2129 Rayburn H.O.B.
Washington, D.C. 20515
USA

Dear Congressman Baker

PROMOTION OF INTERNATIONAL CAPITAL FLOWS THROUGH ACCOUNTING STANDARDS

I attach the submission of the London Stock Exchange on the promotion of international capital flows through accounting standards.

I hope our comments and views are helpful to your consideration of these issues.

Please do not hesitate to contact me if you or your colleagues have any questions on our submission or if you would like further information.

Yours sincerely

Andrew McStravick

Andrew McStravick
Director of Operations
Direct Line: 020 7797 3667
Facsimile: 020 7920 4530

PROMOTION OF INTERNATIONAL CAPITAL FLOWS THROUGH ACCOUNTING STANDARDS

Submission to the Capital Markets Subcommittee of the House of Representatives Committee on Financial Services

1. Introduction

1.1 The London Stock Exchange welcomes the opportunity to contribute to the Subcommittee's hearing on accounting standards.

1.2 As the world's most international stock exchange, we believe that the evolution of a mutually agreed set of accounting standards would contribute significantly to the promotion of cross-border capital flows. To this end, we support the continuing work of the International Accounting Standards Board (IASB) under the chairmanship of Sir David Tweedie.

1.3 This paper sets out the current situation regarding accounting principles in the UK; the limitations on capital flows imposed by the fragmented nature of global accounting standards, including the lack of direct investor access to London Stock Exchange markets from the United States; and the importance of the SEC continuing its full engagement in this debate.

2. London Stock Exchange – The World's Most International Exchange

2.1 The London Stock Exchange is currently the world's most international stock exchange with around 480 companies from over 60 countries listed on our international market.

2.2 These companies have been attracted to London by the widely respected regulatory regime which it operates, and by the presence in London of the world's largest pool of investment funds under management (2000 total = $2.5 trillion).

2.3 We have over 1882 UK companies traded on our Main Market representing 40 sectors across the entire UK economy. Companies range from technology companies such as Misys and ARM Holdings to companies from more established sectors such as BP Amoco and HSBC.

3. UK Accounting Standards

3.1 In the UK, Financial Reporting Standards (FRS) are established by the Accounting Standards Board (ASB), a wholly-owned subsidiary of Financial Reporting Council Ltd, an independent not-for-profit corporation that promotes best practice in financial reporting.

3.2 ASB has established an Urgent Issues Task Force (UITF) to provide interpretative guidance. A related organisation, the Financial Reporting

Review Panel, examines departures from accountancy requirements under the Companies Act.

3.3 Under UK law, domestic companies listed on the London Stock Exchange must follow UK GAAP. Overseas listed companies may follow IAS, UK GAAP, US GAAP, or other national GAAPs, in which case a reconciliation to UK GAAP may sometimes be required.

3.4 The London Stock Exchange accepts IAS on their merits as high-quality standards that aid transparency and decision-making.

3.5 In June 2000, the European Commission issued a Communication proposing that all listed companies in the European Union would be required to prepare their consolidated financial statements using International Accounting Standards no later than 2005. The UK Government supports this initiative.

4. The Limitations of Fragmented Global Accounting Standards

4.1 The London Stock Exchange believes that a single set of high quality, uniform, globally applied and enforced accounting standards is essential for the promotion of cross-border capital flows.

4.2 We are aware of the two major difficulties of the current situation:

- issuing companies seeking to raise capital in overseas jurisdictions are forced to prepare financial statements using more than one set of accounting standards, incurring valuable time and expense in the process.

- investors (and analysts) who wish to compare companies from different countries are currently forced to understand many different sets of accounting requirements. This causes additional costs for them. Furthermore, these costs create entry barriers that impede competition. Also, investors inevitably have less detailed knowledge of some of those sets of requirements, which lead to sub-optimal investment and resource allocation decisions and causes them to seek a risk premium, which raises the cost of capital.

4.3 Clearly, were a set of global accounting standards to evolve, it would cut the cost of capital to companies and cut the cost of cross-border investment.

5. US Investor Access – Greater Investment Opportunities

5.1 The London Stock Exchange would like to offer US investors the choice of directly investing their funds on its markets. We believe there would be significant benefits to US investors and broker dealers from directly accessing the London Stock Exchange.

5.2 These benefits would include:

- greater choice for investors to invest in overseas UK regulated securities;
- lower-cost trading in overseas securities;

- opportunity for US broker dealers to compete with UK broker dealers on equal terms for trading in UK securities; and
- increased profile of US markets, potentially attracting order flow from UK and other EU investors to US broker dealers and exchanges.

5.3 We are currently exploring with the SEC the creation of some form of conditional exemption for the London Stock Exchange from registration with the SEC. However, a related issue is that overseas companies which seek to market their shares to US investors must either use US GAAP or be reconciled to US GAAP if they use IAS or their national GAAP.

5.4 The shares of over 1,100 foreign issuers from 56 countries are registered with the US SEC for the purpose of being able to list on a US exchange. UK registered companies account for roughly one-tenth of this total. Therefore, at this stage only those companies – just 110 of them out of a total of 1882 UK listed companies - would be able to take advantage of direct investor access.

5.5 This is a clear cost barrier to UK registered companies wishing to access US investors either through listing on a US exchange or – if a conditional exemption was granted – through the London Stock Exchange.

5.6 This highlights another public policy problem. Only those companies with sufficient resources to reconcile to US GAAP are able, for example, to register with the SEC and directly access US investors. Smaller companies looking to access overseas investors are in many cases effectively prohibited by the cost – among other expenses - of preparing different accounting standards.

6. The Importance of SEC Engagement

6.1 With the increasing globalisation of capital markets, the SEC is increasing its involvement in a number of fora in order to develop a globally accepted, high quality financial reporting framework.

6.2 We understand that the SEC has the dual objective of upholding the quality of financial reporting domestically whilst simultaneously encouraging convergence towards a high quality global framework for international financial reporting. The SEC has been working in conjunction with IOSCO to encourage the development of accounting standards for use in cross-border listings.

6.3 The SEC's Concept Release on International Accounting Standards issued on February 16, 2000 called for a high-quality, global financial reporting structure, with the following characteristics:

- effective, independent, high-quality accounting and auditing standard setters;
- high-quality auditing standards;
- audit firms with effective quality control worldwide;
- quality assurance across the accounting profession; and
- active regulatory oversight.

6.4 The London Stock Exchange believes that the SEC has a crucial role to play in supporting the efforts of the Financial Accounting Standards Board and IASB to promote convergence between US GAAP, other national accounting standards and International Financial Reporting Standards. The objective must be high-quality solutions that will help participants in the world's capital markets and other users make more efficient economic decisions.

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON THE PROMOTION OF INTERNATIONAL CAPITAL FLOW THROUGH ACCOUNTING STANDARDS

THURSDAY, JUNE 7, 2001

Mr. Chairman, I commend you for your diligence in convening this important hearing on the promotion of international capital flow through accounting standards. As global capital markets continue to grow, often at explosive rates, and as our national economies become more intertwined, there remains a need for us to develop and gain acceptance of uniform, high-quality international accounting standards. While the newly formed International Accounting Standards Board, or IASB, certainly encourages optimism about eventually realizing the creation and implementation of high-quality worldwide accounting standards, the task ahead will not be easy.

Our country, as you know, has long operated the world's most successful capital markets, and the transparency created by the consistent application of the U.S. Generally Accepted Accounted Principles, or GAAP, has played a primary role in that success. As it works to establish a reliable international accounting system, the IASB should examine the factors that have led to the success of the U.S. accounting system, and we must work in Congress to guarantee that we maintain the vibrancy of our nation's capital markets in the long term. Additionally, SEC experts have previously recommended that efforts to improve the quality of accounting standards and audits globally may be accomplished by developing better standards, by improving the governance and public oversight process, and by enhancing enforcement and discipline. It is my sincere hope that the IASB will heed this advice as it moves ahead.

We can also, in my view, help to ensure success in this pioneering endeavor by encouraging the IASB to examine how we can promote consistent compliance with international accounting standards across borders and how we can achieve genuine comparability of financial accounting information for investors. More specifically, the creation of an international accounting system will not, in and of itself, lead to more efficiency in the world's capital markets. The IASB must, therefore, take steps to ensure that companies will consistently apply these standards when compiling their financial records. Furthermore, an effective international accounting system must ensure the comparability of financial data from one company to another. Comparability in the data used by investors will promote transparency and thus facilitate the flow of capital between nations and across continents. Independent and high-quality financial audits, coupled with an effective enforcement regime, will also help to ensure that we will one day attain the worldwide comparability of financial data.

The development and consistent application of high-quality international accounting standards, coupled with high-quality, reliable auditing and enforcement practices, will, I predict, lead one day to acceptance of an international accounting system by the business community. Such convergence in the world's accounting systems will help individuals to make better decisions about how to invest their money as they will also be able to compare apples to apples

and oranges to oranges. It will additionally help them to discern how to invest their money wisely. On this point, SEC Commissioner Hunt perhaps said it best when he recently noted that "[i]f the numbers in the audited financial statements can't be trusted to provide relevant and reliable financial information about the company, investors might as well invest their money in lottery tickets." I agree with his assessments.

In closing, Mr. Chairman, I believe our Committee should explore the issues related to the development and implementation of an international accounting system. It is therefore important that we learn more about the views of the parties testifying before us today, and I yield back the balance of my time.

Opening Statement of Hon. John J. LaFalce
Ranking Member, Committee on Financial Services
June 7, 2001

Mr. Chairman, I'm pleased that you're having this hearing. I believe it is very important to harmonize international accounting standards, yet, I am concerned that in the process we do not undercut the generally strong standards we have in the United States. These standards, and the strength of our accounting and auditing professions, play a fundamental role in protecting investors and maintaining the integrity of our capital markets.

I'd also like to take this opportunity to thank Chairman Volcker for his efforts to improve the international accounting standard-setting process. I believe these efforts will make an important contribution to the integrity and transparency of both our markets and those abroad.

Accounting issues have recently begun to catch the attention of the media. It is difficult not to notice daily reports of financial fraud and restatements of financials by major corporations. I am extremely concerned about this. In fact, outraged may be a better word. The SEC, particularly its Chief Accountant, has also been expressing concerns about various accounting issues and practices involving the accounting profession and corporate management, and I hope they will step up their enforcement efforts, and be given the resources necessary to do that.

Today's hearing obligates me to express my conviction that this Committee and the Congress must not take the strength and integrity of our own accounting system for granted. And most importantly, we should make clear that "harmonizing" international accounting is not an excuse to lower U.S. accounting standards. In other words, standardizing accounting practices around the world should not be a "race to the bottom." Investors, shareholders, and increasingly global capital markets, all benefit from access to the highest quality information.

This hearing should be only the beginning of a new Committee focus on domestic accounting issues and how the application of accounting standards is affecting the integrity of our capital markets. It is certainly an area I shall be pursuing aggressively. This is particularly important in view of the tremendous growth in stock ownership through the country. Estimates from the most recent survey data indicate that approximately half the households in the United States now own corporate stock, either directly or indirectly through a mutual fund, retirement account, or defined-contribution pension plan. This represents over a 60 percent increase in the number of individual shareholders over the last decade. This trend, combined with the decreasing availability

of defined-benefit pension plans, means that more Americans than ever are relying on the performance of their stock investments for their savings and retirement. Twenty years ago, two-thirds of all pension plan participants were in defined-benefits plans. Today, more than two-thirds are in defined-contribution plans. That change is profound in its implications.

High quality accounting standards and financial reporting are essential for sound investment choices to be made. At the same time that Americans have become more reliant on the performance of their stock investments, the pressures on firms to manipulate their financial results have grown tremendously. Executive compensation is increasingly tied to market valuation of corporate stock, creating ever more pressure to meet earnings estimates to the penny, lest their stock price be pummeled in the markets.

Judging by the numbers of companies that have had to restate their financial statements after they were released, many companies have succumbed to the temptation to manipulate their results. According to the SEC, the number of restatements has more than trebled from the early 1990s, from an average of less than 50 a year to 156 last year. More than half of the companies accused of financial fraud in shareholder class action lawsuits last year have already been forced to restate their earnings. These figures are particularly troubling when one notes that these are restatements of financials that had been signed off on by the firms' auditors.

Regrettably, there is increasing and disturbing evidence that the problem is widespread. An article this month by a senior editor of the Harvard Business Review describes the insidious effects of so-called "earnings management," saying that, "The earnings game is now so commonplace that it can sometimes seem like a collective agreement to believe the unbelievable." While many of the techniques used may be technically legal, they are economically indefensible, and the conduct of many companies may cross the line into fraud on investors and the markets. Further, while I would like to think that the conduct of these companies is an aberration, what may look like an ice cube is much more likely to be the tip of an iceberg, as the Chief Accountant of the SEC noted only last week. I suspect that iceberg may be gigantic.

This Committee needs to focus seriously on the importance of accounting standards and their proper application to our capital markets. High quality financial reporting is essential to protecting investors and maintaining investor confidence. We need to ensure the high quality of financial information from all firms that compete for capital in our markets, whether they are U.S. companies or foreign corporations.

If this country does not maintain the highest level of integrity in the accounting area, it will serve as a poor standard for others. Today's hearing is a start – but only a small start – in that effort.

Opening Statement for June 7, 2001 Capital Markets, Insurance, and Government Sponsored Enterprises Subcommittee Hearing Entitled: "Promotion of International Capital Flow Through Accounting Standards" from Rep. Frank Mascara

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I would like to thank Chairman Baker for calling this important hearing. This is a very important subject that deserves sustained attention.

As global markets become more interdependent, it is vital that we reach an international consensus on accounting principles. The adoption of an international standard will enhance investor confidence, encourage further global investing, provide greater transparency in global markets, and reduce volatility.

The U.S., through regulations promulgated by the Federal Accounting Standards Board (FASB), adheres to the Generally Accepted Accounting Principles (GAAP). The U.S. employs the most rigorous and respected accounting principles of any country in the world. As a result of our high standards, our capital markets are the most trusted by global investors.

The International Accounting Standards Committee (IASC) has been working on adopting an international standard. They are doing their best to reconcile different national standards, customs, and practices in the accounting industry. It is a difficult task that requires patience and diplomacy.

While U.S. investors and companies widely support adopting uniform accounting standards, they want to ensure that any internationally adopted standard adheres to the same rigorous U.S. standards. The adoption of a global standard should raise the bar, not serve to lower it.

In my former life I was a practicing accountant. I have tremendous respect for FASB rules. In fact, as a former member of the National Association of County Commissioners, I participated in the formation of the Government Accounting Standards Board. Given my background, I know first-hand the importance of maintaining high international accounting standards. As the IASC continues its work, this Committee will continue to monitor their progress to ensure that their final product adheres to the same high standards we have come to expect in the U.S.

Again, I thank Chairman Baker for holding this hearing and look forward to the testimony of the witnesses.

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
June 7, 2001

"Promotion of International Capital Flow through Accounting Standards"

Today, our Committee begins its consideration of significant issues in public accounting and investor disclosure.

I want to congratulate Chairman Baker for taking the initiative in holding this hearing. I also want to welcome the distinguished former Chairman of the Federal Reserve Board, Paul Volcker, who, once again, is playing a leading role in international finance.

I appreciate the work of the AICPA and the Financial Executives Institute and the willingness of their representatives, from KPMG Peat Marwick and General Electric, to testify today.

We live at a time of growing interdependence in world financial markets. However, financial reports on publicly traded companies, upon which investors and regulators depend, are based on accounting practices that can vary widely by country. These differences result in a lack of comparability and reliability in financial disclosure.

Harmonizing accounting standards will benefit preparers and users of financial statements, promote international trade and investment, and reduce costs for multinational companies. Investors will be better able to make informed investment decisions.

With integrated financial markets, economic crises are not deterred by national borders. By streamlining international accounting standards, we're improving our chances of detecting and preventing financial problems before they reach global proportions.

Businesses, regulators, and the markets must be able to compare apples with apples, when it comes to financial reporting.

I look forward to hearing about the work that the International Accounting Standards Board and others are doing to harmonize global rules and the benefits for investors and the capital markets. I encourage you in further efforts to set a new benchmark for the highest quality financial reporting.

STATEMENT OF PAUL A. VOLCKER
before the
CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES
SUBCOMMITTEE
of the
U.S. HOUSE OF REPRESENTATIVES
Washington, DC
June 7, 2001

Mr. Chairman, members of the Committee, I appreciate having this opportunity to brief you on a project to which I am devoting considerable time -- the harmonization and convergence of international accounting standards.

In May 2000, I was invited to become Chairman of the Trustees of the reconstituted International Accounting Standards Committee, (the "IASC"). The 19-member Trustees have responsibilities for overseeing the newly appointed International Accounting Standards Board (the "IASB"), for assuring adequate financing of the effort, and for appointing members of the Board and associated councils and committees. The Trustees were appointed by a group of leading securities regulators and international businessmen, chaired by then SEC Chairman Arthur Levitt.

The former IASC has been completely restructured. The purpose is both clear and important: to achieve a single set of high quality accounting standards that will command respect around the world, that will discipline auditing approaches, simplify listing by national markets, and encourage effective enforcement by national authorities. The IASB will have its own staff, but will work to the extent possible in partnership with its national counterparts to achieve its goals.

I come at this work not as an expert on the technical issues of accounting and the auditing profession. However, in my roles as a treasury official and central banker, more recently as a director of several global industrial and financial corporations and as a long-time observer and participant in capital markets, I have long been aware of the importance of accounting rules in providing an accurate and consistent picture of a company's performance. Moreover, the rapid development of

global financial markets has greatly reinforced the desirability of -- indeed now demands -- international consistency in accounting standards and auditing approaches.

If markets are to function properly and capital is to be allocated efficiently, investors require transparency and must have confidence that financial information accurately reflects economic performance. Investors should be able to make comparisons among companies in order to make rational investment decisions. In a rapidly globalizing world, it only makes sense that the same economic transactions are accounted for in the same manner across various jurisdictions.

As you will appreciate, I have long been sympathetic to the goal of harmonized standards. What is more important is that that objective has strong support among governments and industry generally, and most important within the United States itself. My understanding has been that both the SEC and FASB, with reason, have considered U.S. GAAP to be the best in the world. In effect, they have long taken the position other countries and companies should conform if they wanted to access U.S. capital markets. In fact, it has seemed that an increasing number of global corporations were accepting this verdict.

However, the Asian financial crisis, and growing concerns about the functioning of the international money and capital markets more generally, have led to a different emphasis. They have made clear the importance, beyond the direct U.S. interest, of more rigorous reporting standards, of greater transparency, and of more effective auditing internationally. At the same time, there has been growing sentiment throughout the world that, while perhaps possessing the most developed body of standards, the U.S. did not have all the right answers. Furthermore, developing *de facto* global standards from Norwalk, Connecticut, has seemed increasingly unrealistic, both politically and economically, in the age of globalization.

To the SEC's and the FASB's credit, they have made it clear to me as to others that they recognize these realities. They have been playing a particularly constructive leadership role in this initiative. Mr. Levitt's chairmanship of the organizing committee was one reflection of that effort, and I have found it interesting and reassuring that two of the members that we Trustees appointed to the new IASB were former FASB members. Other members of the FASB have expressed a strong interest. FASB Chairman Jenkins has been particularly helpful both with advice and organizational cooperation.

The Restructuring of the IASC

As I indicated, I became the Chairman of the Trustees of the IASC as part of the overall restructuring process of the organization. The IASC had existed as a representative organization of national accountancy bodies since 1973. The IASC was a part-time standard setter, meeting three to four times annually with nearly 80 people sitting around the table. My sense is that some substantial progress had been made. However, this process was felt to be prone to compromise for the sake of compromise and moved relatively slowly, without the ability to deal adequately with the thorniest issues or the prestige to command compliance.

The "old" IASC, in its being, recognized the desirability of uniform standards so that companies could access capital not only in their home countries, but also throughout the world. The IASC reached an agreement with IOSCO, the international organization of securities regulators (which includes the SEC), to develop a core set of standards that IOSCO could endorse for use of publicly traded entities. In 1999, this project was completed, but the new standards did not provide a "passport" for raising funds in the United States markets, by far the most important internationally. There was a general understanding that there was more work to be done.

Concurrently, the absence of acceptable accounting standards in emerging economies came to be considered one of the root causes of the Asian financial crisis. That emphasis was strongly pressed by both international institutions and U.S. Government officials. As a result, efforts to improve the quality of financial reporting, and the need for international consistency, received fresh impetus.

After considerable debate, and with the support of the U.S. SEC, the old IASC Board agreed to adopt a new Constitution and effectively vote itself out of existence. In its stead, an organizational structure similar to that of the U.S. FASB, was established as proposed by the organizing committee. Nineteen Trustees have oversight responsibilities for the newly constituted organization. The Trustees appoint an independent and 14-member professional standard-setting Board (including two part-time members), which is chaired by Sir David Tweedie, the former chairman of the UK Accounting Standards Board.

The Trustees Committee, which I chair, includes three other U.S. members, including the Chairman of Pfizer, William Steere; the CEO of TIAA-CREF, John Biggs; and former SEC Chairman, David Ruder. The Trustees were given the responsibility to appoint a representative Advisory Council as well as the Board and to raise the funds to support an estimated $16 million per year cost of operation. The Board was appointed in January and has recently begun to meet in its London offices.

The IASB will formally meet monthly for several days and has adopted due process procedures similar to those of the FASB. The Trustees have recently invited broadly representative individuals from the corporate, regulatory, and academic communities in six continents to join the Standards Advisory Council. The Trustees and the Chairman of the IASB are agreed that the Advisory Council should be an important vehicle for providing input in the Board's decision-making.

In that respect, I note that the Trustees are not to comment or intervene with respect to the technical agenda; it is the Board, not the Trustees, that will set the standards. It is our responsibility as Trustees, to safeguard the integrity of the process, including opportunity for adequate review of proposed standards by the Advisory Council and national standard-setters.

The Board includes men and women chosen on the basis of their accounting expertise and ability to work in harmony toward the common objective, but of diverse professional backgrounds. Five of the fourteen members have worked in the United States for the largest portion of their careers. Five have been drawn from Europe, and one from Japan. In addition to those from auditing firms, we have individuals with experience working at some of the largest multinational companies, including the former chief financial or accounting officers of Citibank, DaimlerChrysler, Anglo American, and Nestlé. The Trustees appointed three members representing the "user" community of analysts and investors. The other members of the members of the IASB have been academics, or professional standard-setters.

The Board has begun its task of working with the national bodies and will shortly consult with the Advisory Council on its work program. We have established liaison relationships with national standard-setters in recognition of the simple fact that success will require a spirit of partnership. Seven members of the Board will have particular responsibilities for consulting with the national standard setters in Australia and New Zealand,

Canada, France, Germany, Japan, the United Kingdom, and the United States. In addition, other board members will be responsible for liaising with other countries and industry groups, such as analysts and corporations.

Finally, I am happy to report the Trustees have achieved enough financial underwriting to move forward with the work. We have received support from all of the "Big Five" accounting firms, nearly all of the world's most prominent financial institutions, and a sizable number of multinational corporations in all six continents. Recognizing the value of broad based support, and with the cooperation of important national business organizations, we are now planning to contact a larger number of firms. I am particularly pleased that the initiative has the support of central banks, regulatory authorities and official international institutions, reflected in tangible financial support.

The Benefits of High-Quality International Standards

I want to emphasize that we are committed to achieving global accounting standards that reflect the best thinking of accounting professionals, independent of particular industry, national or political views. These standards will not be the lowest common denominator, simply to seek harmonization. Rather, we want the international standards to be able to command support around the world by virtue of their highest professional quality.

In some circumstances, this may well lead to convergence toward the U.S. GAAP. In other cases, I fully expect the IASB will lead to improved approaches over U.S. practice, and I hope in those cases the U.S. will then follow the international lead. The end product will hopefully be a usable and well enforced set of standards that will yield better information for investors. Similar transactions will be accounted for in the same manner across the globe.

If successful, this result should enable users of financial information in the United States as elsewhere to make investment decisions better grounded in the facts. It will also make it possible for foreign corporations to reach investors in the U.S. capital markets more easily. In concept, the cost of capital for corporations would be reduced, and investors would have increased opportunities for portfolio diversification.

More concretely insofar as individual companies are concerned, accounting costs for firms operating in different jurisdictions will certainly be reduced. U.S. firms will also find themselves with a more level playing field with respect to accounting practices when it comes to mergers and acquisitions and other business decisions that span national boundaries.

Beyond these considerations, I believe there are strong reasons for the United States to participate actively in this work. The exercise of strong leadership and responsible stewardship with respect to the integrity of our capital markets has long been a national interest. As the world's strongest economy, and as a leading proponent of open international markets, those considerations extend globally. We should practice what we preach.

More directly, the United States and U.S. based corporations have an incentive to remain at the table in the upcoming debates on the international treatment of accounting. The European Union is ready to approve legislation mandating that all consolidated statements of publicly traded E.U. companies conform to international standards as developed by the IASB by 2005. Other major trading partners -- Japan, Canada, and Australia - are also strongly supporting this initiative. I believe they will work toward convergence of their standards with those issued by the IASB. Having competing regional sets of rules does not make sense if we want globalized markets and to protect U.S. interests. Such a result would be unnecessarily costly to investors trying to understand the differences.

Reaching Our Goal

While determined to reach the ambitious goal of single-set of accounting standards, we need to be realistic about our approach over the next few years. A reasonable aim in that time frame would be consensus upon many standards, building on what is already common ground, and permitting much simpler reconciliation between the international and U.S. GAAP approaches.

In my new and unaccustomed role of close involvement in accounting issues, I have become impressed more than ever with the difficult conceptual and practical issues facing the accounting profession and those producing and using financial statements. There are deep-seated differences of opinion, colored in the past by established national approaches and contrasting regulatory philosophies.

At the most general level, there is a question of the degree of detail appropriate in setting out the standards. At the heart of the debate is whether a standard should attempt to describe precisely the application of the general standard in almost all conceivable cases, as is practice in the United States, or whether standards should be clear on the overall principle, with more general guidance on its application, while relying more heavily on building precedents in actual audits, case by case.

A fundamental conceptual issue is the extent to which the standards should move away from traditional cost based accounting to marking assets and liabilities to market, euphemistically referred to as "fair value" accounting. There is without doubt considerable momentum to move toward fair value methodologies, but there are also significant questions about the practical and useful application of that approach to certain industries and firms. Those questions have been reflected in the resistance of many bank regulators, including those in the U.S.

Clearly, the new Board will have to grapple with some of the most controversial issues with which FASB has wrestled over the past few years. These include appropriate accounting for business combinations, stock options and other share-based remuneration, and the exceedingly complex problems associated with the accounting of derivative financial instruments. Among other questions, U.S. firms have been concerned that particular GAAP standards have placed them at a competitive disadvantage in global markets. The new IASB should provide a vehicle for ensuring that competitors live up to the same high quality requirements imposed on U.S. industry, leveling the playing field.

Finally, we are aware that good account standards are one thing; enforcement is another, and critically important. The IASB has itself no mandate or authority to enforce its standards. That essential role is for the national regulators and the for the audit firms themselves. The Trustees of the IASC and the members of the IASB are prepared to work with those two groups to encourage enforcement of its standards. I have been encouraged to learn of parallel efforts to develop a self-regulatory framework for the international auditing profession. But we will clearly need the sympathetic understanding and support of the regulators, the Administration, and the Congress in the United States, as of comparable bodies in other countries, if the effort is to succeed.

As I mentioned earlier, the IASC Trustees will not take a position on technical accounting issues, including those I highlighted above. What I can assure the members of the Committee here and other interested parties is that Trustees will assure a fair hearing for the views on all sides of the debate will be heard. The comments of interested parties will be actively solicited and the Board will deliberate on these issues in an open and fair manner.

International Accounting Standards Board®
THE RESTRUCTURING IN BRIEF

A basic restructuring of the International Accounting Standards Committee (IASC) marks a critical juncture in the organization's history. Increased attention on the globalization of financial markets and a growing need for accurate financial information have brought the issue of harmonized accounting standards to the forefront. Today, preparers, users, and auditors of financial statements look to the IASC as the best hope to achieve a single set of high-quality accounting rules. The transformation of the IASC from a part-time organization to a full-time Board, endorsed by stakeholders representing many perspectives, makes this possible.

The successful development and convergence of international accounting standards will provide benefits to auditors, users, preparers and regulators of financial information and statements. For example, users will have access to more reliable financial data to compare and analyze corporate performance in multiple jurisdictions. Preparers, in turn, will be able to access investors more easily, potentially reduce their cost of capital, and certainly save in costs measured by conforming to different requirements in different jurisdictions. Regulators will benefit from the greater consistency and quality of information.

Restructuring for Results

IASC NOMINATING COMMITTEE

- Dr Karl H. Baumann, **Chairman of the Supervisory Board, Siemens AG**, Deputy Chairman DRSC (the German national accounting standards setter)
- Mr James E. Copeland, Jr, Chief Executive Officer, **Deloitte Touche Tohmatsu**
- Mr Howard Davies, Chairman, UK **Financial Services Authority**
- Mr Arthur Levitt, Jr, Chairman, US **Securities and Exchange Commission**
- M Michel Prada, Chairman, **French Commission des Operations de Bourse**
- Mr Andrew Sheng, Chairman, **Hong Kong Securities and Futures Commission**
- Mr James D. Wolfensohn, President, **The World Bank**

Headquartered in London, the IASC is planning to launch an ambitious agenda, aimed at developing a uniform set of accounting rules that will be accepted by the capital markets throughout the world. By pursuing that agenda, cooperation with national standards setters and the improvement of current rules through contact with multiple constituencies will be necessary. To realize these goals, the IASC recognized the need for a full-time board reflecting diverse experiences with the ability to gather input and liaise with the diverse stakeholder groups involved.

To supervise the restructuring, a blue-ribbon Nominating Committee, chaired by U.S. SEC Commissioner Arthur Levitt, selected 19 Trustees with backgrounds in business, finance, regulation, academia, and standard setting. Led by former U.S. Federal Reserve Chairman Paul Volcker, the Trustees are responsible for the appointment of the standard-setting board, fund raising, and oversight of the operations.

On January 25, 2001, the Trustees announced the 14-member International Accounting Standard Board (IASB). The Board will work with national and international organizations to seek high-quality standards, calling upon the best accounting minds in the auditing, user, preparer, and academic worlds. Sir David Tweedie, former Chairman of the Accounting Standard Board (ASB) in the UK, has accepted the role of Board Chairman, and Tom Jones, former Principal Financial Officer of Citicorp, will serve as Vice Chairman. The Board will begin operations in April 2001.

IASC Budget

The evolution of the IASC into a full-time, global institution, capable of attracting some of the top minds in industry, will require an increase in infrastructure and resources. Before the restructuring, IASC has operated with a small staff in London, England, with an annual budget of $3.8 million.

The IASC Trustees have developed a preliminary annual budget of approximately $15 million necessary to support the restructuring project.

The budget reflects

- The need to provide competitive salaries to attract high caliber candidates for Board positions. The proposed salaries will generally match the level of members of the Financial Accounting Standards Board in the United States.

- Travel costs reflect the needs of an organization, which will represent countries throughout the globe and the desire to have meetings not only at the London headquarters, but also in other regions to gain valuable perspectives.

- Salaries include the need to hire technically qualified staff to support the process. IASC plans to keep staff costs low by capitalizing on cooperative arrangements with national standard setters.

IASC TRUSTEES

- Mr. Paul A. Volcker, Former Chairman, **U.S. Federal Reserve Board Chairman of the Trustees**
- Mr. Roy Andersen, Deputy Chairman and CEO, **The Liberty Life Group**
- Mr. John H. Biggs, Chairman, **TIAA-CREF**
- Mr. Andrew Crockett, General Manager, **Bank for International Settlements**
- Mr. Roberto Teixeira Da Costa, Former Chairman, **Brazilian Comissão de Valores Mobiliários**
- Mr. Guido A. Ferrarini, Professor of Law, **University of Genoa**
- Mr. L. Yves Fortier, Chairman, **Ogilvy Renault**
- Mr. Toshikatsu Fukuma, Chief Financial Officer, **Mitsui & Co., Ltd.**
- Mr. Cornelius Herkstroter, Former President, **Royal Dutch Petroleum**
- Mr. Hilmar Kopper, Chairman of the Supervisory Board, **Deutsche Bank**
- Mr. Philip A. Laskawy, Chairman, **Ernst & Young International**
- Mr. Charles Yeh Kwong Lee, Chairman, **Hong Kong Exchange and Clearing Ltd.**
- Sir Sydney Lipworth, Chairman, U.K. **Financial Reporting Council**
- Mr. Didier Pineau-Valencienne, Chairman, **Association Française des Enterprises Privées**
- Mr. Jens Røder, Senior Partner, **PricewaterhouseCoopers**
- Mr. David S. Ruder, Former Chairman, **U.S. Securities & Exchange Commission**
- Mr. Kenneth H. Spencer, Former Chairman, **Australian Accounting Standards Board**
- Mr. William C. Steere, Jr., Chairman and CEO, **Pfizer Inc.**
- Mr. Koji Tajika, Co-Chairman, **Deloitte Touche Tohmatsu**

International Accounting Standards Board

The object of the restructured Board will be to achieve a single set of internally consistent, high-quality global standards. Achieving this goal will involve international agreement on the IASC's mission and acceptance of a global conceptual framework on which the standards would be based. The new Board will be committed to promulgating the highest-quality standards and not seek "lowest common denominator" to reach convergence.

The goal of high-quality global standards will require the active cooperation of national standard-setters, all of which have their own authority and at present issue standards that may be different from those that will be agreed to by the International Accounting Standards Board (the IASB). As the IASB cannot insist on acceptance of the same standards throughout the world, reaching a single set of high-quality global standards will be achieved only if all standard-setters accept that goal and are willing to make every effort to achieve it. IASB's role, in cooperation with the national standard-setters, is to lead the process by facilitating a worldwide partnership. Greater convergence of national and international standards will be the short to medium-term priority.

To facilitate the required cooperation, the IASB anticipates the following roles for the national and international boards. National standard-setters would be expected to: (a) align its agenda with its partner standard-setters to promote convergence, (b) be prepared to lead in developing approaches to certain issues on the international agenda, (c) consider fully the views of IASB in its own debates on the same issues, and (d) develop its views and that of its constituencies on common issues (if necessary by facilitating field testing) and feed them back to IASB.

The Trustees are also selecting seven board members who will have a formal liaison relationship to seven national standard setters (Australia and New Zealand, Canada, France, Germany, Japan, the United Kingdom, and the United States). While maintaining an office at the national standard setter, the liaison board members will not have a vote with the national boards. At board meetings of the national standard setter, the liaison member would test ideas developed at the IASB, and at IASB meetings would put forward proposals by the national standard-setter and its criticisms of IASB views. The idea would be to foster a partnership in which each board feeds into the other with a view to obtaining the best possible result.

MEMBERS OF THE BOARD AND RECENT AFFILIATION

- Sir David Tweedie, Chairman, **U.K. Accounting Standards Board** ***Chairman of the Board***
- Thomas E. Jones, Former Principal Financial Officer, **Citicorp** ***Vice-Chairman of the Board***
- Mary E. Barth, Professor of Accounting, **Graduate School of Business, Stanford University**
- Hans-Georg Bruns, Chief Accounting Officer, **DaimlerChrysler**
- Anthony T. Cope, Member, **U.S. Financial Accounting Standards Board**
- Robert P. Garnett, Vice President of Finance, **Anglo American plc**
- Gilbert Gélard, Partner, **KPMG**
- Robert H. Herz, Partner, **PricewaterhouseCoopers**
- James J. Leisenring, Former Vice Chairman and Director of International Activities, **U.S. Financial Accountings Standards Board**
- Warren McGregor, Former Chief Executive Officer, **Australian Accounting Research Foundation**
- Patricia O'Malley, Chairman, **Canadian Accounting Standards Board**
- Harry K. Schmid, Former Senior Vice President, **Nestlé**
- Geoffrey Whittington, Professor of Financial Accounting, **Cambridge University**
- Tatsumi Yamada, Partner, **ChuoAoyama Audit Corporation**

In addition, the Trustees are mandating that Board members establish informal liaison relationships with other national standard-setters, regulators and political institutions (such as the European Commission), and interested parties in the private sector.

The new Board is expected to meet 10-11 times annually, with the majority of the meetings being held in London. Other meetings will be held throughout the world to foster interchange with interested parties. The Board meetings will last for approximately three days and will be open to the public.

Standards Advisory Council

The Trustees recognize the need to receive additional input from preparers and users of financial information in various jurisdictions. The Trustees attach particular importance to the perspective that Council can bring to the overall effort. The Council is to comprise about thirty members, having diverse geographic and functional backgrounds and the expertise required to contribute to the formulation of accounting standards.

The Council will have the objective of (a) giving advice to the Board on priorities in the Board's work, (b) informing the Board of implications of proposed standards for users and producers of financial accounts and (c) giving other advice to the Board or the Trustees. The Council will normally meet at least three times a year. It is to be consulted by the Board on all major projects and its meetings are to be open to the public.

The Trustees have extended invitations for Council positions and expect that the Council will be announced shortly.

Additional information

One can receive additional information regarding the IASC's restructuring on the IASC website:

http://www.iasc.org.uk

Other inquiries can be directed to:

Tom Seidenstein
International Accounting Standards Board
US Office
610 Fifth Avenue, Suite 420
New York, NY 10020

Phone: +1 (212) 218-7849
Email: tseidenstein@iasc.org.uk

Question for June 7, 2001 Capital Markets Subcommittee Hearing entitled: "Promotion of International Capital Flow Through Accounting Standards" by Rep. Frank Mascara

Panel 1 (Paul Volcker)

1. I would like to ask you about pro forma reporting-more specifically reporting of pro forma earnings. This type of reporting is often seen as deceptive. What could the IASB do to address investor concerns over supplementing IASB standards with potentially misleading pro-forma reporting techniques?

Answer:

I believe this issue will necessarily be considered in the course of IASB deliberations. I hope that high-quality international standards will need to reflect the legitimate concerns of meaningful business reporting while discouraging use of alternative presentations that may be misleading.

TESTIMONY OF

PHILIP D. AMEEN
VICE PRESIDENT & COMPTROLLER
GENERAL ELECTRIC COMPANY

ON BEHALF OF

FINANCIAL EXECUTIVES INTERNATIONAL

BEFORE THE

U.S. HOUSE OF REPRESENTATIVES SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE & GOVERNMENT SPONSORED ENTERPRISES
OF
THE COMMITTEE ON FINANCIAL SERVICES

AT A HEARING ON

PROMOTION OF INTERNATIONAL CAPITAL FLOWS THROUGH ACCOUNTING STANDARDS

JUNE 7, 2001

My name is Phil Ameen. I am Vice President and Comptroller of General Electric Company, and Chairman of the Committee on Corporate Reporting of Financial Executives International (FEI). FEI is the leading advocate for the views of corporate financial management, representing 15,000 CFOs, treasurers and controllers from companies throughout the United States and Canada.

It is my pleasure to share FEI's views on the role of accounting standards in the allocation of capital in global markets. There is no longer any debate that one set of international accounting standards is inevitable; this will be the lingua franca for the digital age of the global securities market. Cross-border securities transactions have been growing at an accelerating pace over the past decade as institutional investors seek new frontiers for investment returns. Yet without the transparency that arises from high quality application of global accounting standards, the markets are not as efficient as they need to be. Consequently, the so-called "flight to quality" can ruin economies and companies and lay waste to the best global strategies. We believe that transparency and comparability of financial reporting are necessary to achieve rational markets.

But having answered the threshold issue affirmatively, the second-order questions are much harder: What should these global accounting standards be and how should we best transition to them? The short answer is that much depends, as it always has, on the people and the processes applied to the task. Our long history of largely successful standards setting in the United States is instructive.

I believe we must first acknowledge that accounting standards and financial statements are, at best, modern versions of 15th century devices. By the turn of the 22nd century, it is hard to imagine my successor at GE worrying about closing the books and drafting footnotes. Rather, management's pulse on the business will be achieved by immediate signals from distributed electronic agents which will monitor orders, shipments, and electronically transferred funds.

Despite what will be a tense debate, investors will be granted access to the same electronic agents, and will make investment and credit decisions based on assembling those data, interpreted under rules of their own devising. Debates about how pension surplus or derivatives or leases affect "net earnings" will seem as amusing then as the handwritten ledgers of the 1900's seem to us now.

In the world of 2100, much of what I did 100 years earlier will similarly be transformed. Today's financial reporting requires those who know the firm best – management – to accumulate and report transactions under an enormously complex rule set of about 100,000 internally inconsistent pages of accounting guidance, with only the most primitive of indices. From a reliability perspective, two features must be noted. First, the only parties who have sufficient knowledge about the enterprise to prepare its financial statements are also among the most biased with respect to the reported results. Second, markets are willing to absorb only relatively modest assurance (audit) costs, so errors inevitably occur. Fortunately, the error rate is far lower than one would expect in these circumstances, as evidenced by the front page banner headlines to announce mistakes that, while unfortunate, rarely jeopardize the affected enterprise. Also, both the assembly and the testing of financial statements impose a second-order but very severe cost – delay in the distribution of information.

In this world, one can rightly pose the question of whether all the energy spent on accounting principles really matters. While we can observe market reaction – sometimes overreaction – to rumors of accounting misstatement, I also must acknowledge the analysts who

are certain that, when GE stops amortizing goodwill at the beginning of next year and adds over $1 billion to net earnings, the stock will not react at all.

In a perfect world, we would not need an International Accounting Standards Board (IASB) or Financial Accounting Standards Board (FASB) because accounting standards would be developed through direct negotiation between corporate management and share owners (or analysts serving as their proxies). All elements of financial reporting from recognition and measurement to disclosure would therefore be investor-focused and responsive to specific, identified user needs at costs that preparers are willing to bear. Obviously, that approach is not realistically achievable. Neither reporting enterprises nor analysts have the energy or resources to build this model for each company, so standard setters necessarily serve as the intermediary. But today, preparers and users – the two parties that have an economic stake in the answer – are not a majority of any standard-setting body.
Instead, standard-setting bodies contain a majority of conscripted auditors, whose backgrounds provide no experience with the economic value of perfect, timely, cost effective data. Indeed, auditors have incentives to develop quite the opposite type of standard, a standard with more complexity, application of which demands expensive audit expertise. There are predictable failures that arise from this standards-setting algorithm, and U.S. experience illustrates this phenomenon.

The United States provides the most ideal conditions imaginable for a standard setter: one business language, one regulatory environment, one national tax code, one government, a small number of highly-

developed capital markets and sophisticated, involved professionals from all disciplines that care very deeply about improving the quality of financial reporting. Due process in this environment ought to produce robust, high quality final standards every single time.

The reality is quite different. As good as U.S. standard-setting appears to be relative to the rest of the world, it nevertheless has produced a surprising number of failures:

- Shortly after its formation in 1973, the Financial Accounting Standards Board (FASB) issued a statement – their eighth – related to foreign currency translation. This statement required that all changes in currency exchange rates be reported as gains and losses – this just as the U.S. left the gold standard and the world adopted floating exchange rates. When the Board surveyed constituents to see how they were doing as a standard setter, this standard drew pointed criticism. FAS 8 was rescinded just six years after it was issued and replaced with FAS 52, which appropriately limited gain/loss recognition to transactional exposures. And the FASB discontinued the formal constituent survey.
- In 1987, the FASB issued FAS 96 on accounting for income taxes, which required companies to schedule the reversals of transactions that were to be recognized in different periods for tax and book purposes. While the FASB's approach was conceptually pure, it did not consider the costs and was practically impossible to implement. Most companies never adopted FAS 96 and

waited instead for its much simpler replacement, FAS 109, which was issued in 1991.

- For the new millennium, we have FAS 133, accounting for derivatives, which is built on a phenomenal maze of requirements that govern qualification for hedge accounting. Users, meanwhile, have shown no interest in the reported results. Given the failure of this standard to pass any cost/benefit test, we believe that it will soon join FAS 8 and FAS 96 in the category of rescinded standards.

If you ask my peers what went wrong in each of these cases they will tell you that the standards ignored issues that were important to companies, investors or both.

The due process of international standards setting is far more nuanced than its U.S. counterpart. And, speaking parochially, there is a very real risk that the economic interests of the United States will get lost in the avalanche of feedback that the new International Accounting Standards Board will face. We have a saying at GE that your product is unsatisfactory if it does not delight your toughest customers. In the arena of global accounting standard setting, the toughest customers are right here in the United States. With all due respect for our global associates, it is clear that the U.S. leads the way with the most innovative transactions and structures that the world has ever seen. But U.S. concerns will carry relatively modest weight with members of the new IASB. And inevitably, representatives from simpler environments, environments without the transactions that test the limits of a proposed accounting standard, will be hard-pressed to cast knowledgeable votes.

It will take a very careful approach to due process on the part of the new IASB to ensure that meaningful standards are issued.

The IASB was launched with great hopes and tremendous challenges. It is essential that all of us ensure that the IASB does not stray too far from its core mission: to develop accounting standards that are representative of the financial reporting rules that investors and companies would have negotiated on their own had they been given the chance.

This completes my prepared remarks. I would like to thank the Chairman and the members of the Subcommittee for allowing FEI the opportunity to testify. I would be pleased to answer any questions.

STATEMENT OF

ROBERT K. ELLIOTT
IMMEDIATE PAST CHAIRMAN
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

BEFORE THE HOUSE COMMITTEE
ON FINANCIAL SERVICES

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE
AND GOVERNMENT SPONSORED ENTERPRISES

CONCERNING

PROMOTION OF INTERNATIONAL CAPITAL FLOW THROUGH ACCOUNTING STANDARDS

JUNE 7, 2001

STATEMENT OF ROBERT K. ELLIOTT

JUNE 7, 2001

Thank you, Chairman Baker, for allowing me the opportunity to share my perspective about the role accounting standards play in encouraging the global flow of capital.

It may be illustrative to use a rough analogy in opening our discussion of this very complex issue. International accounting standards to be used in the preparation of financial reports throughout the world are somewhat like international rules of driving. Both establish a fundamental, commonly understood language. The road signs signifying what is permissible, for example, are analogous to the rules governing what is presented in financial statements and what those presentations mean. Both lead to greater ease of movement — whether traffic or capital — across borders.

Now consider the quality of the rules. If we had common traffic rules across all nations, but they allowed people to misinterpret traffic signs or did not make clear which traffic had the right of way, the global total of accidents would likely rise. It is only when common rules represent a gain in quality that the reduction in incompatibility serves the common good. In the case of accounting rules, more compatible financial presentations make it easier for investors to compare companies and make it easier for companies to file in different markets. But that is not enough. The rules must also provide the informa-

tion that gives investors a reasonable chance to make good decisions. Capital flows in the end are based on decisions by investors, not merely ease of securities registration. And capital flows do not serve economic growth unless they represent economically useful decisions.

Herein lies the issue. Common "rules of the road" are not enough. They must be effective. When the word "transparency" is used, those who use it typically assume that it means better quality information. That is assuredly the right goal. But mere uniformity in accounting rules will not guarantee better quality information. The uniform rules must require better quality information.

This point is especially important at this moment in the history of the world economy and in the development of accounting standards. The economy has changed in many ways, and accounting must adapt to provide the information investors need to make good decisions. I would like to pursue this issue with you, because it is, to my mind, vital to how we view international accounting standards.

The current financial reporting model — in the U.S. and overseas — is very much based on the assumption that profitability depends on physical assets, like plant and machinery; on raw materials, like coal, iron ore, sheet metal, electrical wire, and plastic; in other words, on the tangible assets needed to produce tangible products. This is the financial reporting model of the industrial age.

But, as we all know, we are no longer in an industrial age. We still have elements of it, of course, and we always will, but we have moved deeply into the information age.

Today's economy is different from anything we have dealt with before. It is founded upon new technologies, globalization, and the increasing importance of intangibles, such as brands, relationships, people, systems, and knowledge. Companies are creating value in different ways, using new combinations of tangible and intangible assets. In fact, it is the combination and interaction of various types of assets that will determine a business's economic success.

Alan Greenspan put it succinctly when he said that "virtually unimaginable a half-century ago was the extent to which concepts and ideas would substitute for physical resources and human brawn in the production of goods and services."

Those looking to deploy their capital do not restrict the kind of information they use to only financial information. They also use non-financial information, such as information about top executives, product developments, and capacity for innovation. There should be no surprise here that non-financial information has been considered useful. This Committee's predecessor in 1991 required insured depository institutions to begin to report on internal controls and auditors to express an opinion about management's assertions.

There is good reason to believe that the accounting model should not be limited to financial information. You may know of the AICPA Special Committee on Financial Reporting, the so-called "Jenkins Committee." It described investor information needs that go far beyond what is required by the current financial reporting model and included non-financial information. In fact, to capture the idea of reporting non-financial information, the Jenkins report adopted the broader term "business reporting."

Those with capital will not invest it if they are unable to estimate to their own satisfaction the potential returns on their investments. They depend on information to make these decisions. Thus the amount and quality of the information available to investors affects the volume of capital flows.

Now consider the effect of the amount and quality of information on economic growth. Capital must be deployed where it can be most productive, or it will not contribute maximally to economic growth. At the root of productive investment is information. Those with capital cannot select the most productive companies unless they have information that lets them pick winners — information that reflects how value is created by companies today. Yet most of these are not recognized by the current accounting model.

Important work is in progress by scholars. But looked at even nationally, our country's effort is far from what is needed. We are not addressing this issue in a manner commensurate with its importance to investors, the economy, and our future.

The timeliness of business information is as critical to its usefulness as its relevance. Investors cannot make effective decisions with out-of-date information. Yet corporate prospects don't just vary annually or quarterly. Thus the timeliness of business reports is also essential to the effective flow of capital around the globe. This is another area where progress can be made. The capabilities for more rapid disclosure are coming into being. The Internet provides a remarkable communications vehicle. Many companies already make investment information available on their Web sites. Computers, telecommunications, and increasingly powerful software are also revolutionizing internal corpo-

rate accounting. Cisco Systems, for example, can "close its books" — traditionally a process measured in weeks — in mere hours.

The capabilities I have been describing will allow a frequency and richness of disclosure that is more helpful to investors, because it is more closely aligned with the pace of change in corporate prospects.

I make my statement in favor of the need to improve the quality of accounting standards as a member of the AICPA, which has a strong record of support for international standard setting. The AICPA was a founding member of the International Accounting Standards Committee (IASC), and has used its best efforts to support the IASC's work since 1973. Through its Accounting Standards Executive Committee, the AICPA has commented on all IASC proposals in the core standards work program. In addition, the AICPA appoints one of two U.S. delegates to the IASC, provides a technical adviser to the U.S. delegation, and has provided members of IASC steering committees.

The AICPA appreciates the efforts of the IASC, and we recognize the significant progress that has been made since the International Organization of Securities Commissions and the IASC initiated the core standards work program. We recognize the effectiveness of the IASC's Framework for the Preparation of Financial Statements as a sound basis for the development of the core standards, although we believe that a reconciliation to U.S. GAAP for foreign filers should continue. We supported the recent restructuring of the IASC and believe it should be capable of producing high quality international standards. Nevertheless, we call upon all parties to recognize in the most forthright manner and with determination the urgent need to improve the quality of disclosure.

I previously cited the work of the Jenkins Committee and pointed out that it was based on research into investors' needs. The Jenkins Committee produced and recommended an accounting model that included non-financial information. It is hard to believe that the Committee's report was produced in 1994 and so little has been done in response. If investors' needs were not being met then, they are likely being met even less well today.

The information needs I have been describing were just recently underscored by the findings of the "Garten Task Force," an independent group formed by Dean Jeffrey E. Garten of the Yale School of Management at the request of former SEC Chairman Arthur Levitt. The report, "Strengthening Financial Markets: Do Investors Have the Information They Need?", concluded there was much room for improvement and made two recommendations: the Task Force called for the creation of a new framework for supplemental reporting of intangible assets and operating performance measures and, equally important, the fostering of an environment that encourages innovation in disclosure.

The SEC should heed the advice of the Jenkins Committee and the Garten Task Force and encourage registrants, auditors, and standard setters to develop and present more relevant and timely information to investors, and it should reduce regulatory barriers to useful innovations along these lines.

Clearly, I believe that more can and should be done to provide investors with relevant, timely financial and non-financial information, reflecting both tangible and non-tangible assets. Without doubt, internationally accepted accounting standards will help international flows of capital. But creating international standards alone is not enough to

result in meaningful or sustained improvement. I ask all relevant parties — standard setters, regulators, and the profession at large — to carefully consider the need to modernize the business reporting model to provide investors of all kinds the information they need to assess how companies create value today — in the U.S. and around the globe. We owe it to all investors around the world, and to the economy, to make sure we adapt without great delay. ■

Financial Accounting Standards Board

Financial Accounting Foundation

June 5, 2000

Jonathan G. Katz
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Dear Mr. Katz:

This letter is in response to the request for comment on the Securities and Exchange Commission (SEC) Concept Release, "International Accounting Standards," File No. S7-04-00 (the Concept Release). We commend the SEC for its ongoing efforts to uphold the quality of financial reporting domestically while encouraging the development of a high-quality global financial reporting framework, and we appreciate the opportunity to respond to the Concept Release.

The views expressed in this letter are supported jointly by the Financial Accounting Standards Board (FASB) and the Trustees of the Financial Accounting Foundation (FAF).[1] Because the FAF does not involve itself in standard-setting matters of a technical nature, this jointly issued letter expresses the FAF's and FASB's views only on nontechnical matters. The FASB is providing a separate comment letter that includes a more comprehensive response to other issues and to individual questions posed in the Concept Release. Although that comment letter reaches a conclusion about the conditions for acceptance of IASC standards similar to the conclusion in this letter, the FAF is not commenting on any views expressed in the FASB's separate comment letter.

[1] The FAF is an independent body responsible for (among other things) exercising general oversight of the FASB (except with regard to the FASB's resolution of technical issues).

The FAF and FASB are committed to the objective of increasing international comparability while maintaining the highest quality accounting standards in the United States. Our position on that topic is set forth in a report, *International Accounting Standard Setting: A Vision for the Future,* issued jointly by the FAF and the FASB (the FAF-FASB Vision report). There is a strong and growing demand for high-quality, internationally comparable financial information that capital providers find useful for decision making in global public capital markets. Ideally, that demand would be satisfied by use of a single set of high-quality accounting standards for both domestic and cross-border financial reporting. The FASB continues to work with the International Accounting Standards Committee (IASC) and with other standard setters in an effort to converge national and international standards while improving the quality of financial reporting worldwide. Our comments reflect our commitment to the objective and goals in the FAF-FASB Vision report.

Introduction

The Concept Release seeks input to determine under what conditions the SEC should accept in U.S. markets financial statements of foreign private issuers (foreign issuers) that are prepared based on standards promulgated by the IASC. We acknowledge that the IASC has made significant improvements to many of its standards as a result of its core standards project and that an increasing number of countries and international organizations have expressed support for use of the IASC core standards for cross-border filings. We also appreciate the salience of the SEC's consideration of the IASC core standards. The SEC's conclusions about the conditions for acceptance of those standards may affect, for example:

1. The extent to which those standards are used worldwide
2. The extent to which an appropriate infrastructure will develop to support their use
3. The nature of the restructured IASC's agenda priorities

4. The future agenda priorities of other standard setters that are working with the IASC to converge national and international standards to achieve the highest quality international solutions.[2]

There seems to be an unfortunate perception on the part of some that the future of the IASC as an organization is in some way contingent upon the SEC's conclusions about the acceptability of the core standards in their current form for use without reconciliation by foreign issuers listing in the United States. Regardless of the SEC's conclusions, we believe that more widespread use of IASC standards outside U.S. markets is desirable and that the IASC, once restructured, will play an increasingly important role in the evolving global financial reporting infrastructure. As we have publicly stated on many occasions, we support the restructuring of the IASC and believe the IASC will help in leading efforts to converge national and international accounting standards. Further, there will continue to be a prominent role for the IASC as emerging-market countries look to IASC standards as a basis for developing their own standards and as member states of the European Union increasingly consider IASC standards for use in European capital markets. The success of the restructured IASC will be vital to the continued development of a single set of high-quality international accounting standards and to the successful evolution of a high-quality global financial reporting infrastructure.

Although the future of the IASC is bright, conclusions about the acceptability of the IASC's core standards for use in U.S. markets must be reached in the present, amid a number of competing national and international perspectives and in an environment in which the elements of a global financial reporting framework are in various stages of development. The SEC's decision, while it may weigh heavily outside of the United States, must ultimately be in the best interests of U.S. investors participating in U.S. markets—consistent with the SEC's mandate to protect U.S. investors. Such a decision should be one that benefits U.S. investors by increasing their ability to compare investment opportunities and to make informed investment decisions.

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[2] In the FAF-FASB Vision report, *convergence* is described as different standard setters arriving at high-quality national or international standards that are as similar as possible. The process of convergence includes using all

Joint Conclusions of the FAF and the FASB

The Concept Release poses four alternatives to the level of acceptance of IASC standards, three of which would require elimination of some or all of the current requirements for foreign issuers using IASC standards to reconcile their financial statements to U.S. generally accepted accounting principles (GAAP). Our conclusion about the acceptability of IASC standards for use by foreign issuers in U.S. markets is that the current reconciliation requirements should be maintained, not eliminated. The factors we considered most significant in arriving at that conclusion are:

- *Convergence.* As stated in the FAF-FASB Vision report, we are committed to (1) ensuring that international accounting standards are of the highest quality and (2) accelerating convergence of national and international standards to achieve the highest quality international solutions. The IASC shares a similar commitment. Current reconciliation requirements provide a focal point for the efforts of the IASC and the FASB and a mechanism for measuring progress toward meeting the goals of high quality and convergence. Removing the requirement that foreign issuers using IASC standards provide a reconciliation to U.S. GAAP could impede those efforts by removing a powerful incentive to work together toward greater comparability.
- *Comparability.* Regardless of the relative quality of the two sets of standards, there are differences between IASC standards and U.S. GAAP and there are variations in the way IASC standards are applied around the world. Current reconciliation requirements are intended to help create comparability among foreign issuers using different accounting standards and comparability between foreign issuers that do not use U.S. GAAP as a basis for their financial reports and domestic issuers that use U.S. GAAP. We believe that a continued reconciliation requirement will assist in creating comparability and will reduce costs that would arise if reconciliation were abandoned.
- *The SEC's enforcement role.* The early stage of development of a high-quality global financial reporting infrastructure (in particular the lack of a global enforcement mechanism for IASC standards) places a great deal of pressure on the SEC's enforcement role of ensuring comparability and transparency of financial information reported in the United States by foreign issuers using IASC standards. The pressure on the SEC to relax its enforcement role would increase if instead of requiring reconciliation, the SEC allowed variations in the way IASC standards are presently interpreted and applied outside the United States to influence its enforcement decisions. In contrast, failure to accede to these variations may ultimately place the SEC in the awkward position of establishing a "U.S.-only" version of IASC standards.

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reasonable efforts to arrive at consensus, recognizing that it may be beneficial to arrive at very similar higher quality national standards when consensus on a single international standard is not possible.

Each of those factors can ultimately lead to increased costs to financial statement users—that is, U.S. investors—attempting to compare the investment opportunities available in U.S. markets. Those factors are discussed in more detail below.

Convergence

It would be ironic if, in an attempt to accelerate the widespread use of IASC standards, their acceptance without reconciliation in the United States actually became an impediment to the process of converging national and international standards. For a number of reasons we are concerned that eliminating the requirements for foreign issuers to reconcile IASC standards to U.S. GAAP could potentially hinder the ability of national standard setters (like the FASB) and the IASC to converge their standards. The following concerns would arise if the SEC decided to relax the current reconciliation requirements for foreign issuers that use IASC standards—whether that conclusion extended to one or more standards (or aspects thereof) assessed on an individual basis or to the entire set of core standards assessed as a whole. In particular:

- *Absence of a reconciliation requirement can eliminate an important source for identifying and prioritizing areas on which to focus convergence efforts.* Both the IASC and the FASB support the objective of developing a single set of high-quality global accounting standards. In the United States, reconciling items tend to arise from differences between the results that are reported based on the standards used by foreign issuers to prepare their financial statements and the results that would have been reported if the financial statements had been prepared based on U.S. GAAP. A requirement to reconcile helps to identify the primary areas of noncomparability on which national and international standard setters need to focus their convergence efforts in order to achieve the highest quality international solutions.
- *Absence of a reconciliation requirement can reduce incentives for the FASB and the IASC to converge their standards.* One of the greatest perceived benefits of using a single set of accounting standards worldwide is the concurrent increase in the quality and the comparability of financial reporting. When two sets of standards are not comparable and there is no requirement to reconcile, the motivation to converge those standards to achieve a single high-quality international solution is likely to be reduced. Further, without a reconciliation requirement, important information about the quality of one solution relative to another may be lost or obscured. Reconciliation provides a means not only for identifying areas on which to focus convergence efforts, but also for identifying areas in which there are variances in the application or interpretation of standards, that is, areas in which the quality of standards potentially could be improved. In conjunction with the intensifying demand for a single set of

high-quality global accounting standards, the reconciliation requirement provides a strong incentive for both the IASC and the FASB continually to evaluate the quality of their respective standards in their efforts to eliminate differences.

- *Absence of a reconciliation requirement can make it more difficult to measure the progress of convergence efforts.* A reconciliation requirement is a source that can be used in monitoring and evaluating the success of convergence efforts. To the extent that convergence efforts are successful, there will be a natural decline in the amount and type of reconciling items that prevail when IASC standards are reconciled to U.S. GAAP. If convergence efforts are not successful, reconciling items may continue or new reconciling items may emerge.

If the SEC removes reconciliation requirements at this stage, before national standard setters and the IASC have had the opportunity to converge their standards, we fear that a significant motivation for convergence efforts would disappear and that achieving the goal of a single set of high-quality international standards will be pushed even farther into the future. The failure of the IASC to actively pursue convergence could lead to less support for the restructured IASC and could jeopardize the chances for its success in developing a high-quality global financial reporting infrastructure.

Comparability

Current SEC requirements permit use of IASC standards by foreign issuers as an alternative to using their home country standards in preparing their primary financial statements, provided that an audited reconciliation[3] to U.S. GAAP also is prepared.[4] The present reconciliation requirements provide U.S. investors with a basis for making comparisons among entities regardless of the accounting standards used in preparing the primary financial statements. A lack of comparability—whether it relates to comparing the financial statements of two IASC-based foreign issuers or to comparing IASC-based financial statements to U.S. GAAP-based financial statements—increases the costs and uncertainties related to making informed investment decisions. In particular:

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[3] There are some exceptions to the reconciliation requirements for aspects of certain IASC standards.

[4] It is our understanding that the SEC is not considering a change to the requirements for foreign issuers that do not choose to use IASC standards. We support the continued option for foreign private issuers to prepare financial statements based on U.S. GAAP or based on home country standards with full reconciliation to U.S. GAAP.

- *Absence of a reconciliation requirement can increase costs to U.S. investors even if IASC standards and U.S. GAAP are judged to be of equivalent quality.* International comparability is cited by many as a primary benefit to be gained by using a set of international accounting standards. Ideally, the unreconciled financial statements of a foreign issuer prepared based on IASC standards would be of equivalent quality with those of other foreign issuers using IASC standards and with the financial statements of foreign and domestic issuers reconciling to or using U.S. GAAP. However, even if the two sets of accounting standards were of equal quality, there would be differences between them that would create costs in comparing those financial statements.
- *Absence of a reconciliation requirement shifts the costs of producing comparable financial information from the preparers of that information to the users of that information and creates uncertainty.* Without reconciliation, the burden of producing comparable information will fall on a group of users (that is, U.S. investors, creditors, and others) that will have to expend resources in order to make the data comparable. Additionally, differences between reported financial results for essentially similar transactions and events creates uncertainty about the relevance, reliability, and representational faithfulness of those results. Reconciliation to U.S. GAAP helps to create comparability between foreign and domestic issuers, which minimizes the costs to investors of comparing investment alternatives and making informed investment decisions and reduces uncertainty.

Comparability issues will remain until there is worldwide use of a single set of high-quality international accounting standards. As the restructured IASC and national standard setters work together to converge standards and develop high-quality international solutions, comparability will naturally increase and investors will reap benefits as they arise, without bearing the costs that would be introduced by eliminating current reconciliation requirements.

The SEC's Enforcement Role

In the FAF-FASB Vision report, we identified a number of elements that would be necessary to support an international accounting system in the future. Those elements are similar to many of the elements identified in the Concept Release as necessary to a high-quality global financial reporting infrastructure. We continue to believe that in order for a set of high-quality international accounting standards to be used successfully worldwide and the maximum benefits of their use to be comprehensively realized those standards must be supported by an adequate global financial reporting infrastructure.

We observe that many of the various elements of a global financial reporting infrastructure are still in the early stages of development or do not yet exist. In that situation, a conclusion must be reached about the acceptability of IASC-based financial statements for U.S. markets in terms of the current U.S. financial reporting infrastructure. That is, the SEC will necessarily have to evaluate whether methods and means are available in the various nations to ensure the appropriate application and enforcement of IASC standards. The current lack of enforcement mechanisms in other countries places burdens on the SEC to provide the means of ensuring that IASC standards are properly applied.

We recognize that the SEC has some jurisdiction through its review and comment process to regulate interpretation and application of IASC standards outside the United States when financial statements are prepared by foreign issuers for consumption in U.S. markets. The role that the SEC plays in enforcing accounting standards to ensure comparability and transparency is more proactive than the roles of market regulators in many countries—that is part of the reason that there are variations in the way that IASC standards are presently being interpreted and applied worldwide. To the extent that those circumstances continue, and in the absence of a global enforcement mechanism for IASC standards, we believe that the SEC likely will find itself filling the gap created by the lack of a global enforcement mechanism for IASC standards. That is, by virtue of maintaining its significant interpretive and enforcement role for U.S. markets, the SEC staff will have a significant impact on how IASC standards are interpreted and applied worldwide.

That situation seems inevitable whether or not the current reconciliation requirements continue. However, we believe that eliminating the requirements for foreign issuers to reconcile to U.S. GAAP for some or all of the IASC's core standards would exacerbate that situation. Many IASC standards include implicit and explicit alternatives or provide only general implementation guidance. As such, in the absence of reconciliation, the SEC staff would find itself in the position of deciding on a case-by-case basis which accounting methods in IASC standards are acceptable for financial reporting in the United States—a role that would place it in the position of creating standards on an ad hoc basis.

We do not believe the SEC should be an ad hoc standard setter. Although the SEC has the legislative authority to assume the role of standard setter, its historical position has been to look to the private-sector to develop and interpret standards through extensive and open due process.

If the lack of reconciliation significantly increases the SEC's interpretive role through its enforcement responsibility, ultimately its interpretations could interfere with the development of a sound, independent international accounting standard-setting process and with the convergence of national and international standards. That result could come about if the SEC were to approach acceptance of unreconciled IASC standards on a case-by-case basis; that is, an approach that focuses on the acceptability of an accounting standard in the context of a filed financial statement.

A case-by-case approach would carry additional difficulties. If the SEC were to accept IASC standards without reconciliation and then interpret and accept IASC standards used in a filed document, that acceptance could relate only to the present standard and any applicable interpretations that existed at the time the SEC reached conclusions regarding the document. The SEC would then be enforcing those standards and interpretations and resolving issues related to alternatives and ambiguities in terms of what the SEC currently found acceptable for foreign issuers listing in the United States. That approach might place the restructured IASC in a difficult position as it attempts both to improve the quality of its standards and to facilitate the convergence of national and international accounting standards toward the highest quality international solutions. There is the possibility that the IASC would be disinclined to choose to amend or interpret a standard in a way that varies from what has been deemed acceptable for purposes of filing in the United States—even if a different solution would increase the quality and international comparability of reported financial information.

A case-by-case approach could also increase the danger that there would be two (or more) versions of IASC standards—those that are acceptable to the SEC and those that are acceptable in markets outside the United States. To the extent that the SEC's

interpretation and enforcement of unreconciled IASC standards predominated, the SEC would, in effect, become a global standard setter.

Continued reconciliation requirements would allow the restructured IASC to maintain flexibility to interpret and amend its standards without potentially being influenced by the possibility that a particular solution would change a standard's status as acceptable without reconciliation in the United States.

The Overall Objective of the FAF and the FASB

We strongly support the efforts to develop a single set of high-quality accounting standards to be used worldwide within our overall objective of increasing international comparability while maintaining the highest quality accounting standards in the United States. There is much work left to be done in achieving that objective, including work on converging national and international standards and work on developing an adequate financial reporting infrastructure to support their use. Consequently, we conclude that at this time, elimination of the current requirements for foreign issuers using IASC standards to reconcile to U.S. GAAP would not move us closer to our goals.

In particular, the results of that conclusion would conflict in some respects with the FAF and the FASB's overall objective. For example, if the SEC concluded that an individual IASC standard was of a quality equal or superior to its U.S. GAAP counterpart but that standard differed from its U.S. GAAP counterpart, eliminating the requirement for a foreign issuer using that standard to reconcile to U.S. GAAP would decrease the comparability of financial information provided to U.S. investors. Decreased comparability would increase costs to those investors.

We also find it problematic to consider the use of IASC standards by foreign issuers in U.S. markets in the absence of key elements of a global financial reporting infrastructure. In that situation, there is no ideal solution. We note that even if the entire set of core standards were accepted without reconciliation, some reconciliation to U.S. GAAP still would be necessary in those cases in which an IASC standard did not address a particular type of transaction, for example, for specialized industry transactions. Thus, even if the

decision were reached to eliminate reconciliation requirements for the IASC's core standards, some reconciliation would continue to be required for at least some foreign issuers that use IASC standards.

Closing Remarks

We reiterate our support for the IASC's past and future efforts to improve the quality of international accounting standards. Those standards are only one element of a global financial reporting infrastructure. Other elements of the global financial reporting infrastructure are not yet sufficiently developed to be relied upon for the rigorous interpretation and application of the IASC's core standards. Thus, the SEC will necessarily have to rely on the methods and means available within its own jurisdiction with regard to application and enforcement of the core standards, primarily the significant interpretive and enforcement role of the SEC staff. Maintaining current reconciliation requirements can help to avoid some of the possible implications stemming from the SEC's enforcement role on the future development of international accounting standards and on the convergence of national and international accounting standards. The current reconciliation requirements facilitate convergence of standards and help to maintain comparability between foreign and domestic issuers.

Those observations are based on the current status of the various elements identified by the SEC as necessary to a high-quality global financial reporting framework and the need for the SEC to continue to carry out its mandate of investor protection. The restructured IASC will be better positioned than its predecessor to lead the convergence of national and international accounting standards and to achieve high-quality international solutions that increase both the quality and the comparability of financial reporting worldwide. The success of the restructured IASC would be jeopardized if it did not focus on convergence or if its process of interpreting or amending standards was influenced by the SEC's acceptance of unreconciled accounting standards in U.S. markets. That outcome, which we are concerned could result from eliminating current reconciliation requirements, would impede the ability of national standard setters and the IASC to ensure that

international accounting standards are of the highest possible quality and to accelerate convergence of national and international accounting standards.

At the present time, we believe that there is only one conclusion that we can support as an optimal solution to the issues raised in the Concept Release—the SEC should continue to require that foreign issuers that use IASC standards in preparing their primary financial statements also provide full reconciliation to U.S. GAAP. That conclusion is consistent with our vision for international accounting standard setting, in which the ideal outcome is worldwide use of a single set of high-quality accounting standards for both domestic and cross-border financial reporting. Continued progress toward that outcome will result from pursuing the overall objective of increasing international comparability while maintaining the highest quality accounting standards in the United States. In the meantime, reconciliation would help to minimize costs to financial statement users by helping to create comparability between investment alternatives presented based on different accounting standards.

We hope that our comments are helpful. We would be pleased to discuss any aspects of our comments at your convenience.

Sincerely,

Edmund Jenkins
Chairman
Financial Accounting Standards Board

Manuel Johnson
Chairman and President
Financial Accounting Foundation

Financial Accounting Standards Board
401 Merritt 7, Box 5116, Norwalk, CT 06856-5116 | Telephone: (203) 847-0700 Fax: (203) 849-9714

June 5, 2000

Jonathan G. Katz
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Dear Mr. Katz:

This letter is in response to the request for comment on the SEC Concept Release, "International Accounting Standards," File No. S7-04-00 (the Concept Release). We commend the SEC for its ongoing efforts to uphold the quality of financial reporting domestically while encouraging the development of a high-quality global financial reporting framework, and we appreciate the opportunity to respond to the Concept Release.

The views expressed in this letter and its appendix are those of the Financial Accounting Standards Board (FASB). The FASB has also expressed its views on some nontechnical issues in another comment letter jointly issued by the FASB and the Trustees of the Financial Accounting Foundation (FAF).[1] Although both letters reach similar conclusions about the conditions for acceptance of IASC standards in the United States, because this letter contains technical subject matter, the FAF was not asked to comment on any of the FASB's views in this letter or its appendix. The two letters should be viewed together as the FASB's response to the Concept Release.

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[1] The FAF is an independent body responsible for (among other things) exercising general oversight of the FASB (except with regard to the FASB's resolution of technical issues).

The FASB is committed to the objective of increasing international comparability while maintaining the highest quality accounting standards in the United States. Our position on that topic is set forth in a report, *International Accounting Standard Setting: A Vision for the Future,* issued jointly by the FAF and the FASB (the FAF-FASB Vision report). There is a strong and growing demand for high-quality, internationally comparable financial information that capital providers find useful for decision making in global public capital markets. Ideally, that demand would be satisfied by use of a single set of high-quality accounting standards for both domestic and cross-border financial reporting. The FASB continues to work with the International Accounting Standards Committee (IASC) and with other standard setters in an effort to converge national and international standards while improving the quality of financial reporting worldwide. Our comments reflect our commitment to the objective and goals in the FAF-FASB Vision report.

Introduction

The Concept Release seeks input to determine under what conditions the SEC should accept in U.S. markets financial statements of foreign private issuers (foreign issuers) that are prepared based on standards promulgated by the IASC. We acknowledge that the IASC has significantly improved many of its standards as a result of the core standards project and that an increasing number of countries and international organizations have expressed support for use of the IASC core standards for cross-border filings. The potential benefits that can be reaped from those improvements must be assessed with consideration given to (1) the potential differences between financial information reported by cross-border filers that would use IASC standards and other cross-border and domestic filers that would use or reconcile to U.S. generally accepted accounting principles (GAAP), (2) the desire to support the restructured IASC, and (3) the current lack of an adequately developed global financial reporting infrastructure.

Potential Differences between IASC-based and U.S. GAAP-based Filers

We believe it is appropriate for the SEC to consider the extent to which IASC standards might contribute to improving the quality of *cross-border* financial information reported

(that is, the information reported in financial statements of foreign private issuers) in U.S. markets. However, we note that if the SEC concludes that foreign issuers may use IASC standards without reconciliation of their financial statements to U.S. generally accepted accounting principles (GAAP), that would inevitably lead to questions about whether domestic issuers should likewise be permitted to use IASC standards. We do not believe it is appropriate at the present time to consider whether there is a role for IASC standards for *domestic* financial reporting in the United States. The Concept Release does not contemplate use of IASC standards for domestic financial statements and the SEC's conclusions would apply only to cross-border filers. However, because there are differences between IASC standards and U.S. GAAP, acceptance of IASC-based financial statements without reconciliation would inevitably introduce noncomparability between those financial statements and financial statements prepared by domestic or foreign issuers based on U.S. GAAP or financial statements prepared by foreign issuers that are reconciled to U.S. GAAP. Investors should not bear the additional costs that would result from that noncomparability.

Desire to Support the Restructured IASC

We appreciate the salience of the SEC's consideration of the IASC core standards. The SEC's conclusions about the conditions for acceptance of those standards may affect, for example:

1. The extent to which those standards are used worldwide
2. The extent to which an appropriate infrastructure will develop to support their use
3. The nature of the restructured IASC's agenda priorities

4. The future agenda priorities of other standard setters that are working with the IASC to converge national and international standards to achieve the highest quality international solutions.[2]

There seems to be an unfortunate perception on the part of some that the future of the IASC as an organization is in some way contingent upon the SEC's conclusions about the acceptability of the core standards in their current form for use without reconciliation by foreign issuers listing in the United States. Regardless of the SEC's conclusions, we believe that more widespread use of IASC standards outside U.S. markets is desirable and that the IASC, once restructured, will play an increasingly important role in the evolving global financial reporting infrastructure. As we have publicly stated on many occasions, we support the restructuring of the IASC and believe it will help in leading efforts to converge national and international accounting standards. Further, there will continue to be a prominent role for the IASC outside of the United States as emerging market countries look to IASC standards as a basis for developing their own standards and as member states of the European Union increasingly consider IASC standards for use in European capital markets. The success of the restructured IASC will be vital to the continued development of a single set of high-quality international accounting standards and to the successful evolution of a high-quality global financial reporting infrastructure.

Lack of a Global Financial Reporting Infrastructure

In the FAF-FASB Vision report, we identified a number of elements that would be necessary to support an international accounting system in the future. Those elements are similar to many of the elements identified in the Concept Release as necessary to a global financial reporting infrastructure. We continue to believe that, in order for a set of high-quality international accounting standards to be used successfully worldwide and the

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[2] In the FAF-FASB Vision report, *convergence* is described as different standard setters arriving at high-quality national or international standards that are as similar as possible. The process of convergence includes using all reasonable efforts to arrive at consensus, recognizing that it may be beneficial to arrive at very similar higher quality national standards when consensus on a single international standard is not

maximum benefits of their use to be comprehensively realized, those standards must be supported by an adequate global financial reporting infrastructure. Ideally, acceptance of international standards would result from a process-oriented approach (like the SEC's approach to acceptance of FASB standards) with all of the elements of a global financial reporting infrastructure, as identified both in the Concept Release and in the FAF–FASB Vision report, in place.

We observe that many of the various elements of a global financial reporting infrastructure are still in the early stages of development or do not yet exist. As a result, a conclusion must be reached about the acceptability of IASC-based financial statements for U.S. markets in terms of the current U.S. financial reporting infrastructure. For example, the SEC will necessarily have to evaluate whether methods and means are available in various nations to ensure the appropriate application and enforcement of IASC standards because there is no international counterpart. Without a global enforcement mechanism and without the adequate development of other elements of a high-quality global financial reporting infrastructure, there is no ideal conclusion about the use of IASC standards by foreign issuers in U.S. markets.

Although the future of the IASC is bright, conclusions about the acceptability of the IASC's core standards for use in U.S. markets must be reached in the present, amid a number of competing national and international perspectives and in an environment in which the elements of a global financial reporting framework are in various stages of development. The SEC's decision, while it may weigh heavily outside of the United States, must ultimately be in the best interests of U.S. investors participating in U.S. markets—consistent with the SEC's mandate of U.S. investor protection. Such a decision

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possible.

should be one that benefits U.S. investors by increasing their ability to compare investment opportunities and to make informed investment decisions.

In lieu of an ideal solution, we believe that an optimal conclusion about the use of the IASC's core standards by foreign issuers in U.S. markets would be one that does not increase the costs to financial statement users of comparing investment alternatives to make effective investment decisions but that (1) maintains the comparability and quality of financial information provided by foreign issuers to U.S. investors, (2) intensifies pressure on national standard setters (including the FASB) and on the IASC to converge their standards to achieve the highest quality international solutions, and (3) helps to identify and prioritize those areas of accounting that should be the focus of convergence efforts. Further, an optimal solution should maintain reliance for the development of international accounting standards (and their interpretations and amendments) on an independent, private sector standard-setting structure and process.

Summary of FASB's Conclusions

We support the IASC's efforts and are, ourselves, committed to supporting the development of a single set of high-quality accounting standards to be used worldwide. However, it is difficult to conclude that elimination at this time of some or all of the current requirements for foreign issuers using IASC standards to reconcile to U.S. GAAP would provide a net benefit to U.S. investors. In particular, the results of that conclusion would conflict in some respects with the FASB's overall objective of increasing international comparability while maintaining the highest quality accounting standards in the United States. For example, if the SEC concluded that an individual IASC standard was of a quality equal or superior to its U.S. GAAP counterpart but that standard differed from its U.S. GAAP counterpart, eliminating the requirement for a foreign issuer using that standard to reconcile to U.S. GAAP would decrease the comparability of financial information provided to U.S. investors.

We also note that it would not be possible to completely eliminate all reconciliation requirements for foreign issuers that use IASC standards. Even if the entire set of core

standards was accepted without reconciliation, some reconciliation to U.S. GAAP still would be necessary in those cases in which an IASC standard did not address a particular type of transaction, for example, a specialized industry transaction.

The Concept Release poses four alternatives to the level of acceptance of IASC standards, three of which would require elimination of some or all of the current requirements for foreign issuers using IASC standards to reconcile their financial statements to U.S. GAAP. As noted above, unless elimination of reconciliation requirements maintains or improves both the comparability and the quality of financial reports used in the United States, each those three alternatives poses difficulties. In principle, we are concerned about eliminating some or all of the current reconciliation requirements for the following reasons:

1. *Convergence.* As stated in the FAF-FASB Vision report, we are committed to (1) ensuring that international accounting standards are of the highest quality and (2) accelerating convergence of national and international standards to achieve the highest quality international solutions. The IASC shares a similar commitment. Current reconciliation requirements provide a focal point for the efforts of the IASC and the FASB and a mechanism for measuring progress toward meeting the goals of high quality and convergence. Removing the requirement that foreign issuers using IASC standards provide a reconciliation to U.S. GAAP could impede those efforts in the following ways:
   - *Absence of a reconciliation requirement can eliminate an important source for identifying and prioritizing areas on which to focus convergence efforts.* Both the IASC and the FASB support the objective of developing a single set of high-quality global accounting standards. In the United States, reconciling items tend to arise from differences between the results that are reported based on the standards used by foreign issuers to prepare their financial statements and the results that would have been reported if the financial statements had been prepared based on U.S. GAAP. A requirement to reconcile helps to identify the primary areas of noncomparability on which national and international standard setters need to focus their convergence efforts in order to achieve the highest quality international solutions.
   - *Absence of a reconciliation requirement can reduce incentives for the FASB and the IASC to converge their standards.* One of the greatest perceived benefits of using a single set of accounting standards worldwide is the concurrent increase in the quality and the comparability of financial reporting. When two sets of standards are not comparable and there is no requirement to reconcile, the motivation to converge those standards to achieve a single high-quality international solution is likely to be reduced. Further, without a reconciliation

requirement, important information about the quality of one solution relative to another may be lost or obscured. Reconciliation provides a benchmark not only for identifying areas on which to focus convergence efforts, but also for identifying areas in which there are variances in the application or interpretation of standards, that is, areas in which the quality of standards potentially could be improved. In conjunction with the intensifying demand for a single set of high-quality global accounting standards, the reconciliation requirement provides a strong incentive for both the IASC and the FASB continually to evaluate the quality of their respective standards in their efforts to eliminate differences.

- *Absence of a reconciliation requirement can make it more difficult to measure the progress of convergence efforts.* A reconciliation requirement is a source that can be used in monitoring and evaluating the success of convergence efforts. To the extent that convergence efforts are successful, there will be a natural decline in the amount and type of reconciling items that prevail when IASC standards are reconciled to U.S. GAAP. If convergence efforts are not successful, reconciling items may continue or new reconciling items may emerge.

2. *Comparability.* Regardless of the relative quality of the two sets of standards, there are differences between IASC standards and U.S. GAAP and there are variations in the way IASC standards are applied around the world. Current reconciliation requirements are intended to help create comparability among foreign issuers using different accounting standards and comparability between foreign issuers that do not use U.S. GAAP as a basis for their financial reports and domestic issuers that use U.S. GAAP. We believe that a continued reconciliation requirement will assist in creating comparability and will reduce costs that would arise if reconciliation were abandoned because:

   - *Absence of a reconciliation requirement can increase costs to U.S. investors even if IASC standards and U.S. GAAP are judged to be of equivalent quality.* International comparability is cited by many as a primary benefit to be gained by using a set of international accounting standards. Ideally, the unreconciled financial statements of a foreign issuer prepared based on IASC standards would be of equivalent quality with those of other foreign issuers using IASC standards and with the financial statements of foreign and domestic issuers reconciling to or using U.S. GAAP. However, even if the two sets of accounting standards were of equal quality, there would be differences between them that would create costs in comparing those financial statements.

   - *Absence of a reconciliation requirement shifts the costs of producing comparable financial information from the preparers of that information to the users of that information and creates uncertainty.* Without reconciliation, the burden of producing comparable information will fall on a group of users (that is, U.S. investors, creditors, and others) that will have to expend resources in order to make the data comparable. Additionally, differences between reported financial results for essentially similar transactions and events creates uncertainty about the relevance, reliability, and representational faithfulness of those results. Reconciliation to U.S. GAAP helps to create comparability between foreign and

domestic issuers, which minimizes the costs to investors of comparing investment alternatives and making informed investment decisions and reduces uncertainty.

3. *The SEC's enforcement role.* The early stage of development of a high-quality global financial reporting infrastructure (in particular the lack of a global enforcement mechanism for IASC standards) places a great deal of pressure on the SEC's enforcement role of ensuring comparability and transparency of financial information reported in the United States by foreign issuers using IASC standards. The pressure on the SEC to relax its enforcement role would increase if instead of requiring reconciliation, the SEC allowed variations in the way IASC standards are presently interpreted and applied outside the United States to influence its enforcement decisions. In contrast, failure to accede to these variations may ultimately place the SEC in the awkward position of establishing a "U.S.-only" version of IASC standards.

Each of those concerns arises in the context of a conclusion to modify the current reconciliation requirements for foreign issuers that use IASC standards—whether that conclusion extends to one or more standards (or aspects thereof) assessed on an individual basis or to the entire set of core standards assessed as a whole. Those concerns are explained in more detail in the joint FAF-FASB letter. Ultimately, each of those concerns can lead to increased costs to financial statement users—U.S. investors—attempting to compare investment opportunities available in U.S. markets.

At the present time, we believe that there is only one conclusion that we can support as an optimal solution to the issues raised in the Concept Release—the SEC should continue to require that foreign issuers that use IASC standards also provide full reconciliation to U.S. GAAP. The following sections of this letter describe some of the factors that led us to conclude that reconciliation to U.S. GAAP continues to be necessary for IASC-based financial reporting. Additional support for our conclusions can be found in our responses to the specific questions in the Concept Release, which are included as an appendix to this letter.

Our views are based on the issues we identified as being of primary importance in our role as an accounting standard setter committed to improving the quality and comparability of financial reporting in the United States through an independent and open due process. We recognize that other commentators on the Concept Release are likely to

consider different issues and have different objectives for arriving at their own conclusions. We appreciate that the SEC will consider and weigh the various views and may find compelling reasons to modify the current reconciliation requirements despite our conclusions. We have, therefore, provided in a later section of this letter some thoughts on significant considerations that might be useful in contemplating a conclusion to modify the requirement for foreign issuers using IASC standards to reconcile to U.S. GAAP.

Why Reconciliation Continues to be Necessary

We conclude that the optimal solution to the issues raised in the Concept Release would be for the SEC to continue to require that foreign issuers that use IASC standards also provide full reconciliation to U.S. GAAP. We support that conclusion for the following reasons:

1. It is consistent with our objective of increasing international comparability while maintaining the highest quality standards in the United States.
2. It facilitates the convergence of national and international accounting standards to achieve the highest quality international solutions.
3. It helps to maintain the independence of international accounting standard setting.

We considered a number of factors in arriving at our conclusions, including (1) existing evidence about the quality and comparability of reported financial information prepared using the core standards, (2) the potential costs to users of eliminating reconciliation to U.S. GAAP when IASC standards are used, (3) the potential demands for the SEC to accommodate non-IASC standards without reconciliation, and (4) questions about the future interaction of the SEC, the IASC, and others. Each of those factors is described in more detail below.

Quality and Comparability of Reported Financial Information Prepared Using the Core Standards

The success of capital markets in the United States is in part due to a long tradition of requiring those that seek capital to provide relevant, reliable, and transparent information so that investors can compare alternative opportunities and make informed economic

decisions about the allocation of capital. A major component of the information package that investors rely on is financial reporting. In the United States, the objective of financial reporting is to provide decision-useful information to assist investors in making rational investment decisions. We believe that the IASC's objective for financial statements, "to provide information . . . that is useful to a wide range of users in making economic decisions," as stated in paragraph 12 of its "Framework for the Preparation and Presentation of Financial Statements," and reiterated in the IASC's proposed new constitution, is consistent with the objective of financial reporting in U.S. markets.

Consequently, we believe that IASC standards, when appropriately interpreted and applied, can produce financial information that is more relevant, comprehensive, transparent, and of higher quality than financial information prepared based on the national standards of countries that do not share that objective. However, we are not convinced that is the case when financial information prepared under IASC standards is compared with financial information prepared in accordance with U.S. GAAP. We were unable to arrive at a positive conclusion about the quality of the IASC's core standards for a number of reasons. Among the most compelling are the following:

- IASC standards lack widespread use as a comprehensive basis for the preparation of financial reports. While we do not know the exact number of companies that use IASC standards as the primary basis for financial reporting, the IASC's website identifies fewer than 1,000 IASC-based companies that list on stock exchanges worldwide. Further, many of the core standards have only become effective in the last couple of years or are not yet effective. There is insufficient evidence or experience to conclude that IASC standards constitute a comprehensive, generally accepted basis of accounting; are of high quality; and can be rigorously interpreted and applied.
- Available evidence indicates that there are a number of issues that must be resolved before such a positive conclusion about the quality of the core standards could be reached. The (1) presence of differences between IASC standards and home country standards (2) differences in national accounting infrastructures, (3) ambiguities within IASC standards, and (4) newness of, and lack of experience using, IASC standards all are factors that have led to differences in how IASC standards are applied and enforced.
- Even if all of the IASC core standards were judged to be of sufficiently high quality for use by foreign issuers without reconciliation to U.S. GAAP, there would not be comparable application of IASC standards because the other elements of a high-quality global financial reporting infrastructure identified by the SEC in the Concept

Release are not presently sufficient to support the rigorous interpretation and application of IASC standards. The potential for lack of comparability among foreign issuers that use IASC standards is increased by the existence of implicit and explicit alternatives, the ambiguousness of the guidance, and the lack of sufficient implementation guidance in many IASC standards.

- Even if the IASC core standards were rigorously interpreted and applied so that financial reporting among foreign issuers was comparable, there are significant differences between IASC standards and U.S. GAAP. Thus, permitting use of IASC standards without reconciliation would decrease the comparability of financial information reported by foreign issuers that used IASC standards without reconciliation and financial information reported by other foreign and domestic issuers using or reconciling to U.S. GAAP.

Based on that evidence, the IASC's core standards do not meet the criteria set forth in the Concept Release to be considered of sufficiently high quality for use without reconciliation in U.S. markets. Moreover, a lack of comparability—whether it relates to comparing the financial statements of two IASC-based foreign issuers or to comparing IASC-based financial statements to U.S. GAAP-based financial statements—can create uncertainty and confusion about the relative quality and representational faithfulness of items reported in financial statements based on those standards. Without reconciliation to a common benchmark, noncomparability also increases the costs and uncertainties related to making informed investment decisions.

Potential Costs to Users of Eliminating Reconciliation to U.S. GAAP

Current SEC requirements permit use of IASC standards by foreign issuers as an alternative to using their home country standards in preparing their primary financial statements, provided that an audited reconciliation[3] to U.S. GAAP also is prepared.[4] We believe that, because it helps to create comparability between foreign and domestic

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[3] There are some exceptions to the reconciliation requirements for aspects of certain IASC standards.

[4] It is our understanding that the SEC is not considering a change to the requirements for foreign issuers that do not choose to use IASC standards. We support the continued option for foreign private issuers to prepare financial statements based on U.S. GAAP or based on home country standards with full reconciliation to U.S. GAAP.

issuers, reconciliation to U.S. GAAP minimizes the costs to investors of comparing investment alternatives and making informed investment decisions.

We realize it is perceived that there are a number of benefits that would potentially result from modifications to the current requirements for foreign issuers to provide a reconciliation to U.S. GAAP when IASC standards are used. Those may include lower costs to financial statement preparers and a reduction in the variety of financial reporting bases used in U.S. markets to the extent that IASC standards are used in place of home country standards. Presumably, a decision to remove some or all reconciliation requirements would be based on an expectation that the information provided would be of equivalent or higher quality than that which is received under current reconciliation requirements. Changes to current requirements that result in higher quality financial reporting would facilitate the flow of better quality information to U.S. investors.

On the other hand, we believe it is important to acknowledge that the absence of a requirement for reconciliation of IASC-based financial statements to U.S. GAAP requirements could actually increase the costs to investors to the extent that noncomparability of reported financial information in U.S. markets is increased. The present reconciliation requirements provide U.S. investors with a basis for making comparisons among entities regardless of the accounting standards used in preparing the primary financial statements. Without such a reconciliation, new costs to users can arise because, in the absence of a single set of high-quality accounting standards that is used for *both* domestic (U.S.) and cross-border financial reporting, acceptance of IASC standards for cross-border reporting but not domestic reporting increases the noncomparability of the financial reporting basis of domestic filers and that of cross-border filers.

The SEC will have to judge whether those new costs outweigh the benefits of allowing foreign issuers to use IASC standards without reconciliation. However, we believe that, in the absence of comparability between foreign issuers using IASC standards and those issuers using or reconciling to U.S. GAAP, even sophisticated U.S. investors may have

difficulty identifying and understanding variations in measurement, recognition, and disclosure approaches.

Potential Demands for the SEC to Accommodate Non-IASC Standards without Reconciliation

A number of countries assert that their national standards are the same as, or comply in all material respects with, IASC standards. At present, based on information from the IASC's website, there are over 30 countries that have policies to adopt some or all IASC standards or to ensure that their standards comply with IASC standards. In addition, a number of other countries, such as Australia, Haiti, and Sweden, undertake to issue standards that are the same as IASC standards to the extent permitted by their national laws. If the SEC permits use of some or all IASC standards without reconciliation, it is likely to receive requests from foreign issuers of many of those countries to likewise be afforded elimination of the reconciliation requirements if they are using home country standards that purport to comply with similar IASC standards. If accommodations are made for those foreign issuers, tension might be created with foreign issuers from other countries (whose standards are not based on, or compliant with, IASC standards) that would still be required to reconcile their financial reports to U.S. GAAP. Those countries may have a longer-standing and more-rigorous national accounting infrastructure than exists for IASC and IASC-based home country standards—and may believe their standards are superior to IASC standards. That issue is further complicated by the fact that IAS 1, *Presentation of Financial Statements,* permits an entity to look to other accounting frameworks in the absence of an IASC standard or interpretation of the IASC's Standing Interpretations Committee (SIC). Countries that adopt IAS 1 as a home country standard can essentially look to another country's accounting principles in the absence of a home country standard of their own and still be considered to comply with IASC-based standards.

We note that at the time the SEC accepted aspects of IAS 22, *Business Combinations,* without reconciliation, foreign issuers from the United Kingdom (UK) and from Canada requested that the SEC recognize their similar home country standards on that topic. In

those cases, the onus was on the SEC to investigate and reach a conclusion as to whether the national standards in question were, in fact, consistent with IAS 22. Further, when the SEC concluded that a UK foreign issuer would not be required to reconcile UK accounting for certain aspects of amortization of goodwill that were deemed consistent with requirements in IAS 22, the SEC staff was required to provide further guidance to indicate the conditions that must be met before that accounting would be considered acceptable. Such requests inevitably use up valuable time and resources and, thus, create costs that offset the benefits expected to be obtained by modifying the reconciliation requirements to accept some or all IASC standards without reconciliation.

We believe it is inevitable that the acceptance of some or all IASC standards without reconciliation will lead to demands on the SEC to consider particular national standards for acceptance on an ad hoc basis. Thus, the SEC might be better served to address the implications of modifications to reconciliation requirements in a larger context, not just in terms of using IASC standards. In that vein, if the usefulness of reconciliations is in question, that may indicate that, rather than eliminate reconciliation requirements, the quality of reconciliations should be improved.

Future Interaction between the SEC, the IASC, and Others

Inconsistencies already have been observed in the application of IASC standards. In *The FT International Accounting Standards Survey 1999*, a survey that assesses the use of IASC standards by companies, national standard setters, regulators, and stock exchanges, David Cairns observes that "there is considerable variety in the approaches adopted by survey companies to compliance with IASs and the levels of compliance." He further notes that "even among the companies which claim full compliance, there are material omissions or other non-compliance."[5] If the SEC accepts financial statements prepared

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[5] David Cairns, *The FT International Accounting Standards Survey 1999* (London: Financial Times, 1999), 3.

using IASC standards without reconciliation, the SEC will have to specify the level of compliance with IASC standards that is necessary to be acceptable for U.S. markets. To do so will require interpretations of IASC standards. Because IASC standards are not consistently applied, it is likely that those interpretations will differ from what may be acceptable outside the United States. That raises the possibility that a company that has been preparing IASC-based financial statements for filing purposes for non-U.S. exchanges may be required to file IASC-based financial statements with a different application of IASC guidance for purposes of filing in the U.S. markets.

Given those observations and the absence of a global regulatory body to coordinate efforts to ensure that IASC standards are consistently interpreted and applied, it seems that an increasing emphasis on the SEC's interpretive role through enforcement would be necessary to compensate for effects of deficiencies in the present global financial reporting infrastructure. Further, it seems inevitable that the SEC's enforcement of IASC standards on a case-by-case basis, even in the limited context of their use in U.S. markets, could lead to jurisdictional questions such as the following:

- How would disputes among national regulators or stock exchanges be settled when there are differences in the interpretation and enforcement of IASC standards used in different nations?
- Would interpretations by the SEC regarding the appropriate use of IASC standards for purposes of U.S. markets potentially limit the independence of the IASC Board and of the SIC to subsequently address the underlying issue and arrive at different conclusions?
- If the SEC decides to accept IASC standards without reconciliation and enforce those standards by providing interpretations, would it then also be bound to accept the future amendments or interpretations of those standards by the IASC Board or by the SIC when those amendments or interpretations differ from SEC interpretations?

It is not clear how the issues related to national policy and process for accounting standard setting, interpretation, and enforcement can be reconciled in the current stage of development of a global financial reporting framework. No body of accounting standards is immutable, and, ideally, the organization responsible for those standards—the IASC—also should ultimately be responsible for their interpretation and amendment. However, ASR No. 150, *Statement of Policy on the Establishment and Improvements of Accounting*

Principles and Standards, does not currently recognize the IASC as a source for establishing accounting principles for use in the United States. Yet, if the SEC accepts IASC standards without reconciliation—especially standards that have not yet been implemented because they are new—that would implicitly endorse the past IASC standard-setting process and structure. If the SEC does not endorse the restructured IASC process for future interpretations, absent both a global regulation and interpretation function, a potential danger of the SEC accepting IASC standards without reconciliation is that there will be two (or more) versions of IASC standards—those that are acceptable to the SEC and those that are acceptable in non-U.S. markets.

We believe that the IASC, through its SIC and the successful completion of its plan for restructuring, will strengthen its ability to reduce the possibility of various interpretations of IASC standards in the future. Nonetheless, we believe that to the extent that the SEC rigorously interprets and enforces IASC standards in the meantime and other countries do not, the SEC may find itself de facto in the role of a global regulator. Thus, although the SEC's acceptance of IASC standards need not be conditioned upon the success of the IASC's restructuring, we believe it is important to contemplate how the SEC, the new IASC Board, and the SIC would interact when issues of application and enforcement of IASC standards arise.

Assessing Alternatives for Modifications to the Current Reconciliation Requirements for IASC-based Financial Reports

The foregoing discussion has focused on our conclusion, and the reasons for our conclusion, that the SEC should continue to require foreign issuers that use IASC standards to reconcile their financial statements to U.S. GAAP. We do not support any of the alternatives presented in the Concept Release that would result in modifications to the current reconciliation requirements for foreign issuers. However, the SEC will undoubtedly receive different viewpoints and may find compelling reasons to explore whether one or more IASC standards would be acceptable without reconciliation. Therefore, we provide in this section some thoughts on the possibility of modifications to the reconciliation requirements.

As indicated in the Concept Release, the SEC will be assessing the quality of the IASC's core standards both on a standard-by-standard basis and as a set. The maximum benefits of using a set of international accounting standards are possible only if those standards, as a set, are sufficiently comprehensive, are judged to be of high quality, and are rigorously interpreted and applied. If the quality of one or more of the core standards is found unacceptable on an individual basis, that would seem to preclude a decision to accept the whole set of core standards without reconciliation. Thus, the SEC likely will explore whether any individual IASC standards would be acceptable without reconciliation for cross-border financial reporting. Under such a standard-by-standard approach, reconciliation to U.S. GAAP would be required for some IASC standards (or aspects of some IASC standards), but not for others. Some believe that there are incremental benefits that would be obtained from modifying the current reconciliation requirements for individual IASC standards that are of sufficient quality, including:

- Reducing costs to foreign issuers with multiple listings based on IASC standards
- Facilitating the use of IASC standards instead of home country standards when using IASC standards to increase the overall quality and comparability of financial information reported by foreign issuers
- Increasing the prominence of IASC standards worldwide, which, in turn, would assist in developing more widespread expertise in the interpretation, application, and enforcement of those standards.

With those perceived benefits also come costs associated with the loss of information provided by a reconciliation requirement, such as those identified earlier in this letter. Ideally, only those IASC standards that maintain or increase the quality and comparability of reported financial information relative to what U.S. investors currently receive would be judged to be acceptable for use without reconciliation in preparing financial reports for U.S. markets. The assessment of an individual IASC standard should be based not only on recognition and measurement requirements, but also on disclosures, and it should look not only to the "black letter" standards, but also to the "gray letter" background and implementation guidance contained within the standard.

For a number of the IASC standards, it would be difficult to assess whether the standard would consistently result in comparable, high-quality, transparent financial reporting. For

example, an IASC standard with any of the following characteristics creates special problems for determining whether that standard is of sufficient quality or comprehensiveness or will result in comparable financial reporting:

- An IASC standard that has not yet gone into effect or has only been in effect for a short time
- An IASC standard that explicitly permits alternative treatments
- An IASC standard that contains ambiguities that introduce implicit accounting alternatives
- An IASC standard that requires accounting that is specifically prohibited under U.S. GAAP (or under SEC rules).

Each of those characteristics can contribute to a decrease in either the quality or the comparability of financial information reported using IASC standards relative to that reported using U.S. GAAP or a reconciliation to U.S. GAAP. For an IASC standard that has not yet gone into effect or has only been in effect for a short time, it may not be possible to determine whether the standard is of sufficient quality or comprehensiveness until more experience is gained through the use of the standard over time. Further, as a general rule, accounting standards should minimize the possibility of alternative treatments in order to ensure comparability. For an IASC standard that contains explicit alternatives, the SEC would have to determine the extent to which more than one alternative is acceptable and, if not, explicitly select the alternative that would be acceptable for U.S. markets. Such an approach decreases the overall global benefits of using IASC standards because non-U.S. markets that permit use of IASC standards may accept all explicit alternatives. An IASC standard that implicitly provides accounting alternatives poses even more difficulty because the alternatives may not be apparent until various interpretations and applications are evident. In those cases, the SEC may have to provide detailed interpretations to ensure comparability. Finally, an IASC standard that requires a treatment that is currently prohibited under U.S. GAAP, by definition, will not result in financial reporting that is comparable to that which results under U.S. GAAP.

In exploring the possibility of accepting IASC standards on a standard-by-standard basis, we believe that the SEC should consider requiring reconciliation in each of those circumstances identified above, as well as for topics covered by U.S. GAAP that are not

covered by IASC standards (including guidance for specialized industries) to the extent that they are relevant to a particular entity.

On the other hand, in some cases—notwithstanding the lack of comparability that would result from the use of standards that differed from U.S. GAAP—an individual IASC standard might be considered to maintain or increase the quality and comparability of reported financial information when foreign issuers use IASC standards. In theory, certain individual standards could be judged to be of sufficiently high quality to be used without reconciliation to their FASB counterparts if either:

- The particular IASC standard has been proven through use to be sufficiently comprehensive and of sufficient quality to provide comparable, relevant, reliable, and transparent financial information (for example, because it already is accepted by the SEC without reconciliation) or
- For a new IASC standard (that is, one that has only recently gone into effect or has not yet gone into effect), there is other evidence that supports a presumption that it would be sufficiently comprehensive and of sufficient quality for use in a U.S. financial reporting environment (for example, because the standard is substantially the same as an FASB standard that is being used for financial reporting in U.S. markets).

The SEC also might consider acceptance of an IASC standard without reconciliation when there is no U.S. GAAP counterpart. We would like to clarify that should the SEC find some individual IASC standards acceptable without reconciliation, in circumstances in which SEC requirements supplement a particular FASB standard or other GAAP, the SEC should strive to maintain the amount and quality of information provided by the existing combination of accounting standards and SEC regulatory requirements.

We propose the above as a guideline for identifying potential IASC standards that might be candidates for consideration for use without reconciliation to their U.S. GAAP counterparts but believe that the implications of modifications to reconciliation requirements should be carefully assessed. We are aware of the SEC's experiences with the acceptance of aspects of IAS 22, related to the methods of accounting for a business combination. At the time that the reconciliation requirement was removed, it had been judged that the criteria articulated in IAS 22 with regard to the circumstances in which the uniting-of-interests method could be used were sufficiently clear and rigorous to ensure

their consistent application. However, as experience was gained with the use of IAS 22, it became obvious that many and varied "acceptable" interpretations of that standard resulted in a lack of comparability in the accounting for similar transactions worldwide. As a result, removing the requirement for foreign issuers using IAS 22 to reconcile to U.S. GAAP decreased the comparability of financial reporting related to business combinations in the United States. Such circumstances undermine the perceived benefits of eliminating reconciliation requirements, make demands on the SEC's scarce resources, and create political tensions to the extent that the SEC is perceived to be overstepping its jurisdiction.

Experiences like the one surrounding IAS 22 highlight the difficulty of predicting whether today's expectations about the quality of financial information reported using IASC standards will be met in reality.

Closing Remarks

We reiterate our support for the IASC's past and future efforts to improve the quality of international accounting standards. Those standards are only one element of a global financial reporting infrastructure. Other elements of the global financial reporting infrastructure are not yet sufficiently developed to be relied upon for the rigorous interpretation and application of the IASC's core standards. Thus, the SEC would necessarily have to rely on the methods and means available within its own jurisdiction with regard to application and enforcement of the core standards. In that situation, the optimal conclusion about the acceptability of IASC standards would be the one that provides a net benefit to U.S. investors by maximizing the quality and the comparability of financial information reported by foreign and domestic issuers in U.S. markets. A requirement to reconcile IASC-based financial statements to U.S. GAAP provides that benefit while simultaneously helping to mitigate some of the risk and uncertainty associated with IASC standards. For example, requiring reconciliation would be beneficial because it would:

- Provide U.S. investors with a basis for making comparisons of the financial statements of foreign issuers using IASC standards with those of other foreign issuers

(whether using IASC standards or other national standards) and with those of domestic issuers using U.S. GAAP without increasing the costs to users of obtaining that information.

- Highlight areas of financial reporting that would benefit from future standard setters' efforts to converge their standards toward the highest quality solutions and provide a source for measuring progress.
- Help to identify areas or topics in IASC standards that need improvement without the risk associated with adopting an as-yet-untested accounting regime.
- Provide the opportunity to test and strengthen or, if necessary, create mechanisms for the appropriate application, interpretation, and enforcement of IASC standards.

Irrespective of the SEC's conclusion about the extent to which reconciliation should continue to be required for IASC standards, we are concerned about the implications of the increased pressure on the SEC to interpret IASC standards on a case-by-case basis if they were accepted without reconciliation for use in U.S. markets. That approach ultimately could interfere with the development of a sound, independent international accounting standard-setting body of the type identified in the Concept Release. That issue is discussed in more detail in the joint comment letter from the FAF and the FASB.

Our conclusions are based on our observations of the current status of the various elements identified by the SEC as necessary to a high-quality global financial reporting framework and the need for the SEC to continue to effectively carry out its mandate of investor protection. We believe that continued full reconciliation requirements are necessary to facilitate and accelerate the convergence efforts of national standard setters (like the FASB) and the IASC toward high-quality international solutions. Successful convergence efforts will decrease the differences between national and IASC standards.

To the extent that convergence efforts are successful, there is no need for the SEC to selectively accept IASC standards because there will be a natural decline in the amount and type of reconciling items that prevail when IASC standards are reconciled to U.S. GAAP. We believe that some of the issues identified in this letter likely will be resolved over time as more experience is gained with IASC standards and as standard setters around the world work together to achieve greater convergence.

We hope that our comments are helpful. We would be pleased to discuss any aspects of our comments at your convenience.

Sincerely,

Ed Jenkins

Edmund Jenkins