Standards Setting

What's the State of International Standards?

ILLUSTRATION: EYEWIRE IMAGES

WE'RE STILL A LONG WAY FROM HARMONIZATION

BY LAWRENCE RICHTER QUINN

Will there ever be any teeth behind international accounting standards? That's a question the Securities & Exchange Commission (SEC) has been asking since the International Accounting Standards Committee (IASC) was launched in London in 1973.

The goal of the IASC, which morphed into the International Accounting Standards Board (IASB) in March 2001, is to create a single set of understandable and enforceable global pronouncements that will result in transparency and consistency in numbers crunching across the globe.

"Regulatory convergence can raise standards and facilitate cross-border business, provided the convergence is a race to the top and not to the lowest common denominator," SEC Commissioner Roel C. Campos said at the Centre for European Policy Studies conference in Brussels last June.

The SEC's concern: Without a way to police those standards, widespread abuse may occur if corporate executives think they face no civil or criminal penalties as a result of "gaming" the system—or even if they simply misunderstand or misapply the standards.

"European officials and issuers for years have urged the SEC to accept financial statements prepared under IAS without requiring reconciliation to U.S. GAAP, as is required at present," Campos continues. "SEC staff has noted two important considerations in assessing this requirement: progress in converging IAS and U.S. GAAP and the development of an effective global financial reporting infrastructure for the consistent application, auditing, and enforcement of IAS. Because investor protection is the fundamental mission of the SEC, we will look at the quality of the information received by U.S. investors. The standards themselves are very important. No less crucial is how standards are interpreted and applied in practice."

The good news: The SEC is actively involved in ensuring a global infrastructure happens.

"Such an infrastructure is as important as the accounting standards themselves," Campos notes. "It is meant to ensure consistency and accountability. Without such a mechanism, a 'single' set of standards quickly could devolve, for practical purposes, into multiple standards."

Scott Taub, the SEC's deputy chief accountant, chairs Standing Committee Number One, which is charged with developing a global enforcement regime for the Madrid-based International Organization of Securities Commissions (IOSCO). Among its initiatives, IOSCO says it's resolved "to unite [the efforts of national securities regulators] to establish standards and an effective surveillance of international securities transactions."

The SEC is supportive of other initiatives, such as the joint projects started last fall by the IASB and the U.S. Financial Accounting Standards Board (FASB) to improve and converge international accounting standards and U.S. GAAP. "The SEC has fully supported this project," Campos says.

While it's encouraging the development of IAS, the SEC still says that it will be 2005 or beyond before it decides whether to accept IAS from companies that want to raise money in the U.S. Final judgment day is yet to come.

A COMPELLING NEED FOR GLOBAL ENFORCEMENT

The recent U.S. accounting scandals (think Enron, WorldCom, Tyco, and others) indicate that enforcement is as much a problem in developed countries as in emerging markets. If the world's most respected securities regulator has difficulty discovering those who cheat, that suggests the problem will be all the more daunting in emerging market countries.

"In emerging markets, even where the securities market is well regulated, it doesn't have the horsepower and hundreds of financial examiners," says Paul Pacter, IASB director of standards for small- and medium-sized entities and director of Deloitte's International Financial Reporting Standards (IFRS) Global Office. "So you have a situation of 'IAS Lite' around the world."

Indeed, the need for a global enforcement mechanism goes without saying: Companies both big and small aren't interpreting IAS correctly or even uniformly as they report numbers. In some cases they're "cherry picking," employing IAS when it makes them look better.

The cherry picking can be unintentional: Local accounting professionals aren't fully prepared for or schooled in IAS. In other cases, regulators in an individual country say they want their companies to report in IAS, but the regulator itself "modifies" part of the IAS reporting requirements. "When we talk with the Chinese finance ministry, it says it's adopting IAS, and at a high level it's true," Pacter explains. "You can look at almost all the rest of Asia—Japan, Thailand, Japan, Hong Kong, and Singapore—and none of these countries is in compliance with IAS. Each says it conforms, but when you look at the details you find many differences. My point is that no matter which country in Asia says it's modeling itself after IAS, there's not one country that can say its standards are identical to IAS."

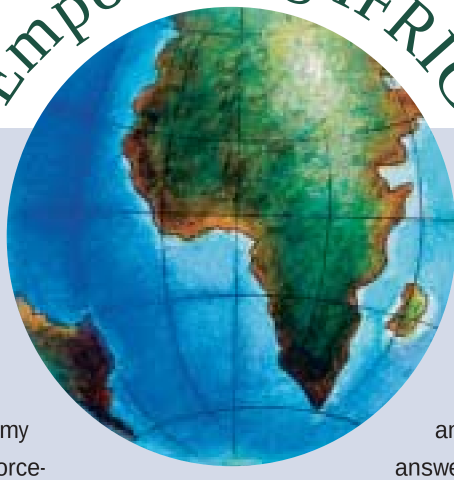
Beyond cherry picking, some companies may use other non-IAS standards (any variety of local GAAP, U.S. GAAP, or IAS) to put the company in a better light. Unfortunately, few institutional or individual investors—or even those working for the Big Four—have the sophistication to pick apart the numbers from companies using multiple reporting rules, making the information almost useless.

PRINCIPLES-BASED ARENA

The push toward a more "principles-based" method of accounting standards setting everywhere will give auditors and accountants much more flexibility in using their judgment in specific individual accounting situations. That means it may be possible for "reasonable" accountants, auditors, and investors to agree that there may be two answers to a particular accounting problem or concern. But it may also mean that different national standards setters and regulators may not agree to disagree and accept different answers—leading to greater confusion for investors and others trying to figure out the books.

In developed markets, the problem may be exacerbated

Empowering IFRIC



If creating separate global or regional enforcement agencies isn't the answer, what is?

In Europe, it's this: Letting securities regulators and accounting standards setters in individual countries maintain their own autonomy and beef up their own domestic enforcement efforts. And it's turning over any major accounting disputes to the IASB's International Financial Reporting Interpretations Committee (IFRIC), which is the equivalent of the FASB's Emerging Issues Task Force (EITF).

If there's a dispute regarding how to treat a specific accounting issue, it will be referred to IFRIC to rule quickly on the matter. If IFRIC doesn't resolve the matter quickly—and lots of regulators come up with different answers in the interim—will that make matters worse rather than better?

According to IFRIC Chairman Kevin Stevenson, "Proliferation of courses of interpretation would not be consistent with having a single set of standards. Still, there's a general feeling that some issues need to be local because of speed, but it's still preferable if they come to IFRIC."

If an accounting dispute needs an urgent decision, a local regulator or accounting standards setter will decide the matter. But what happens if local regulators make a decision and—retroactively—IFRIC comes out with an opinion that differs from the local regulators?

Other key players have expressed support for IFRIC. "Appropriate use of national and international interpretative bodies, such as the Emerging Issues Task Force in the U.S. and the International Financial Reporting Interpretations Committee, or IFRIC, is a critical element to the success of this effort," Jackson M. Day, former acting chief accountant at the SEC, noted in late 2002. "While not every question can be answered, there cannot be 15 answers to a pervasive question as well. That would undermine the credibility of the system."

Ideally, national standards setters would work proactively with IFRIC. Says Stevenson: "If national standards setters had the resources, they might work with IFRIC to get an answer. It's better for them to come to IFRIC and say, 'We need to deal with issue X.' And we'd say, 'That's a good issue; you do the research, and we'll come up with a global answer.' It's a cooperative approach, kicking around ideas like that."

Even the EITF is supportive of the IFRIC solution. Day notes: "Did you realize that the EITF is in the process of changing its operating procedures, and that they likely will more closely align with IFRIC?" Stevenson adds that "The chairman of the EITF sat through one of our IFRIC meetings, and their staffs are exchanging papers on various matters."

Could it all fall apart? Absolutely. "Everybody has to be focused on providing the best information rather than protecting their own markets," an SEC observer notes. "That's going to be a problem. When regulators have really different views, that will be a signal to get the IASB to react quickly. The challenge is to find a way for everyone to have input quickly and not affect the flow of capital."

because IAS are said to be more principles-based than U.S. GAAP, so some professionals will have to adapt to that more principles-based environment. In emerging markets, problems will result because accounting professionals are just getting their hands around local accounting requirements—never mind IAS.

"When one goes to a more principles-based approach, one outcome is that you establish a basic principle and do not permit alternatives to the principle," says Lynn E. Turner, former chief accountant at the SEC and now director of the Center for Quality Financial Reporting at Colorado State University in Fort Collins. As an example, “No one can imagine a single securities regulator... You need to know the local markets. Bringing them together would be a nightmare.”

Turner points to eliminating alternatives for accounting for inventories. “However, I suspect many an American company would squeal like a stuck pig if they had to give up their alternatives.”

A more principles-based arena is also bound to test the system and its stamina. “Surveys have shown that many large international companies abuse international standards and do not properly apply them in financial statements,” Turner adds. “Principles are only good if they are followed.”

The bottom line? The number of enforcement actions—and confusion among investors—may increase. No wonder, then, that at the SEC and, increasingly elsewhere, consistency, transparency, and enforcement are the buzzwords of the day.

EUROPEANS STEP UP TO THE PLATE

What’s adding extraordinary urgency to the issue is that the European Union is requiring public and private companies within its borders to come into compliance with IAS by 2005. Europe’s urgency may come as a surprise to some: Neither the U.K. nor most of those on the continent are known for aggressive enforcement actions.

“A huge driver behind this is the creation of a single European market,” Alastair Wilson, senior technical partner at Ernst & Young in London, explains. “There’s a real concerted effort by the Europeans to get their act together and create a level playing field by 2005. The European Union is keen that all parties work together in a cooperative way because we all have a common interest in this. We’re talking about common laws and common interests.”

In fact, there’s been almost a mad rush to get a European enforcement mechanism in place over the past 18 months. In June 2001, the European Commission created the Committee of European Securities Regulators (CESR), which held its first meeting in Paris on September 11, 2002. Since then, it has issued a draft statement on enforcement principles that will be the cornerstone of a pan-European enforcement effort.

According to David Devlin, president of the European Federation of Accountants and a partner at PricewaterhouseCoopers in Dublin, “We did a survey a couple of years ago to figure out where Europe is at and found out many countries had little if any enforcement.”

Before CESR came into existence, a variety of enforcement solutions were considered, including a “global” SEC—but that was quickly rejected. “No one can imagine a single securities regulator,” says Philippe Danjou, chief accountant at the Commission des Operations de Bourse (COB) in Paris. “You need to know the local markets. Bringing them together would be a nightmare.”

Others agree. Says Devlin: “We decided it would take an age to create a European SEC, so instead we started strengthening regulation in each country, and we created CESR. This isn’t an SEC by design. Enforcement has to be organized by each European securities regulator.”

So how far along are CESR’s enforcement principles? “It’s all going according to plan. There are 21 principles of enforcement laid out so we all understand the game,” Devlin notes. “The deadline is 2005, and we are moving like lightning. While there’s plenty of work to be done, there’s a clear road map.”

Because of CESR’s work, “we have a common understanding regarding what the securities regulators need to do and what the SEC is doing,” Danjou adds.

EYES ON CESR

While CESR is completing its work, others are moving ahead, too, albeit not as quickly—and with an eye toward watching CESR. Primary among them: IOSCO, which gave its final imprimatur to IAS standards as the way to go during its most recent annual meeting and which now is exploring enforcement options. Beyond IOSCO, others have both endorsed IAS and are promoting them around the globe. Among them: the World Bank, the International Monetary Fund, and the United Nations.

Meanwhile, for some time the SEC itself has been taking pains to point out that it doesn’t now and won’t in the future discriminate against those using IAS. In his 2002 Frankfurt presentation, for instance, former SEC Chief Accountant Turner said: “Let me be clear that [my] comments are not criticisms of IAS. Rather, they're meant to support those standards. I'm also not suggesting that we hold registrants that use IAS to a higher standard of compliance; I have the same expectation of full compliance with every registrant, regardless of the body of accounting standards used." The mood continues to be echoed at the SEC today.

SEVERAL IMPEDIMENTS TO EFFECTIVE ENFORCEMENT

Logically, as the group representing securities regulators worldwide, it would make sense for IOSCO to take the lead on enforcement issues. "The SEC and CESR are members of IOSCO, so [the way this is happening] all fits together," Devlin says. "It makes sense to make this global because international standards are popular."

Although IOSCO is talking about enforcement, it has yet to issue any proposals for enforcement, and it's not clear that it will be ready to do so any time soon. Regulators seem to be a bit defensive about just how quickly IOSCO may or may not be responding. "IOSCO is very concerned about vigorous enforcement," Wilson says, while Kevin Stevenson, director of technical activities at IASB and chairman of IASB's International Financial Reporting Interpretations Committee (IFRIC), notes that "various IOSCO representatives see that there can't be a global enforcement agency."

A great number of impediments are in the way of a viable enforcement regime. Let's look at the key ones.

- The IASB still needs to write many of its standards.
- Outside of Europe, Canada, and a handful of other countries, few accounting groups abroad have been proactive in enforcement activities, typically responding only when complaints have been brought to them.
- Auditing of IAS is inconsistent. According to a report by David Cairns, former IASC secretary general from 1985 to 1994, there are auditors who express unqualified IAS opinions on financial statements, condone accounting policies and disclosures that clearly do not comply with IAS, and allow companies to correct their IAS financial statements in SEC filings. (Cairns now heads his own consulting firm, London-based International Financial Reporting, and is the author of the book *Applying International Accounting Standards*.)
- Training in IAS isn't up to snuff—and it isn't clear who's going to be providing it in the future.
- The decision-making process of the IASB's IFRIC takes a long time—much longer than the approximate two months for the FASB's Emerging Issues Task Force (EITF), according to one Washington, D.C.-based accounting executive.
- The move—once again—toward more principles-based accounting may lead to more disagreements about accounting treatments under IAS and to more decisions to be made by national accounting authorities, IFRIC, and global auditors. That could slow IFRIC down, leading to more divergence.

The bottom line: Investors can't trust reports that say they're based on international standards. And—even if they could—it appears that even the biggest institutional investors in the U.S. and elsewhere need help in how to better analyze reports that say they're using IAS in part or whole.

MONEY AND CROOKS

Beyond IFRIC and IOSCO, there's the sore point of who's going to pay for enforcement. It's well known that the FASB and IASB have had trouble raising nonpartisan, nonconflict-of-interest funding, and there's no discussion at all about how to find similar funding for enforcement in the world at large.

"The biggest single issue is getting the resources in place to provide a proactive regulatory framework that has proper enforcement," Wilson says. "I think that's going to be a huge resource issue to move from a reactive to a proactive basis. In the U.K., for instance, we've been on a reactive basis."

Finally, is any regulator willing to throw the real crooks in jail? No one's talking about that yet, but the U.S.'s lack of success in doing just that post-Enron doesn't appear to bode well for a more global effort to do the same. But that issue—how various national police and justice authorities will interact with the process—isn't deterring those who want to move forward.

"At the moment, [the CESR effort is] working," Wilson notes. "The big unknown is that another 10 countries are joining in the next two to three years. It's going to be a learning curve as far as they're concerned."

That may be Europe's big unknown. For the world, however, the great unknown will come down to how the SEC weighs in. And there, mum's still the word. ■

Lawrence Richter Quinn is a Washington, D.C.-based freelance writer specializing in IAS, governance, auditing, corporate finance, and enterprise risk management. You can reach Larry at larry_quinn1@hotmail.com.