ACCOUNTANCY IN A GLOBAL VILLAGE

THE QUEST FOR INTERNATIONAL STANDARDS

by DONALD J. MOULIN

The absence of international standards for financial statements and prospectuses is a barrier to a true global marketplace. Dramatic and widespread changes are on the horizon.

The goal of common international accounting and auditing standards for use in audited financial statements of issuers of multinational prospectuses has been much discussed for well over a decade. Throughout the discussion, different accounting and auditing standards have been recognised as a major barrier to the development of a multinational prospectus that is comprehensive, yet meets the cost/benefit criteria. With more and more closely linked capital markets, the spread of electronic communications and a need for more information, some solution to the problem appears to be increasingly urgent.

The goal has always been considered long-term because differences in accounting and auditing principles reflect national laws, customs and cultures. The practical question is what steps can be taken now to make progress in this difficult task. IOSCO recognised this at its 1987 annual conference by adopting a recommendation to "examine practical means of promoting the use of common standards in accounting and auditing practices."

This paper describes the internationalisation of the securities markets, the need for common accounting and auditing standards, and the work being done by the International Accounting Standards Committee (IASC) and the International Federation of Accountants (IFAC). It also identifies essential prerequisites to an acceptable set of common accounting standards for use in a multinational prospectus and presents our recommendations.

Internationalisation

At one time, capital markets were mostly national. For example, UK companies raised capital in the UK market, and UK investors evaluated one UK company against another to determine their best investment choice. Today, the capital markets have become much more complex and less tied to geographic boundaries. Companies can decide whether to raise capital onshore, offshore, or both, while investors search the world for their best risk-adjusted rate of return. An Australian investor may consider purchasing securities in Japanese, French or other non-Australian companies.

Varying exchange rates, less expensive resources (both materials and labour), additional markets and a host of other reasons lead many companies to expand or establish their businesses offshore. To finance these operations, capital is either borrowed or raised through equity issues. More than 500 companies have equity securities actively traded in more than one country. About 84 American, 73 Japanese, 49 Australian, 48 British and 40 Canadian companies are actively traded on foreign exchanges.[1]

Raising capital through debt markets

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is also expanding greatly. For example, the dollar value of the bonds issued on the London-based Euromarket increased from $38 billion in total financings for 1980 to $195 billion in 1987.

It became apparent during the stock market crash and the days surrounding October 19, 1987, that trading in the world's capital markets has become integrally linked. The exchanges in Tokyo, Sydney, Toronto, New York, London, Frankfurt, Zurich and Singapore behaved with a degree of sympathy that demonstrated their economic linkage. Moreover, some people believe that when clearing and settlement practices allow efficient trading among markets, the volume of international equity trading will increase significantly.[2]

The surge in international securities trading has undoubtedly increased the population of investors who use financial reports prepared by transborder issuers. It has also made the decisions of these investors more important to the world economy. Nevertheless, accounting and auditing requirements for financial statements are still determined on a country-by-country basis. Because national accounting standards differ, the financial statements prepared in different countries are much less comparable than they might be. The usefulness of a company's financial statements increases significantly when comparisons can be made with similiar information about other companies and with similiar information about the same company at other points in time. The significance of information, especially quantitative data, depends primarily on the ability of the user of financial information to relate it to some benchmark.[3] Limits on the availability of comparable information, therefore, can diminish the effectiveness of investing and lending decisions that involve evaluating alternative opportunities.

Consider, for example, the different national practices in accounting for "goodwill" in business combinations. Purchased goodwill is the excess of the fair value of the consideration paid over the fair value of the acquired company's identified net assets. In Canada, the United States and Japan, goodwill costs are capitalised as an asset and amortised against future income. In Canada and the United States, the maximum amortisation period in accounting literature is 40 years, whereas Japan specifies only five years. West Germany and the United Kingdom permit firms to choose between capitalising and amortising goodwill or writing it off against shareholders' equity. International Accounting Standards permit either capitalising and amortising goodwill (no maximum or minimum period is specified) or writing the goodwill off against shareholders' equity.[4] Thus identical transactions are reflected very differently in the financial statements of various countries.

Users of financial statements are also affected by differences among national auditing standards. Auditing standards guide independent auditors in gathering evidence to support opinions on whether the financial statements are presented fairly (or "give a true and fair view") in accordance with the basis of accounting indicated in the auditor's report. The auditor's opinion helps add credibility to the financial statements. Because auditing standards govern the amount of evidence required to support an opinion, sharp differences among auditing standards may cause a financial statement user to place more reliance on a given set of financial statements than is warranted. International auditing standards are, therefore, like international accounting standards, very important to the comparability of financial statements.

Because of the national differences in accounting standards and the alternatives available in current IASC standards (discussed later in this paper), some countries have already unilaterally adopted requirements for foreign issuers. Unfortunately, however, as each country develops its own approach, incentives to develop common approaches may diminish.

In the US, the Securities and Exchange Commission requires foreign issuers to file special forms to register securities and to satisfy periodic reporting requirements. Because of the differences between US requirements and those of many foreign countries, the SEC made modifications to permit some foreign issuers to file financial statements conforming to generally accepted principles in the country in which the issuer is domiciled, provided the issuer reconciles net income and stockbrokers' equity to amounts conforming with US generally accepted accounting principles.

In Japan, the Tokyo Stock Exchange and the Ministry of Finance have simplified the documents and amended regulations to ease the financial reporting requirements for foreign companies. For example, certain deadlines have been extended for foreign companies, and financial statements audited by an independent accountant in the country of origin do not have to be examined by a Japanese accountant, thereby eliminating the "dual audit principle".[5]

In addition to such actions by individual countries, some have considered multilateral approaches to facilitate the registration process for foreign issuers. In the US the SEC has taken initial steps by exploring two concepts. Under the first concept, the United States, Canada and the United Kingdom would establish an agreement that a prospectus accepted in the issuer's home country, that meets certain standards, would be reciprocally accepted for offerings in each of the three countries. The second concept was the development of a common prospectus acceptable for filing in any or all of the participating countries.[6]

The choice between the reciprocal and common prospectus approaches is a fundamental issue and was addressed at one of the 1987 IOSCO conference workshops.[7] Although a common multinational prospectus is desirable – because it would ensure that all countries have the same level of disclosure – many people believe that worldwide agreement

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on what information it should include is not readily achievable and advocate the reciprocal approach. Whether common or reciprocal prospectuses are to be pursued, the need for common accounting and auditing standards remains.

In 1980, the European Economic Community took a regional approach to facilitating access to capital markets. The European Council adopted Directive 80/390 regarding the requirements of preparation, review and distribution of a prospectus published for the admission of securities to official stock exchange listings. In June 1987 the council amended the directive, requiring member States, under specified circumstances, to mutually recognise prospectuses and limiting the supplemental information to be disclosed by the issuer when applying for admission on stock exchanges in two or more member States.

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The European Commission is collaborating with the Federation of European Accounting Experts (FEE) in developing a separate directive to harmonise definitions of the independence of auditors. The 8th Company Law Directive contains a description of minimum training and qualification requirements for statutory auditors, but provides no detailed measures on independence.[8]

The International Accounting Standards Committee has been working for common accounting standards for 15 years. It has approved 26 International Accounting Standards (IASs) and issued a further five exposure drafts. The most recent of these, *Framework for the Preparation and Presentation of Financial Statements*, proposes basic concepts – the objectives and qualitative characteristics of financial reports and the definition, recognition, and measurement of the elements of financial statements.[9]

The International Auditing Practice Committee (IAPC) established by the International Federation of Accountants (IFAC) has been dedicated to developing and issuing guidelines on generally accepted auditing practices and on the form and content of the auditor's report for 11 years. The IAPC has approved 26 International Auditing Guidelines (IAGs) and has another exposure draft outstanding.

Neither the IASC nor IAPC has the ability to mandate the adoption of its standards and override local regulations in each country. Therefore, both organisations must depend on the efforts of their members – private sector, professional accounting bodies – to promote acceptance of the accounting and auditing standards they issue.

Auditing

An IFAC survey in February 1987 showed that the existing international auditing guidelines (IAGs) are generally followed by most IFAC members. Sixty-four of the 100 member bodies (representing 833,000 of an estimated 1,000,000 membership) responded.[10] When asked to describe the steps taken towards implementing IFAC guidelines, 41 respondents representing 783,000 members indicated that:

- IAGs have been adopted in substance:
- national standards/local requirements conform in substance to the IAGs; or
- IAGs are used as a primarily reference or form a basis for national standards.[11]

It is possible that this high rate of compliance is a result of the general tone of the IAGs – suggestive in nature, rather than requiring specific auditing procedures. The questionnaire revealed, however, less acceptance and compliance with ethics guidelines, which deal with such matters as independence and competence, than with procedural guidelines.

The international accounting firms are another source of uniformity in auditing. Such firms and their affiliates, which perform the majority of audits of international issuers, are believed to have a high level of compliance with IFAC guidelines and to have developed detailed auditing procedures using these guidelines.

Although the exisiting IAGs are generally followed by most IFAC members, there is a question whether the IAGs are sufficiently detailed to use as the standards for auditing financial statements included in multinational prospectuses. The IAPC and IOSCO recently formed a working party to explore the the modification and expansion of the guidelines. Although this group's work is just beginning, it is a positive step towards a set of suitable common auditing standards.

Accounting

In its first 14 years of developing accounting standards, the IASC often permitted alternative accounting treatments to achieve consensus among its members. This is illustrated by the previous example of accounting for purchased goodwill. In March 1987, the IASC decided to shift its emphasis from developing additional accounting standards to reducing the number of options in its existing standards. One goal is for the IASC standards to form a benchmark for use in multinational securities offerings. The IASC recognised that to achieve this goal, it must work closely with regulatory authorities, national standards-setting bodies, multinational companies and accounting firms to achieve the greater degree of harmonisation that financial statement users and preparers wish.[12]

IOSCO has indicated to the IASC that its accounting standards might eventually be accepted for use in prospectuses of multinational offerings, provided fewer alternatives exist for accounting treatments.[13]

Much of the work to eliminate options in IASC standards is being done by a five-member steering committee which is preparing an exposure draft on the *Comparability of Financial Statements*. The aim of the project is to produce proposals for the removal of free choices of accounting treatment now permitted in IASs and to eliminate all but one accounting treatment when the different treatments represent a free choice for like transactions and events.[14] However, in situations where alternatives are to be retained to obtain acceptance and to avoid local prohibitions of practices, additional disclosure (such as reconciliation to a preferred treatment) will be prescribed. The steering committee considered whether the elimination of accounting alternatives should apply only to multinational prospectuses, or whether the alternatives should be eliminated for all users of the international accounting standards. The exposure draft amends the individual IASs, thus eliminating alternatives for all preparers applying the IASs.

In the most recent version of the draft, the committee identifies the following criteria in deciding which alternatives should be required or preferred:

- current worldwide practices and trends in national accounting standards, laws and generally accepted accounting principles;
- conformity with the proposed IASC *Framework for the Preparation and Presentation of Financial Statements;*
- the views of regulators and their representative organisations, such as IOSCO and similiar agencies;
- consistency within an International Accounting Standard and with other International Accounting Standards.[15]

The IASC's comparability project holds out the promise of providing a set of standards that can be used for reconciliations in multinational prospectuses or that can be used to prepare financial statements for multinational prospectuses. But that promise is no cause for euphoria. There is still much to be done. There are prerequisites to an acceptable set of standards for these purposes that will be difficult to achieve, and still other issues that should be considered for IASC to fully satisfy those who support their use for multinational prospectuses. The prerequisities are:

- *The standards must be sufficiently detailed.* The more general a statement of requirements, the more it opens the way to alternative treatments when it is applied in similiar circumstances. Unless the standards provide sufficient detailed guidance, they will not generate comparable financial statements, but could lull users and other interested parties into believing that the presentations are comparable when, in reality, they are not.

If the standards are too general, preparers will interpret them in accordance with their customary practices (articulated and unarticulated), which may differ from country to country. For instance, the concept of "liability" differs; provisions are made for all "liabilities" or losses in some countries, but not in others. Severance pay obligations to workers, pension agreements and estimated losses on purchase commitments or other forward contracts are not recognised in the financial statements of some European and South American countries; other countries do recognise them. Some countries allow the creation of so-called "secret reserves" by the liberal estimation of liabilities and the financial effects of uncertain future events. Again, specificity is needed for financial statements to be comparable. This does not, of course, mean that judgement can be eliminated or that specificity should be doctrinaire and stifling, but it does mean greater detail is needed in existing guidance.

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- *The standards must be sufficiently complete.* IASC standards to date have concentrated on essentials.[16] The committee relied on individual countries to provide guidance on additional topics not covered by IASC standards, such as earnings-per-share, discontinued operations, and accounting for specialised industries (for example, insurance companies). If multinational companies are forced to rely heavily on individual country guidance for subjects not covered by IASC standards, financial statement comparability will not be achieved.

The IASC should establish an agenda of subjects treated in the authoritative accounting literature of different countries and/or incorporated into law and begin to act on that agenda. The task calls for great prudence and restraint in order to assure that the agenda is practical and will not result in excessively detailed standards, but the project still should be undertaken.

- *The accounting standards must contain sufficient disclosure requirements.* IASC standards focus on accounting measurements. They contain relatively little on the nature and extent of needed disclosures. Disclosures, usually in the form of notes, help the reader of the financial statements by providing information on material matters that may affect the use, understanding and interpretation of the financial statements. Accordingly, the IASC should re-examine the extent of accounting disclosures within its standards.
- *The standards must be perceived as developed with sufficient mindfulness of the needs of users of financial statements.* The number of interested parties in the effort to achieve a multinational prospectus is considerable, particularly because the issues affect national economies, but in the end, the best support improved standards could have is a valid claim that they serve the interests and needs of users. All elements of the standards-setting effort should, therefore, demonstrate concern for thoses needs. Although the users' needs are mentioned in the proposed IASC *Framework for the Preparation and Presentation of Financial Statements,* the IASC's comparability project does not discuss how the interests and needs of users are being considered. The IASC should ensure that the improved standards are developed with sufficient mindfulness of the needs of users and convey this fact in the documents that result from the comparability project.

The prerequisites cited above would have to be reasonably satisfied if multinational prospectuses using IASC standards are to have a chance of success, but a number of other issues will influence the likelihood of acceptance of the scheme and the consequences of adopting IASC and IAPC standards:

- *Securities regulators may be reluctant to endorse the use of IASC accounting standards for multinational prospectuses because of the effect on domestic issuers.* If a foreign company prepares its financial statements in accordance with requirements of the country in which it is domiciled and then reconciles in some manner to the IASC standards, domestic issuers' financial statements will not be comparable to those of multinational issuers. This difference may be seen as giving foreign companies preferential treatment. Some securities regulators have considered the possibility that domestic issuers might reconcile their financial statements to IASC standards, but are concerned about the additional record-keeping burden on issuers whose securities are traded only domestically. Conversly, when foreign companies are required to reconcile to requirements of the country in which the securities are to be offered, domestic and foreign issuers are on a "level playing field." This issue exemplifies the balance needed between facilitating the flow of the international capital markets on the one hand, and maintaining consistency within the domestic markets on the other.

If the improved standards are considered to be less stringent than a given country's domestic standards, that country's securities regulators may be reluctant to adopt the improved IASC standards for multinational prospectuses on the grounds that it would be unfair to domestic investors. Securities regulators have a responsibility for domestic investor protection. Ideally, IASC standards that are different from domestic standards would not be perceived as less stringent than those standards. Multinational prospectuses including financial statements using IASC accounting standards that are sufficiently detailed and complete, and that are accompanied by adequate disclosure, would enable all users to make informed decisions about those issuers. The reconciliation concept is a practical approach to satisfying both the needs of local country requirements and allowing multinational issuers access to the global markets.

International auditing guidelines do not contain sufficiently detailed guidance on the independence of auditors, and IAGs may need to be modified or expanded in other areas that affect audited financial statements. IFACs ethics guideline says: "When in public practice, an accountant should both be and appear to be free of any interest which might be regarded, whatever its actual effect, as being incompatible with integrity and objectivity."[17] This guidance is broad conceptually, and requires each country to form its own detailed requirements. Unlike accounting standards, auditing standards of one country cannot be "reconciled" to the auditing standards of another country. The IAPC should consider adding independence to its agenda of topics needing further clarification for multinational issuers. In addition, the IAPC should use the work of the joint IOSCO and IPAC working party to determine whether the IAGs are sufficiently detailed to use as standards for audited financial statements included in a multinational prospectus.

The opinions in auditor's reports vary from country to country. The auditor's reports of the United States, United Kingdom and the Netherlands serve as an example. Unqualified auditor's reports issued in the US state that the financial statements are "presented fairly in conformity with generally accepted accounting principles;" an unqualified auditor's report issued by UK standards states that the financial statements "present a true and fair view and comply with the law"; and a Dutch auditor's report states that the financial statements "comply with the law and company statutes". Despite the differences, all three reports are in substantial compliance with international auditing guidelines. Recognising that the task is not easy, the IAPC should eliminate the existing alternatives permitted by the IAGs and develop a common set of requirements for audit opinions to be used in audits of multinational issuers. The standard would address reporting issues such as references to comparability and consistency of financial statements between reporting periods.

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Improved IASC standards endorsed by IOSCO and accepted by a given country may appear to undermine the efforts of that country's accounting standards-setting body. Undermining domestic standards-setting bodies in this way would not serve the goal of quality in financial accounting and reporting. International standards-setters should seek to cooperate with the various national standards-setters. It is important that the IASC continue its efforts to have the various national standards-setting bodies find the new international accounting standards acceptable. Some helpful actions have been taken – for example, inviting representatives from the US Financial Accounting Standards Board and the European Economic Community to join the IASC Consultative Group – but more could be done. Existing national standards-setting bodies have valuable resources (such as personnel and established research capabilities) that could be used in the IASC's work. Further, because IASC accounting standards will be used worldwide, the needs of varying economic and social environments must be considered. Working more closely with national standards-setters would enhance the acceptability of IASC standards. On the other hand, national standards-setting bodies should contribute to the IACS's effort by establishing liaison groups and regularly submitting information on standards-setting activities and plans.

If IASC standards are to serve as the basis for a comparable multinational prospectus, financial-statement presentation issues other than those covered by accounting standards would have to be commonly treated. For example, multinational issuers should provide financial statements covering the same dates and periods in their prospectuses. Issues such as how recent the date of the financial statements should be at the time of registration, the possible need for financial statements of acquired businesses, and any special instructions for interim-period financial statements should also be addressed. Recommendations for such requirements should be devised by an international private-sector body such as the IASC. The requirements would form a framework for consistency among multinational prospectuses and would be especially beneficial when prospectuses are filed simultaneously in more than one country.

The legal implications of financial

statements that are reconciled to the IASC standards remain to be fully explored. In many of the major capital markets, financial statements are prepared for statutory reporting purposes with the authoritative literature embedded in the laws of the country in which the company is domiciled. The financial reports are sometimes an integral component of such a country's taxation systems and its profit- sharing and labour agreements. Research is needed to determine whether financial statements reconciled to IASC standards or filed under them would create legal problems in these or other situations.

IOSCO's participation in setting IASC's international accounting standards (through the working group of advisors to the steering committee) may be perceived as standards-setting in the public sector. IOSCO has not set out to establish accounting or auditing standards, and that position is appropriate and should be continued. Moreover, by participating in the IASC's development of accounting standards, IOSCO would be acknowledging that the IASC is the proper forum for international accounting standards-setting. Nevertheless, if the respective roles of the IASC and IOSCO are not clearly distinguished, IASC's accounting standards-setting stature could be diminished.

The list above illustrates that the international standards-setting bodies face a challenging set of tasks. Given the importance of the work, it is therefore fair to ask whether sufficient resources are available to get the job done with reasonable dispatch. Is the standards-setting operation adequately staffed and funded? How can the national standards-setting bodies help to achieve these goals? Does the IASC have the necessary research capability? Is the structure designed for efficient communication with the widely dispersed and numerous interested parties?

It is fair to ask as well whether professional accounting organisations and accounting firms are providing enough support to the IASC work. Collectively, professional accounting bodies have a claim to representing the global population of users. Moreover, international accounting firms, because of their network of practising firms and correspondents, should not be biased by national obligations and requirements. They have extensive experience of clients' difficulties in filing prospectuses in different countries. It is not unreasonable to hold that additional support from the accounting profession would be constructive.

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Recommendations

The twin themes of this paper have been the need for common accounting and auditing standards for use in multinational prospectuses, and the tasks that remain to be done to realise that goal. The need for the standards is apparent from the internationalisation of the securities markets and the impediments to international liquidity posed by the absence of a multinational prospectus. It is ironic that the impressive degree of liquidity so clearly demonstrated in today's marketplace also shows us how much wider we need to open the door through a multinational prospectus, but it is not really surprising. The current level of activity is a response to the global market's demand for transnational capital. It makes no sense, given the lessons of the past, to inhibit international economic activity, and the absence of a multinational prospectus has that effect.

So the need for common accounting standards is clear. The primary question has been how to achieve it. The IASC's project to eliminate the accounting options in AISC standards is one of the keys, partly because it recognises the widespread support for a multinational prospectus that serves users' needs for comparable financial information. And for the same reason, there are related tasks that the IASC should undertake. Comparability will not be achieved without providing in the standards a sufficient level of detail, coverage of a breadth of accounting topics sufficient to achieve the necessary completeness, and more guidance on the extent of appropriate accounting disclosures. IOSCO's constructive relationship with the IASC has been essential to progress and will continue to be so.

This paper has identified other issues that could affect the success of a multinational prospectus using IASC and IAPC standards. For example, more should be known about the legal implications of financial statements that would be reconciled to IASC standards and how to arrive at appropriate requirements for financial-statement presentation matters other than those prescribed by accounting standards. In addition, the IAPC needs to develop a common set of requirements for audit opinions and more guidance on the independence of auditors. Such issues, together with the essentials cited above, suggest that additional resources may be needed to achieve a multinational prospectus expeditously. At the least, the adequacy of the resources now devoted to the effort should be evaluated.

NOTES

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17. Ibid, p12.