

TRANSCRIPT

FEE Seminar

IFRS Convergence and Consistency

ING Belgium Auditorium, Brussels
1 December 2005

Roadmap to elimination of the SEC's reconciliation statement requirement

Ethiopia Tafara, US SEC, Director Office of International Affairs

Thank you, David. It is a pleasure to be in Brussels again, and I am very happy that the Federation of European Accountants decided to devote this conference to such an important topic as accounting convergence and consistency.

I've been asked to speak about the "Roadmap" articulated by SEC staff that sets forth the milestones toward eliminating the US GAAP reconciliation requirement for foreign issuers selling shares in the US capital market, but preparing their home financial statements using International Financial Reporting Standards.

Unfortunately, I have to admit that I am standing in for a much more interesting and engaging speaker, SEC Chairman Christopher Cox, whose schedule, regrettably, did not permit him to be here today. Compounding your pain, if not mine, David has asked me to follow Commissioner McCreevy's keynote address. To paraphrase the great American comedian W.C. Fields, you never want to share the podium with an Irishman. In terms of rhetorical skills, it's just not a level playing field.

On the plus side, I am standing in for Chairman Cox today and discussing a topic to which our Commission and its staff have given considerable thought. While this is not quite the equivalent to speaking *ex cathedra*, and I cannot dispense with the traditional SEC disclaimer noting that these remarks represent my views only, I can add that these are more than just my own musings. Chairman Cox has asked me to share with you some of our thinking about the future of the reconciliation requirement and what we hope will be accomplished in the very short term.

Let me begin by noting that the SEC fully recognizes the enormous possibilities that a truly global set of high quality accounting standards offer capital markets around the world — including those in the United States. Indeed, the SEC was one of the earliest backers of the development of International Accounting Standards. A single set of global accounting standards would improve investor confidence in the market, so long as they are high-quality, sufficiently comprehensive and rigorously applied. They would serve to increase market efficiency by allowing investors to draw better comparisons among investment options. They would also lower costs for issuers. Issuers would not have to incur the cost of preparing financial statements using different sets of accounting standards.

But before addressing the "Roadmap," please indulge me if I start with a bit of history as some background may be useful in terms of framing the issues.

A History of US GAAP

US GAAP has been used extensively in the United States since the 1930s. As most of you know, the SEC was formed out of the crucible of the 1929 Stock Market Crash and the Great Depression. One thing that may be less well-known outside the US is the degree to which the United States had become an “equity culture” by that time. Of course, it was nothing like today. Today, more than half of all US households are invested in our stock markets. In 1929, this figure was much lower. But, even in the early 1900s, businesses relied heavily on the markets for capital. And by the Roaring Twenties everyone seemed interested in the stock market. In August 1929, just two months before Black Tuesday, John Jakob Raskob, the builder of the Empire State Building, published an article in the *Ladies Home Journal* that would hardly seem out of place in the 1990s. The title of this article was “Everybody Ought to be Rich,” and Raskob described how:

If a man saves \$15 a week, and invests in good common stocks, and allows the dividends and rights to accumulate, at the end of twenty years he will have at least \$80,000 and an income from investments of around \$400 a month. He will be rich.

And this exuberance wasn't limited to readers of the *Ladies Home Journal*. A telling statistic of the extent of the enthusiasm, perhaps, is the fact that purchases of stock on margin increased 900% between 1921 and 1929.¹ Joseph Kennedy, the SEC's first chairman and father of President John F. Kennedy, reputedly told colleagues that he sold most of his stock prior to the 1929 Crash after his shoe-shine boy started giving him stock tips. He reasoned that if his shoe-shine boy knew something he didn't, something had gone seriously awry with the markets.

The boldness of the financial improprieties that came to light following the 1929 Crash make some of our more recent scandals look like mere schoolyard misbehaviour. It has been suggested that at a time when the New York Stock Exchange traded the shares of approximately 800 companies, the prices of more than 100 of these were openly manipulated by syndicated stock pools. Disclosure of financial information throughout this period was voluntary. Even for those companies that did provide investors with audited financial statements, the balance sheet and dividends were paramount. Investors seemed to trust dividend payments rather than income statements as an indicator of a company's financial condition.

When the SEC was created in 1934, its enacting legislation authorized the Commission to not only establish disclosure standards for issuers, but also set the accounting standards to be used in preparing these disclosures. Given the complexity of this task, in 1938 the SEC began to look to the private sector for assistance in setting these accounting standards.

The reason for this short history discussion is that any conversation about where we are going would be incomplete without an understanding of where we have been. Accounting standards in the United States have a long and unique history. Of course, the roots of accounting are far older, with origins in Europe and elsewhere. Double-entry bookkeeping was invented in Italy during the Renaissance, and flourished in England in the 1700s, to give an enterprise's owners as fair and complete an idea as possible of their company's performance. US GAAP exists for the same reason. I believe the strength of US GAAP, however, derives at least partially from the fact that it has been stress-tested, developed and leavened for many decades in an economic environment in which retail investors — and not just banks or entrepreneurial families — have played, and continue to play, a substantial role.

The SEC's enacting legislation charges it with setting the accounting standards used by issuers accessing the US capital market. While the SEC today looks to the FASB to set US accounting standards, it retains ultimate responsibility for them. With active oversight of the standard setting process by the SEC through the decades, this model has served accounting well in terms of developing a robust, well-articulated set of standards that well serves and protects the users of financial statements.

¹ Malkiel, Burton G. *A Random Walk Down Wall Street* (1990) at 44.

Current Situation

With this historical perspective, I will turn to the present. Today, when measured by market capitalization, US GAAP is used by more than half of the world's companies. It is far from perfect. But because it has been around for nearly 70 years, both its strengths and weaknesses are well-known — by issuers as well as investors. Seventy years of interpretation and application by tens of thousands of issuers and other companies has meant that US GAAP's applicability to a wide range of industries and markets has been tested and refined.

In short, despite whatever shortcomings it may have, US GAAP today is widely-used, comprehensive, well-understood, and well-regarded both at home and internationally.

IFRS is also a set of comprehensive, high-quality accounting standards. IFRS is now also relatively widely-used, given the adoption by the European Union and others. To this extent, IFRS is similarly situated to US GAAP.

This is a new development. Very new, particularly when you think that IFRS have only existed in this form — as a truly comprehensive set of accounting standards — for just a few years. However, IFRS differs from US GAAP in that it has little to no history of application and interpretation. Indeed, regulators, investors and issuers alike are still inquiring as to whether IFRS will be interpreted and implemented consistently in all of the jurisdictions that have decided to use them.

In short, IFRS is now a widely used set of comprehensive, high-quality accounting standards, with limited history of interpretation and application. As you will note in the "Roadmap", the SEC staff is asking for some time to assess the consistency and faithfulness of IFRS interpretation and application.

The time we are seeking for this is not long, though some seem to think otherwise. I was at a conference recently where a very senior European executive referred to the "Roadmap" and stated "2009 is not soon enough. We must have mutual recognition now, or never." The sense of indignity was quite palpable.

The irony, for me, at least, is that, as Americans, we are used to being considered impatient. Yet, at this conference, the European business leaders seemed nearly American in their desire to change the world by the afternoon.

But this reversal of stereotypes is understandable in light of developments in the EU. The European Union's capital markets are in the midst of some of the most significant changes in decades. The EU is now attempting to forge a single capital market across 25 different countries with widely varying financial cultures, legal traditions, and disclosure standards. Accounting standards are just one part — albeit a quite significant part — of a larger project. The EU has reached a tipping point where companies demand and expect change.

By contrast, for the past seventy years the United States has had a single, large, deep and unified capital market. The situation of the US capital market over the past 70 years is one characterized by overall steadiness of regulation. And this steadiness has played a large part in the market's success. But this is not to say that the SEC is averse to change. Far from it. When an opportunity to improve investor protection and capital market efficiency presents itself, the SEC can move with relative speed.

IFRS represent an outstanding opportunity. The standards start with the benefit of the lessons garnered over the past century from numerous national accounting standards. They also benefit by having brought to bear some of the accounting industry's brightest and most experienced minds. But they have almost no track record in terms of implementation and interpretation. This next step of faithfully implementing and consistently interpreting and applying IFRS is no longer primarily in the hands of the IASB, but rests heavily with the different jurisdictions that are requiring IFRS, with the issuers using IFRS ... and with you — the accounting profession.

Accounting Convergence

So you have heard me state the paramount importance of faithfulness and consistency in interpretation and application of IFRS as prerequisite to eliminating the reconciliation requirement. By now you are asking yourself about the role of convergence in eliminating the reconciliation requirement. I know I certainly would not be able to leave this building without addressing this issue. Let me start off by noting that the convergence project between the International Accounting Standards Board and the US Financial Accounting Standards Board is recognized in the US and the EU as seeking the best of both worlds — convergence of IFRS and US GAAP provisions around a single best approach to each issue. Over the past three years, this effort has reduced the differences between the two sets of standards and, importantly, improved both in the process.

Of course, accounting standards are both numerous and complicated, and, as we have seen over the course of the past couple of years, discussions over changes to them can prove difficult. It is no small wonder that, consequently, some have come to view the IFRS-US GAAP convergence project as a never-ending story and thus the elimination of the SEC reconciliation requirement as effectively an unreachable goal.

But I am here today to make clear that we do not expect full or even a finite degree of convergence before we are willing to eliminate the reconciliation requirement. What is important is that investors in the United States be able to understand financial statements prepared under IFRS. While convergence between IFRS and US GAAP will certainly help us all in reaching that goal, it is clearly possible for US investors to understand financial statements prepared using a rigorously applied system of IFRS, even if there remain differences between IFRS and US GAAP.

Accordingly, we do not expect an artificially paced standard-setting work targeted at a specific level of convergence before eliminating the reconciliation requirement. That said, before eliminating the requirement, the Commission likely will be keen to see that a robust process for converging IFRS and US GAAP is in place and active. This will help make sure that, going forward, both sets of accounting standards will converge rather than diverge. Of course, the only way to judge the effectiveness of a process is through the results it generates. This means that, before the reconciliation requirement can be eliminated, the Commission will need to review the progress of the IASB/FASB convergence project and will look for convergence of standards that reflect a sense of priority and a measure of efficiency.

The Roadmap

So what is SEC staff doing?

As a next step, the staff will identify changes to SEC rules that will be necessary for the SEC to eliminate the reconciliation requirement.

Critically, this next year, because of the new EU requirement, the SEC expects approximately 300 of its foreign private issuers to file their 2005 home country financial statements using IFRS. At the same time, European regulators will review the first major set of IFRS filings of EU issuers. SEC staff plans to review the US GAAP reconciled financial statements of some of these same companies that also list shares in the US. For both of us, this will be the first time that there will be a substantial number of such statements. And these statements will prove vital to evaluating the faithfulness, consistency and resulting transparency of IFRS.

After our review, the SEC staff hopes to be able to share the results of its analysis, and assess what implications they may have for the SEC's elimination of the reconciliation requirement. If and where the SEC staff identifies areas in which there is inconsistent application and interpretation of IFRS, it will communicate these concerns to relevant counterparts abroad.

If all goes well — if IFRS are applied and interpreted faithfully, consistently and thoroughly across different jurisdictions and across different industrial sectors, if major remaining differences are either converged or clear, and if further convergence remains an active priority for the IASB and FASB — then this will help place the SEC staff in a position to recommend to the Commission that the US GAAP reconciliation requirement be eliminated for issuers using IFRS.

This is an ambitious goal. To be clear, we fully realize that, in the short-term, IFRS and US GAAP will not be the same. Indeed, financial statements prepared using IFRS likely will be significantly different from those prepared according to US GAAP. Allowing the use of two different sets of accounting standards would be a significant change for the SEC. This necessarily would entail the SEC explaining to the investing public and other interested parties why the co-existence of financial statements prepared under two different sets of accounting standards, which are not entirely comparable, makes sense.

This, in turn, will only be possible if IFRS is more of a known quantity than it is today. Indeed, how IFRS works in practice is something we all need to know.

We all need to recognize what we are considering is of vital importance and much is at stake. It is important to investors that we get it right, and the speed of change should be a secondary consideration where market reputation is concerned. In New York, in London, in Frankfurt, fortunes are so frequently made in seconds that even recent events seem distant. But the pain of Enron and Parmalat is still being felt by us all. Our margin for error is small.

Nonetheless, provided IFRS are used and interpreted faithfully and consistently from jurisdiction to jurisdiction — in other words, we can demonstrate that IFRS are indeed a single set of international accounting standards and not a multiplicity of standards going by the same name — then the potential benefits to investors of allowing the use of IFRS in the financial statements of foreign issuers may justify the risks posed by the use of two separate accounting standards in the United States. These benefits include increased investor access to foreign issuer investment opportunities in the US capital markets — issuers that might otherwise be deterred from listing shares in the US market by the high costs associated with reconciling their financial statements to US GAAP. The risks, by contrast, are not that IFRS are of insufficient quality to provide US investors with adequate information about an issuer. Rather, it is that financial statements prepared using IFRS cannot be compared to one another.

Underlying Assumptions

This “Roadmap,” of course, is predicated on a handful of expectations. These expectations are not numerous, but they are critical to any SEC decision to end the US GAAP reconciliation requirement regarding issuers using IFRS.

First, it is important that the overarching philosophy behind the development of IFRS remain the best interests of current and potential investors. Accounting standards should exist for the benefit of investors, not issuers or other stakeholders. The primary concern should be whether an existing or proposed standard improves investor understanding of an issuer’s performance and financial condition — not whether the standards advance some other stakeholder goal.

Second, it is also important that the standards-setting processes of the IASB be fully transparent, as outlined in the International Accounting Standards Committee Foundation constitutional reforms agreed upon this past June. This means that the process for developing IFRS needs to allow for input from all affected parties. And, in finalizing its standards, the IASB should make clear what substantive views it has adopted, which it has rejected, and why.

Third, it is important that the IASB be an independent professional accounting standards setter. This means that the IASB should be politically independent, not subject to undue funding pressures, and that the individuals who comprise the IASB should be chosen on the basis of professional competence. IASB members should not be chosen on the basis of their willingness to serve specific national interests. While geographic diversity is necessary to ensure that vital expertise from different regions are reflected in the standards-setting process, political representation will undermine investor confidence in IFRS. This is something that none of us should be willing to tolerate.

Fourth, it is important that IFRS-US GAAP convergence continue apace. Indeed, if the SEC were to eliminate its reconciliation requirement, the continued success of the convergence project becomes all the more vital. We all know that markets are nothing if not changing, and new experiences inevitably lead to new ways of looking at particular standards. If the IFRS-US GAAP convergence project were to falter, or if IFRS

and US GAAP were to begin to diverge, it will make more likely that critics will have ammunition to call for re-imposing a reconciliation requirement.

Fifth, and finally, it is important that the current dialogue among financial regulators over IFRS development continue. The steady progress towards ending the reconciliation requirement has depended to a significant degree on the trust and communication that we have shared with European members and with our counterparts in other regions in the world. This dialogue has not always made the financial pages or even been apparent to the larger financial community, but it has always been vital. Things that would undermine this dialogue, such as a finding by the European Commission that US GAAP and IFRS cannot co-exist in Europe, or the introduction of significant additional disclosure requirements for the use of US GAAP in the EU, could also easily cause the public and others to ask the SEC to re-examine whether it can eliminate its own reconciliation requirement. Our mutual effort should be toward creating the conditions that ease the use of US GAAP and IFRS in our jurisdictions, not making it more costly or difficult than is currently the case.

Important Next Steps

We have set an ambitious schedule, but not an unrealistic one. But to make it happen, this “Roadmap,” demands something from all of us.

For us regulators, achieving this goal will require a new degree of coordination. Fortunately, the Committee of European Securities Regulators has already taken a major step in this direction by establishing a database designed to share CESR member views regarding the application and interpretation of IFRS in the European Union. IOSCO, the International Organization of Securities Commissions has also shown leadership in this regard by announcing the creation of a similar database for its members. Hopefully, the result will be an international compendium of regulatory precedents and decisions that will promote the consistent development of IFRS, with the assistance of the IASB and IFRIC, as a single, consistent standard, worldwide.

Accounting firms and their clients also play an essential role. Actual consistency in application of IFRS, to a great extent, will fall on your shoulders. We must not forget that IFRS are new, and accounting firms will need to ensure that IFRS are applied consistently across their entire clientele, wherever based, and regardless of which office in the firm’s network is in charge of auditing the issuer’s financial statements.

This will not be easy, but issuers must insist on it. We can expect that IFRS will come as a shock to some. For many EU jurisdictions, IFRS are significantly different from the national accounting standards traditionally used by issuers, and there will be resistance to change. But the benefits to consistent use of a single set of global standards are just too great to ignore. It will not just lower long-term capital costs and improve European market integrity, but consistency in application across jurisdictions and industrial sectors will contribute to making it possible for foreign private issuers to raise capital in the United States without reconciling their financial statements to US GAAP.

The role of accounting firms, issuers and regulators in this task should not be underestimated. The challenge of crafting one widely-used, comprehensive, high-quality set of accounting standards lies in all of our hands. Unless IFRS is applied and interpreted consistently across all companies, IFRS will no longer be one set of accounting standards, but many. In the latter case, the arguments in favour of eliminating the reconciliation requirement would collapse.

We all owe it to our investors to make sure this doesn’t happen.

Thank you.

Questions and Answers

David Devlin: That was some tour de force, Ethiopis, as a review of where the United States stands in terms of some of the conditions for making a success of IFRS. Again, we have just two or three minutes to keep to schedule, but it's, again, an opportunity to ask some questions of Mr Tafara to make sure that you have well understood the importance of what he has said and the fact that it does seem to me to amount to some significant, at least, potential good news in terms of progress towards eliminating the US GAAP reconciliation for European issuers, albeit subject to a fair number of conditions but I think it does represent quite a step forward in my understanding at least of SEC policy.

Andrew Watchman, Grant Thornton, UK: Ethiopis, I'd like to pick up on what you said about the role of accounting firms in consistent application. Clearly, the role of the audit firm is to reach an opinion on the financial statements, but the audit firm does not select the accounting policies nor does it have a substantive role in preparing the financial statements, indeed, we're not allowed to do that under independence rules. Now, IFRS is open to legitimate interpretational differences in a number of areas; you only have to read, for example, the publications produced by the interpretations body, IFRIC, in IFRIC Update to see that that is clearly the case. So I don't quite, depending on what you mean by consistent application, I don't quite see how the audit firms can ensure absolute consistency of application across their entire client base.

Ethiopis Tafara: It seems to me, given the fact that you do have a clientele which I imagine will be seeking your advice, you have an interest and they have an interest and you're advising them as to how you're seeking to have a particular standard applied or you're advising your clients to apply particular standards across the entire clientele. It's hard for me to imagine that you would not have a role to play in achieving consistency in terms of application interpretation of the standard given the role you play vis-a-vis clients and all I'm suggesting is that for all your clients you should be pushing in the same direction and not allowing for differences to creep in, which I think ultimately will be a disservice to the larger issuer community because it will make it very difficult for us to eliminate reconciliation requirement in the US.

David Lindsay, Ernst & Young, UK: I appreciate that this session isn't really about convergence rather than consistency. One of the things that I think concerns a lot of us is going back to an earlier element of your remarks about the SEC's review of 20F and so on this year, is particularly because of the growing paranoia in the US with re-statements and so on under US GAAP, there is a concern that applying the same sort of mentality to reviewing IFRS financial statements as you do to US GAAP financial statements, could result in a very legalistic approach to the interpretation by the SEC of IFRS. It's well known that, and as you say, we haven't got that much history of practice yet, but in any event, it's well known that IFRS is a bunch of standards based on various principles, not always coherent, or consistent principles at the moment, but nevertheless are open to judgement and that judgement, there will be judgement, and there will be differences until, over a period of time, they get narrowed down through practice and experience. So my question really is, will the SEC in approaching its 2005 reviews, would it really take on board the cultural differences and so on between US GAAP and IFRS?

Ethiopis Tafara: I suspect to a certain degree we would have to but the other thing that I'll say is that my expectation is that once we have done our review and our study, part of what should transpire is discussion with regulators on the other side of the Atlantic, and I think it's part of that discussion we're likely to identify where our viewpoint may be more driven by the environment in which we have traditionally operated, and, you know, that will come out in the wash, I would expect. We have a particular role to play. We have a commission to advise and the logic of eliminating reconciliation requirements that we talked about, another widely used single set of accounting standards. The only way to determine whether or not that is the case is we have to look at the statements and see whether there are differences across jurisdictions. So we have to undertake the study, of course, and undertaking that study, you know, our background will colour how we look at things. My expectation, though, as we work with our counterparts and we fully intend to work with our counterparts on the other side of the Atlantic, our biases will be pointed out to us and we will have to contend with those in our final assessment of what the study is about.

Nigel Sleight Johnson, ICAEW, UK: As the convergence process is continuing between US and IFS standards, there's a concern, I think, in Europe, that there'll be a need for European auditors and preparers

to make greater reference to the very complex body of US accounting literature that underpins US standards as the identity between IFRS and US standards continues to pay, so this might lead to perhaps a more rules based approach to standards and their interpretation in Europe. One thing we're hoping for is that the US would move a little bit more towards what we understand is a principles based approach to standard setting. Is that a realistic prospect in the near future given especially where the tendency in the US for there to be a considerable amount of pronouncements from the SEC staff and from the FASB on interpreting standards given and giving guidance on implementation and so on?

Ethiopsis Tafara: Sir David Tweedie and Michael Crooch from FASB are better placed to answer that question. Do I think it is a fair prospect? I couldn't say. As you saw from the staff report in 2003, which was mandated under the Sarbanes-Oxley Act, the staff has concluded that US GAAP has seen a departure from the principles that clearly underlie the standards. Part of the effort now is draw those principles back to the fore and to give them the sort of prominence they deserve. But as Sir David Tweedie noted in one of the first meetings I ever had with him, the issue is not whether principles based accounting or rules-based accounting is the better approach. What matters is finding the right balance between principles and rules. You can't have principles with no meat on them and rules without principles are prone to circumvention.

David Devlin: On which note, I think in order to respect our timetable, we should say thank you again to Ethiopsis Tafara for his tremendous contribution and for the trouble he has taken to be here. Thank you very much.