American Accounting Association’s Financial Accounting Standards Committee

James M. Wahlen, Chair; James R. Boatsman; Robert H. Herz; Gregory J. Jonas; Krishna G. Palepu; Stephen G. Ryan; Katherine Schipper; Catherine M. Schrand; Douglas J. Skinner

Response to the SEC Concepts Release on International Accounting Standards

This manuscript responds to the request for comment on the SEC Concepts Release, International Accounting Standards (File No. S7-04-00). The Financial Accounting Standards Committee of the American Accounting Association (hereinafter, the Committee) is charged with responding to requests for comments from standard setters and regulators on financial reporting issues. The opinions in this letter reflect the views of the individuals on the committee and not those of the American Accounting Association.

INTRODUCTION

Our letter contains three primary sections. The first section presents the framework for the Committee’s responses to the questions posed in the Concepts Release. The second section contains several overall recommendations linked to issues in the Concepts Release that the Committee views as fundamental. The third section contains responses to specific questions posed in the Concepts Release. The Committee has not responded to questions that seem aimed at eliciting responses from practicing accountants concerning their experiences with International Accounting Standards (hereinafter IAS). Where possible, the Committee’s responses to specific questions are based on published and unpublished accounting research or on the framework laid out in both this letter and the Committee’s previous response to the IASC’s Discussion Paper, “Shaping IASC for the Future” (AAA FASC 1999).

The principal authors are Katherine Schipper and Gregory J. Jonas.
THE COMMITTEE'S FRAMEWORK FOR RESPONDING TO THE CONCEPTS RELEASE

We infer from the Concepts Release, and from other SEC releases and speeches by Commissioners and staff, that the SEC's current consideration of the IASC's core standards is motivated by a wish to move toward a single set of global financial-reporting standards with comparable implementation worldwide. The Committee agrees with this objective, and believes that stating it explicitly is important because the objective provides a benchmark for assessing whether a given proposed action or outcome represents meaningful progress, and for judging the costs and benefits of interim steps that might be taken to move toward the objective.

The Committee believes that the objective—a single set of global financial-reporting standards with comparable implementation worldwide—has two major elements:

1. A single set of comprehensive, high-quality standards
2. To achieve comparable implementation:
   2a. Acceptable level of preparer readiness to implement the standards, consistent with their intent. Preparer readiness subsumes expertise (the ability to implement), adequate technology for keeping books and records, and preparer intent (the willingness to implement); and applies to management and the board of directors.
   2b. Acceptable level of attestation using global auditing standards, comparably implemented worldwide. In addition to global auditing standards, this element requires both comparable audit processes worldwide and comparable training for auditors worldwide. Of particular concern are auditor expertise (the ability to implement audit processes and auditing standards) and auditor independence.
   2c. Globally harmonized regulation and enforcement. This element implies comparable securities laws and regulations, enforced consistently worldwide.

The Committee recognizes that developing each of these two major elements requires delegating some decision rights to international bodies, and that in some cases actions by legislative bodies will be required. A transition period of movement toward the objective of developing these elements therefore seems inevitable. Regulatory and other arrangements during this transition period should be handled carefully, with appropriate attention to matters of due process. In particular, the Committee believes that ad hoc transition arrangements, arrived at without due process, could in the end impede progress toward the ultimate objective.

The Committee views the three elements of preparer readiness, attestation, and regulation/enforcement as essential financial-reporting infrastructure elements. To some extent, particular strength in one element might, at least temporarily, compensate for weakness in another element. Ultimately, however, all three infrastructure elements must be strong, because weakness in one element places increased pressure and stress on the other elements to achieve comparable implementation. For example, a deficiency in preparer readiness places pressure on the auditor and the regulator to “inspect in” a quality implementation of the existing reporting standards, and this cannot be a long-run solution. In general, the Committee views the discussion of financial-reporting infrastructure in the

1 For additional discussion of the Committee's views about the importance of financial-reporting infrastructure, see the Committee's response to the IASC Discussion Paper, “Shaping IASC for the Future” (AAA FASC 1999).
Concepts Release, taken as a whole, as placing relatively more emphasis on the attestation element and relatively less emphasis on the preparer readiness and regulation/enforcement elements. As we have previously noted, the Committee believes that combining a single set of global financial-reporting standards with a reporting infrastructure in which an essential element is weak or even missing altogether will result in surface or apparent comparability of reporting but not comparability in substance, because implementation of the standards will suffer.

RECOMMENDATIONS OF THE COMMITTEE

The Committee believes that the combination of (1) comprehensive and high-quality IAS and (2) essential elements of the financial-reporting infrastructure are not yet in place. During the transition from current conditions to conditions that support the ultimate objective of comparable implementation of high-quality and comprehensive international reporting standards, the Committee recommends the following:

1. The SEC should approve the processes of the IASC and not its standards, piecemeal. Once the IASC's processes are approved, the IASC can adopt the existing IAS with or without amendment. The Committee believes this step is necessary because the existing IAS were set by a body that does not meet the SEC's independence criterion for standard setters (Section I of the Concepts Release). This recommendation is based on the view that a piecemeal approach is cumbersome and confusing and the SEC's approval of standards, not processes, makes the SEC the de facto international standard setter.

2. The SEC's approval of the IASC's processes should be conditioned on the outcome of the current restructuring of the IASC. Specifically, the elements of a restructured IASC have been laid out on paper, but this plan has not been implemented. While the Committee believes the currently proposed IASC structure and processes meet most of the criteria for a high-quality standard setter, this proposal could be subverted in implementation.

3. The SEC's approval of the IASC's processes should also be conditioned on the existence of a suitable financial-reporting infrastructure, as described earlier in this letter. In particular, we urge the SEC to take an expansive view of investor protection and assume a leadership role in the convergence of securities regulation and enforcement worldwide. The current unfettered access of U.S. investors to capital markets not overseen by the SEC or by a regulatory agency with values, rigor, and command over resources comparable to those of the SEC adds an element of urgency to the matter of investor protection. The Committee hopes the SEC will not retreat into a domestic focus on regulation and enforcement, because the values of the SEC—and the wealth of historical experience with regulating to protect investors—makes the SEC the natural catalyst and natural global leader in the globalization of securities regulation and enforcement. The Committee hopes the SEC will take the lead, perhaps using IOSCO or some similar forum, in convening discussions.

---

2 It is not clear how the SEC's relation to the IASC will differ from the SEC's relation to the FASB. Differences in this relation may imply a higher standard of robustness for the IASC's processes, and this (potentially) higher standard in turn may imply a period (of length yet to be determined) during which the SEC observes the IASC's processes in order to evaluate their robustness and their conformity to the criteria laid out as part of the IASC's restructuring plans.

3 These criteria are discussed in the Committee's response to the IASC (1999) Discussion Paper, "Shaping IASC for the Future."
aimed at taking actions to achieve global convergence in securities regulation.

4. During the transition period, the SEC should implement regulatory processes that maintain reconciliation requirements and reconsider the existing reconciliation rules with a view toward improvement while they remain in place.

The Committee's view of the steps in the coming transition is as follows:

1. The restructured IASC is to be implemented as designed.
2. The essential elements of a world financial-reporting infrastructure are to be developed (comparable audits with global auditing standards; preparer readiness to implement global reporting standards; global regulation/enforcement using comparable approaches). The Committee does not express an opinion or a forecast on the relative speeds of development of these elements. The Committee also recognizes that some infrastructure elements will be in place earlier than others, and that this differential rate of development could influence the SEC's acceptance process.
3. IAS accepted for non-U.S. registrants from jurisdictions where the financial-reporting infrastructure is in place.
4. IAS accepted for all registrants.

The Committee's view of the transition is based on the following observations. First, some enterprises will not, for the foreseeable future, wish to access foreign capital markets. Domestic reporting standards will presumably remain in place and available for use by these enterprises in some jurisdictions. Second, the commitment of the Financial Accounting Standards Board to international convergence in financial-reporting standards will hasten the move toward U.S. GAAP that are coterminous with international rules. Third, the use of IAS without reconciliations for some SEC registrants (those domiciled outside the U.S.) and U.S. GAAP for SEC registrants domiciled in the U.S. implies a dual reporting system for firms traded on the same exchange but domiciled in different jurisdictions; the Committee believes such a dual system could possibly confuse investors and will surely impair comparability. In addition, the Committee believes it will be difficult to defend the position that if IAS without reconciliations are good enough for some SEC registrants, then they are somehow not good enough for all SEC registrants.

ANSWERS TO QUESTIONS POSED IN THE CONCEPTS RELEASE

Q.1. Do the core standards provide a sufficiently comprehensive accounting framework to provide a basis to address the fundamental accounting issues that are encountered in a broad range of industries and a variety of transactions without the need to look to other accounting regimes? Why or why not?

Q.2. Should we require use of U.S. GAAP for specialized industry issues in the primary financial statements or permit use of home-country standards with reconciliation to U.S. GAAP? Which approach would produce

4 However, as noted earlier in this response, the Committee believes that weakness or deficiency in a given infrastructure element increases the pressure on other infrastructure elements.
the most meaningful primary financial statements? Is the approach of having the host country specify treatment for topics not addressed by the core standards a workable approach? Is there a better approach?

Q.3. Are there any additional topics that need to be addressed in order to provide a comprehensive set of standards?

The Committee is aware of no accounting research that speaks to the issue of comprehensiveness or to the issue of the most appropriate approach to take when authoritative guidance is lacking. Speaking narrowly to comprehensiveness, the Committee notes that it is generally agreed that the existing IAS do not cover all the issues addressed by U.S. GAAP, which are themselves not comprehensive.

Q.4. Are the IASC standards of sufficiently high quality to be used without reconciliation to U.S. GAAP in cross-border filings in the United States? Why or why not? Please provide us with your experience in using, auditing, or analyzing the application of such standards. In addressing this issue, please analyze the quality of the standard(s) in terms of the criteria we established in the 1996 press release. If you considered additional criteria, please identify them.

The Committee believes the SEC's criteria, as established in the 1996 press release, confound characteristics of standards with implementation. Our framework emphasizes that the quality of the standards is distinct from the quality of the implementation, and that high-quality financial reporting requires both.

Existing accounting research speaks to one element of the SEC's criteria, comparability. For samples of firms filing Form 20-F, researchers have documented the type, frequency, and magnitude of differences between amounts reported under U.S. GAAP and other reporting systems (including IAS) and the value relevance to investors of these differences. Inferences from this research are limited by small sample sizes and by the lack of experience with some of the more recent IAS. Subject to these limitations, the Committee believes that the weight of the evidence supports the inference that comparability is increased if alternative treatments for the same underlying event or transaction are eliminated.

Q.5. What are the important differences between U.S. GAAP and the IASC standards? We are particularly interested in investors' and analysts' experience with the IASC standards. Will any of these differences affect the usefulness of a foreign issuer's financial information reporting package? If so, which ones?

The second edition of *The IASC-U.S. Comparison Project: A Report on the Similarities and Differences between IASC Standards and U.S. GAAP* (1999) compiles and discusses differences between U.S. GAAP and IAS. This comparison does not speak to the frequency

---

6 Pownall and Schipper (1999) provide a discussion and analysis of this literature and its implications for comparability.
and magnitudes of differences in financial statements. Accounting research that enumerates these differences using Form 20-F filings finds that, in some cases (up to one-third of some samples), there are no reconciling items at all (domestic GAAP or IAS yields the same results as U.S. GAAP) or that reconciling items are very small. However, the range of these items can be considerable.

Q.6. Would acceptance of some or all of the IASC standards without a requirement to reconcile to U.S. GAAP put U.S. companies required to apply U.S. GAAP at a competitive disadvantage to foreign companies with respect to recognition, measurement, or disclosure requirements?

As noted previously in this response, the Committee does not believe that the SEC should be accepting or not accepting standards, either individually or in groups. The Committee believes the SEC should accept the IASC's process when the necessary elements are in place. That said, there is no research evidence to support the view that preparing financial reports using U.S. GAAP as opposed to another reporting system imposes a competitive disadvantage.

Q.7. Based on your experience, are there specific aspects of any IASC standards that you believe result in better or poorer financial reporting (recognition, measurement, or disclosure) than financial reporting prepared using U.S. GAAP? If so, what are the specific aspects and reason(s) for your conclusion?

The Committee's experience with reports prepared using IAS stems from research and teaching. A general observation that is consistent with the Committee's experience, the Committee's framework, and certain research findings is that standards that provide for free choice (for example, a benchmark and an alternative treatment) in the accounting for the same underlying event or transaction decrease comparability; it is more difficult to understand the intent of standards that lack a basis for conclusions; the current IASC approach of providing for "black letter" and "gray letter" portions of its standards seems to obfuscate, not clarify. The Committee also notes that the IASC's provision of free choice in the form of a benchmark and an alternative for some standards may be driven by jurisdiction-specific tax and regulatory forces and therefore the costs and benefits of this decision are an empirical issue.

Q.8. Is the level of guidance provided in IASC standards sufficient to result in a rigorous and consistent application? Do the IASC standards provide sufficient guidance to ensure consistent, comparable, and transparent reporting of similar transactions by different enterprises? Why or why not?

The Committee is aware of no accounting research that is directly on point for this issue. Based on the Committee's research and teaching experience with IAS, the Committee believes that standards that provide little or no discussion to facilitate understanding of the intent of the standard are more difficult to understand and implement, and that introductory comments, bases for conclusions, and written dissents all aid understanding and implementation.
Q.9. Are there mechanisms or structures in place that will promote consistent interpretations of the IASC standards where those standards do not provide explicit implementation guidance? Please provide specific examples.

The Committee is aware of no accounting research that is directly on point for this issue. Based on our research and teaching experience with U.S.GAAP (supported by the EITF and AcSEC) and with IAS (supported by the Standing Interpretations Committee [SIC]), we observe that implementation guidance is most helpful when it is timely, in the sense of developing and promulgating interpretations quickly when problems arise; when it involves the affected constituencies that have expertise in the matters at issue; and when it is supported with adequate resources. The Committee is aware that the SIC of the IASC meets only four times a year.

Q.10. In your experience with current IASC standards, what application and interpretation practice issues have you identified? Are these issues that have been addressed by new or revised standards issued in the core standards project?

Q.11. Is there significant variation in the way enterprises apply the current IASC standards? If so, in what areas does this occur?

The Committee is aware of no accounting research, other than the study referenced in the Concepts Release, which speaks to these issues.

Q.12. After considering the issues discussed in (i) through (iv) below, what do you believe are the essential elements of an effective financial-reporting infrastructure? Do you believe that an effective infrastructure exists to ensure consistent application of the IASC standards? If so, why? If not, what key elements of that infrastructure are missing? Who should be responsible for development of those elements? What is your estimate of how long it may take to develop each element?

The Committee's response to the IASC's (1999) Discussion Paper, "Shaping IASC for the Future" and the first section of this response provide the Committee's views about the essential elements of a financial-reporting infrastructure. The Committee believes that the necessary infrastructure elements are not yet in place, including preparer readiness and globally comparable regulation and enforcement.

In terms of responsibility, the Committee believes that governmental agencies (and sometimes legislative bodies) that oversee regulators and promulgate securities laws and regulations, as well as the regulatory agencies themselves have responsibility for developing a globally comparable approach to regulation and enforcement; that standard setters (who are sometimes part of the government) have responsibility for developing a single, global set of high-quality and comprehensive reporting standards; that auditors, audit firms, and regulatory/supervisory authorities that oversee auditors and auditing have responsibility for developing global auditing standards and a globally comparable approach to assurance; and that educators, auditors, and the preparers themselves have responsibility for developing preparer readiness.
In terms of timing, we note a general sense of urgency. The recent Asian financial crisis tested some elements of the financial-reporting infrastructure and such a crisis, or one more severe and widespread, could occur again. However, this sense of urgency should not induce a rushed decision.

Q.13. What has your experience been with the effectiveness of the SIC in reducing inconsistent interpretations and applications of IASC standards? Has the SIC been effective at identifying areas where interpretive guidance is necessary? Has the SIC provided useful interpretations in a timely fashion? Are there any additional steps the IASC should take in this respect? If so, what are they?

As noted earlier, the Committee has no direct experience with the SIC. In addition, as noted earlier, timeliness of response and sufficient productive capacity (in the form of involved and expert members and adequate staff support) are important features of an effective interpretative body.

Q.14. Do you believe that we should condition acceptance of the IASC standards on the ability of the IASC to restructure itself successfully based on the above characteristics? Why or why not?

As noted earlier, the Committee believes the SEC should evaluate and accept the IASC's process, not the standards, either individually or in groups. The proposed IASC design meets many of the characteristics put forward by the Committee as describing a high-quality standard setter, but the design has yet to be implemented.

Q.15. What are the specific practice guidelines and quality-control standards that accounting firms use to ensure full compliance with non-U.S. accounting standards? Will those practice guidelines and quality-control standards ensure application of the IASC standards in a consistent fashion worldwide? Do they include (a) internal working paper inspection programs and (b) external peer reviews for audit work? If not, are there other ways we can ensure the rigorous implementation of IASC standards for cross-border filings in the United States? If so, what are they?

Q.16. Should acceptance of financial statements prepared using the IASC standards be conditioned on certification by the auditors that they are subject to quality-control requirements comparable to those imposed on U.S. auditors by the AICPA SEC Practice Section, such as peer review and mandatory rotation of audit partners? Why or why not? If not, should there be disclosure that the audit firm is not subject to such standards?

Questions 15 and 16 pertain to auditing and audit firms and are therefore outside the purview of the Committee. The framework laid out in the first section of this response would, however, imply that the answer to Question 16 is yes.
Q.17. Is there, at this time, enough expertise globally with IASC standards to support rigorous interpretation and application of those standards? What training have audit firms conducted with respect to the IASC standards on a worldwide basis? What training with respect to the IASC standards is required of, or available to, preparers of financial statements or auditors certifying financial statements using those standards?

The Committee wishes to emphasize the importance of preparer, auditor, and regulator expertise as elements of the financial-reporting infrastructure. There is no academic research that directly measures or assesses IAS-related expertise in various jurisdictions. However, the Committee’s experience in non-U.S. jurisdictions indicates that the level of IAS-related expertise is uneven across jurisdictions.

Q.18. Is there significant variation in the interpretation and application of IASC standards permitted or required by different regulators? How can the risk of any conflicting practices and interpretations in the application of the IASC standards and the resulting need for preparers and users to adjust for those differences be mitigated without affecting the rigorous implementation of the standards?

The Committee is not aware of accounting research that directly addresses this issue, although we note that the lack of a globally comparable approach to securities regulation almost guarantees some inconsistencies. Indirect evidence in unpublished research by Ball et al. (2000) suggests that allegedly IAS-like reporting standards in Hong Kong, Malaysia, Thailand, and Singapore are implemented such that the resulting income numbers lack the timeliness (measured in terms of associations between accounting income and stock market returns) and conservatism (measured as a greater association between accounting income and negative returns than between accounting income and positive returns) associated with income numbers in the U.S., Australia, Canada, and the U.K. One possible interpretation of these results is that regulatory agencies in the four East Asian jurisdictions analyzed do not enforce the allegedly IAS-like reporting standards in place in those jurisdictions.

Q.19. Would further recognition of the IASC standards impair or enhance our ability to take effective enforcement action against financial-reporting violations and fraud involving foreign companies and their auditors? If so, how?

The Committee is aware of no research that is directly on point for this issue. The Committee’s framework suggests that the SEC should have broad powers, consistent with its investor protection mandate.

Q.20. We request comment with respect to ways to assure access to foreign working papers and testimony of auditors who are located outside the United States. For example, should we amend Regulation S-X to require
a representation by the auditor that, to the extent it relied on auditors, working papers, or information from outside the United States, the auditor will make the working papers and testimony available through an agent appointed for service of process? If not, should we require that the lack of access to auditors' workpapers be disclosed to investors? Is there another mechanism for enhancing our access to audit working papers and witnesses outside the United States?

Question 20 pertains to auditing and audit firms and is therefore outside the purview of the Committee.

Q.21. What has been your experience with the quality and usefulness of the information included in U.S. GAAP reconciliations? Please explain, from your viewpoint as a preparer, user, or auditor of non-U.S. GAAP financial statements, whether the reconciliation process has enhanced the usefulness or reliability of the financial information and how you have used the information provided by the reconciliation. Please identify any consequences, including quantification of any decrease or increase in costs or benefits, that could result from reducing or eliminating the reconciliation requirement.

As discussed in Pownall and Schipper (1999) and elsewhere in this response, the weight of the evidence is that Form 20-F reconciliations from non-U.S.-GAAP financial statements (including IAS financial statements) to U.S. GAAP are value-relevant to investors. However, the evidence also shows that some Form 20-F filers have no reconciling items. In addition, sample sizes are small and evidence on IAS reconciliations is relatively sparse because there are few or no filings that use some of the more recent IASs.

Q.22. Should any requirements for reconciliation differ based on the type of transaction (e.g., listing, debt or equity financing, rights offering, or acquisition) or the type of security (e.g., ordinary shares, convertible securities, investment grade or high yield debt)? Are there any other appropriate bases for distinction?

There seems to be no conceptual basis for such a distinction, which is not found in U.S. GAAP. In addition, the Committee is aware of no research that would support such a distinction.

Q.23. If the current reconciliation requirements are reduced further, do you believe that reconciliation of a "bottom line" figure would still be relevant (e.g., presenting net income and total equity in accordance with U.S. GAAP)?

As previously noted, the Committee does not believe the reconciliation requirements should be reduced at this time. Speaking to a possible distinction between aggregate or bottom-line reconciliations vs. line-item or component reconciliations, research indicates that individual reconciling items are value-relevant to investors, although results are mixed and sample sizes tend to be very small.
Q.24. Should any continuing need for reconciliation be assessed periodically, based on an assessment of the quality of the IASC standards?

Yes. As previously noted, the Committee believes the reconciliation requirement should be removed after the SEC has approved the IASC's process and after the essential elements of a global financial-reporting infrastructure are in place. This decision approach implies periodic reassessments.

Q.25. The IASC standards finalized as part of the core standards project include prospective adoption dates. Most standards are not required to be applied until fiscal years beginning on or after January 1, 1998, at the earliest. Should we retain existing reconciliation requirements with respect to the reporting of any fiscal year results that were not prepared in accordance with the revised standards or simply require retroactive application of all revised standards regardless of their effective dates? If not, why not?

The Committee recommends that the SEC approve the IASC process, not the standards, whether individually or in groups. In addition the practicality of retroactive application could be questionable in some cases.

Q.26. Does the existence of a reconciliation requirement change the way in which auditors approach financial statements of foreign private issuers? Also, will other procedures develop to ensure that auditors fully versed in U.S. auditing requirements, as well as the IASC standards, are provided an opportunity to review the financial-reporting practices for consistency with those standards? If so, please describe these procedures. Alternatively, will the quality of the audit and the consistency of the application of the IASC standards depend on the skill and expertise of the local office of the affiliate of the accounting firm that conducts the audit?

Question 26 pertains to the practice of auditing and is outside the purview of the Committee.

REFERENCES