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Remarks by

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What is the Future of Mutual Recognition of Financial Statements and is Comparability Really Necessary?

Information is King

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The main heading for today's panel discussion is, "What is the future of mutual recognition of financial statements and is comparability [of financial information] really necessary?" The detailed sub-heading for the discussion is,

> "Can changes be expected to the accounting, presentation, and disclosure requirements imposed by capital market regulators on foreign companies wishing to raise finance in their jurisdictions? Should comparability be a necessary pre-condition for the mutual recognition of financial statements? How can the role of IASC enhance and influence these issues? Should not current practices in Europe be accepted by regulators elsewhere?"

In accordance with the Commission's policy, I must tell you that my answers to these questions and my other remarks today will be my views, and will not necessarily reflect the views of the Commission or my colleagues on the Commission's staff.

The answers to those questions, to me, depend on how one answers an unasked question, namely, What is the objective of the financial statements and reports being issued by those companies wishing to offer their securities to investors? Is the objective to make decisions about income to be reported to taxing authorities? Is the objective for state planners outside the enterprise to make decisions about tax policy, labor policy, or other state matters? Is the objective to determine the amount of cash that safely may be distributed to owners of the business while at the same time maintaining sufficient resources within the enterprise to provide jobs for the present workforce and possibly additional workers? Is the objective to state net assets and income with a downward bias so as to minimize demands by owners for dividends? Or is the objective one that is oriented primarily towards the capital markets, that is, toward investors and creditors and making investment and credit decisions?

In the United States of America, starting in the 1930s after the Great Depression and then after World War II, we embarked on a course of preparing financial statements for use by those who make investment decisions. The American Institute of Certified Public Accountants' Committee on Accounting Procedures, in the Introduction to Accounting Research Bulletin No. 43, "Restatement and Revision of Accounting Research Bulletins," wrote as follows in the early 1950s:

> In the past fifty years there has been an increasing use of the corporate system for the purpose of converting into readily transferrable form the ownership of large, complex, and more or less permanent business enterprises.... As a result of this development, the problems in the field of accounting have increasingly come to be considered from the standpoint of the buyer or seller of an interest in an enterprise, with consequent increased recognition of the significance of the income statement.... The fairest possible presentation of periodic net income, with neither material overstatement nor understatement, is important, since the results of operations are significant not only to prospective buyers of an interest in the enterprise but also to prospective sellers.

Writing in 1978, the Financial Accounting Standards Board, in its Concepts Statement 1, said:

> [t]he objectives in this Statement are focused on information for investment and credit decisions [for those] who generally lack the authority to prescribe the information they want.... (Paragraph 30)

> The objectives are those of financial reporting rather than goals for investors, creditors, or others who use the information or goals for the economy or society as a whole. The role of financial reporting in the economy is to provide information that is useful in making business and economic decisions, not to determine what those decisions should be. For example, saving and investing in productive resources (capital formation) are generally considered to be prerequisite to increasing the standard of living in an economy. To the extent that financial reporting provides information that helps identify relatively efficient and inefficient users of resources, aids in assessing relative returns and risks of investment opportunities, or otherwise assists in promoting efficient functioning of capital and other markets, it helps to create a favorable environment for capital formation decisions. However, investors, creditors, and others make those decisions, and it is not a function of financial reporting to try to determine or influence the outcomes of those decisions. The role of financial reporting requires it to provide evenhanded, neutral, unbiased information. Thus, for example, information that indicates that a relatively inefficient user of resources is efficient or investing in a particular enterprise involves less risk than it does and information that is directed toward a particular goal, such as encouraging the reallocation of resources in favor of a particular segment of the economy, are likely to fail to serve the broader objectives that financial reporting is intended to serve. (Paragraph 33)

> Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions. (Paragraph 34)
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> Financial reporting should provide information to help present and potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities or loans. (Paragraph 37)

In fulfilling that capital markets objective, financial accounting and reporting in the United States of America has developed into a system where public companies present the facts surrounding their businesses and operations with great transparency. The degree of the transparency is bounded or constrained only by the necessity to summarize information so as to get the information into a report of manageable size that may be sent to owners and creditors and may be understood and digested and used by them. In this system, information is king, and also queen. Our public companies lay out the facts and let marketplace participants decide on how the facts should affect security prices and how capital should be allocated.

The International Accounting Standards Committee, in its Framework for the Preparation and Presentation of Financial Statements, has adopted much the same approach to deciding what should go into financial statements, that is, an investor-oriented, capital-markets approach. In paragraph 10 of its Framework, the IASC said, "as investors are providers of risk capital to the enterprise, the provision of financial statements that meet their needs will also meet most of the needs of other users [such as, employees, lenders, trade creditors, customers, governments, and the public] that financial statements can satisfy." The IASC, in its framework, also lists most of the same qualitative characteristics of financial information as does the FASB, for example, relevance, reliability, neutrality, and comparability.

I think that the capital-markets approach is the wave of the future for those companies in Europe and elsewhere that wish to offer their debt or equity securities in worldwide markets. If those companies are unwilling to provide to the investing public the same information that they provide privately to their major debt and equity holders, then those companies cannot, it seems to me, expect worldwide investors to bid the full price for their securities. Keeping information private has a cost. That cost is reflected in reduced security prices. I have heard and understand the argument that the price of an issuer's securities is set in the home-country market and is accepted by participants in other markets and therefore there is no need to make any more disclosures than are considered necessary by the home-country regulator. But that argument ignores the fact that an issuer's securities may not be fully priced by participants in the home-country marketplace if disclosures in that marketplace are opaque. It also seems to me, intuitively, that if worldwide investors have a choice as to whether to buy the securities of two issuers--one whose disclosures are great and transparent and one whose disclosures are minimal and opaque--the investor will select the securities of the issuer whose disclosures are great and transparent, all other things being equal.

Under the mutual-recognition approach to regulation of securities offerings, the regulator in the country where the securities are sought to be offered and listed would accept as adequate whatever disclosures the issuer makes in its home country. While this approach may, on its surface, appeal to issuers, it places a great burden on investors. Under that approach, investors have to learn and become familiar with the accounting requirements of the country of the issuer. That approach burdens rather than helps investors. I do not see as practical the proposal that investors in another country know enough about the disclosure requirements and accounting rules or practices in the issuer's country so as to make informed decisions about prices of the issuer's securities. The aim of regulation should be to help investors, not burden them.

Moreover, the mutual-recognition approach has another drawback, which I call the lowest-common-denominator syndrome. By that I mean that managers of some corporations may not necessarily act in the best interests of investors by factually and openly reporting financial information. If some companies in the worldwide markets smooth their earnings, or indeed determine the amounts of their earnings, on an undisclosed and discretionary basis, through the use of hidden accounting reserves, other companies may be motivated to report in a similar way so as to preserve perceived competitive advantage. If some companies, selectively and without disclosure of relevant details, omit cash, working capital, plant, and debt from their financial statements by not consolidating the financial statements of subsidiaries, or some subsidiaries, other companies may be motivated to report in a similar way. If some companies, on the acquisition of other companies, recognize liabilities or asset valuation allowances that have no basis in fact, so as to allow the release of those amounts into earnings in periods after the acquisition, other companies may want to do likewise. If this syndrome became widespread, financial accounting and reporting could sink to a very low level. Although this condition probably would not persist over the long term, I think that any movement of this sort would harm investors.

There is a large body of academic research and literature that says that the accounting numbers that are disclosed by reporting companies can affect stock prices. That accounting numbers make a difference. That accounting numbers are important. I think that issuers of financial statements will resolve the conflict between the desire to keep information private along with the desire to publish only home-country information and the need to get a full price for their securities in the way that they see is in their best self-interest. If the issuers want to maintain closeness about their business affairs, they will opt for less-than-transparent disclosures. If, on the other hand, their current owners demand that the best price possible be obtained for new issues of securities so that current owners' values are not diluted, and if current and prospective owners want full pricing of securities in their portfolios, they will choose transparency, which is the approach to regulation of securities offerings we take in the USA.

In closing, I would like to share with you some statistics that I believe demonstrate the success of complete and transparent financial reporting systems, such as the system used in the United States. Last year alone, equity trading volume in the USA grew by 18%, to nearly (US) -$3 trillion. The growth of securities registered for public offering in the USA also was exceptional, increasing more than 37% in 1992 to $610.5 billion. Registered initial public offerings for debt and equity rose by nearly 43% to about $52 billion. More significant to this audience, securities registered for public offering in the United States by foreign issuers grew 32%, from $25 billion to $33 billion between 1991 and 1992. In the first seven months of 1993, foreign company registrantions reached $26.5 billion. Since January 1, 1990, 228 foreign companies from 31 countries have entered the US public securities markets for the first time. Over that time period, foreign issuers registered approximately $94 billion of securities for issuance to the public. Today, a total of 39 countries, including all major markets except Germany, are represented among the 557 foreign issuers having securities registered with the Commission. And earlier this year, Daimler Benz announced that it will be the first German company to list its shares on the New York Stock Exchange.

I believe that it is, in large part, the SEC's commitment to a financial reporting system with the objective of providing full disclosure to investors that has made the US securities markets attractive for global as well as domestic capital formation. Such transparency must, in my personal view, be a primary ingredient in any standards that are to receive worldwide recognition.

I would like to thank the Federation for inviting me to participate in today's panel discussion, and I look forward to hearing the other participants' views.

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