ASIC

Australian Securities & Investments Commission

The regulatory perspective

An address by David Knott, Chairman, ASIC, to the International Accounting Standards Board World Standard Setters' conference, Hong Kong, 18 November 2002

The case for International Accounting Standards

Until relatively recently we might have started this discussion by debating the case for international accounting standards. That debate is now redundant. The much more relevant questions now are what do we want out of these standards and what expectations of them might we reasonably hold? These questions lead to considerations that are in part technical (going to content and style), part political (involving both domestic and geo-political interests) and part social (involving a variety of national policy objectives, including regulatory objectives).

We all knew prior to ENRON that the increasing pace of international capital mobility was making uniform cross-border accounting standards ever more important. We knew that Europe would have to embrace that initiative in order to maintain the momentum of its trading block aspirations. Indeed, as early as 1993, the International Organization of Securities Commissions (IOSCO), in response to growth in cross-border capital flows, commenced the process of endorsing core standards of the IASC for use in cross-border listings and offerings.

But there can be little doubt that ENRON and other recent corporate failures in the United States have profoundly influenced the degree of engagement by that country – and by others – in the drive towards harmonized international standards. This is why I will not dwell too much on the rationale for harmonization, but move quickly to other issues.

The regulator's perspective

In setting the scene from a regulator's perspective, however, I should record the fact that accounting standards are just one example of a wider imperative – the need for national rules of business to reflect the realities of international traded markets and capital mobility. Governments have lagged well behind the business and professional sectors in responding to these forces. However, in recent years, we have experienced significant changes in the structure of stock exchanges, including their increased "privatisation", and some quite concerted efforts to achieve cross-border regulatory harmonization – particularly in Europe.

In Australia we have been working over the past 12 months on defining some principles to guide our approach to cross border financial services regulation. We share an aim to facilitate greater access to our markets by offshore providers of financial services and to increase the access of Australian investors to foreign financial facilities, products and services. On the other hand, we want to ensure that Australian investors who access such facilities are adequately protected, and that our own market integrity and stability is not prejudiced by opening access to poorly regulated foreign participants.

These concepts seem straightforward but in practice can be very challenging. The temptation is to deal with situations on an ad hoc basis. However, the better approach is to lay out a series of principles that will consistently guide our regulatory response to these issues. ASIC is today releasing in Australia a set of 10 principles which will do just that. These principles are an important step forward for us in facilitating investment flows with other nations that enjoy broad regulatory equivalence, that are committed to adequate information exchange, and that support investor protection with appropriate sanctions.

I have made that digression to illustrate that the internationalisation of accounting standards should be viewed as being in the vanguard of a broader commercially driven direction which is challenging Governments and their regulators worldwide. Again, wearing my IOSCO hat, I consider that securities regulators have provided solid support to business in tackling these issues, although I readily accept that there is still a long way to go and that issues of state sovereignty and competition still constitute significant challenges.

My second scene setting point is to record that securities regulators are at the forefront of investor protection. Detailed approaches to that objective differ between jurisdictions – but there is widespread acceptance that disclosure and transparency are primary regulatory instruments for promoting investor protection. Standards of financial reporting are therefore central to the mandate of securities and corporate regulators. Those wanting evidence to support that supposition need look no further than the October 2002 report from the US General Accounting Office entitled "Financial Statement Restatements". It provides graphic evidence of the correlation between deficient reporting and investor behaviour.

What are regulators looking for?

Against that background, I see the widespread adoption of international accounting standards in 2005 as monumentally important. In Australia we have committed ourselves to that course and our own Financial Reporting Council and our national standards setter are fully supporting both the policy and technical program of the IASB.

As the relevant regulator in Australia my mind has turned to the following issues:

- First, that we should not allow the 2005 timetable to compromise our commitment to raising the quality of standards.

- Second, that we must not lose sight of the investor protection objectives of the standards. Comprehensibility and consistency of reporting are important in that context.

- Third, we must ensure that whatever balance is finally adopted between principles and rules, the standards themselves are directed to the economic substance of the transaction rather than its form.

- Fourth, that we must start working on practical means for ensuring compliance with standards by issuers and auditors, and doing so in a way that will optimise consistency of application across jurisdictions.

Let me comment briefly on those issues.

1. 2005 timetable – quality of standard

As the world's pre-eminent standard setters I hardly need to explain to you the challenges of meeting the 2005 target. In my own country there is a general awareness of the issue by the business sector, but my sense is that business underestimates the challenge of fully converting to international accounting standards and is still only partially engaged in the process. A state of unreadiness in the business sector will generate its own threats to the attainment of 2005 and potentially subject IASB and national standard setters to immense pressure as the date draws nearer and the implications of individual standards become better understood by business. There is a risk that that pressure will in turn lead to compromises in the quality of standards – or at least to lost opportunities for raising the bar in some areas.

I have no doubt that these risks are well understood by the people in this room and that everything possible will be done to overcome them. We can expect that business will seek to actively enlist political support for their special interests – and it will be important for standard setters and regulators to hold the line as best we can. So while I accept that the 2005 timetable provides a major incentive for tangible outcomes and lends credibility and momentum to the change process, I think we need to be conscious of the pressure it places on securing improved standards. We need to continually find new ways of underpinning political support for a process that targets improved standards, and not be content to accept international coherency as a sufficient dividend of itself.

I assume that many of you are familiar with the recent work of the Financial Stability Forum in helping to support these objectives. Its Toronto meeting in September and subsequent roundtable in Basel last month have both resulted in useful papers which I commend to those who have not read them. Perhaps more importantly, the FSF has direct access to the G-7 Finance Ministers and is a good example of how the IASB and national standard setters can harness political support for this work. I believe that the Financial Stability Forum's discussion on the opacity of insurance sector financial reporting – and the relative lack of regulation of the reinsurance market – is a good example of an opportunity to incorporate improved financial reporting within a wider framework of increased investor and consumer protection.

2. Investor protection – comprehensibility and consistency

That leads me to the importance of comprehensibility and consistency from an investor protection viewpoint.

As a regulator I am greatly encouraged by the convergence project being jointly undertaken by IASB and FASB, and particularly by the recent memorandum of understanding recording their commitment to this work.

IOSCO has for some time been promoting convergence as a practical methodology for advancing international coherence of standards while side stepping some of the roadblocks confronting universal adoption of international standards. The prospect that convergence will resolve the many differences that currently exist between US GAAP and international standards, with the alluring consequence of eliminating the requirement for cross border reconciliations, carries enormous potential for facilitating global business at reduced cost. IOSCO strongly supports and congratulates both the IASB and FASB, not only for embracing this strategy, but for their practical and common sense approach of identifying specific standards for priority work. We really do get a sense that sleeves have been rolled up and that a great deal of goodwill and commitment exists.

On the other hand, regulators, more than most, know that the devil lies in the detail. We realise that in cases where two negotiating parties have each developed and embraced their own particular approach, the natural instinct will be to prefer that approach to the other. Even if philosophically both parties have agreed to adopt the best aspects of both approaches and to reject the others, that may be easier said than done. Beauty is, after all, in the eyes of the beholder.

It is possible in such circumstances that the process of convergence could simply break down. However, I think the greater risk is that in the interests of achieving convergence, compromises to true enhancement may be made. That there will need to be compromises of starting positions is not doubted, otherwise little will get done. But a great deal hangs on the intellectual integrity of the negotiators – on their independence of mind, and their freedom to act impartially – if we are to avoid achieving convergence at the expense of best practice.

For those countries like Australia, that have made the commitment to adopt international standards in 2005, much hangs on the progress and outcome of the convergence project. But however successfully that turns out, we will face the transition to wholesale adoption of international standards in 2005. As a regulator I emphasize the 'wholesale adoption' because it is our conviction that tinkering around the edges with international standards by national accounting setters has the capacity to severely undermine the core objectives of the exercise. Here there is another direct linkage to broader regulatory harmonization, because if an industry is governed by laws and regulations that differ substantially between jurisdictions, it becomes more probable that different (or additional) requirements for financial reporting will flow in consequence.

Again, the insurance industry readily comes to mind and it is encouraging that the IAIS has recently commissioned new work to reflect these concerns. It seems inevitable that there will be cases where international standards for some reason do not fully cater for the regulatory environment of a particular jurisdiction. However, we need to do all we can to avoid that circumstance and, at all costs, to not undermine the consistent application of international standards through discretionary domestic fine tuning. Regulators and national standard setters will need to work together over the next few years to identify and pre-empt that possibility by influencing both regulation and the shape of the standards.

The other great opportunity we have over the next few years is to enhance the comprehensibility of standards and of resulting financial reporting. I think there is a growing acceptance that the quality of disclosure is at least as important, and probably more important, than the volume of disclosure. This sentiment is influencing regulatory thinking on fundraising disclosure, financial product disclosure and consumer protection disclosure. There is, for example, much more emphasis now being placed on consumer comprehension surveys as part of the development of new disclosure requirements.

I doubt that many of you would contest the wisdom of this trend, or its relevance to financial reporting. I do not propose this morning to traverse in any depth the "rules" versus "principles" debate, something that I'm sure will be occupying you more fully before this day is out. I recognize that detailed rules have a legitimate design to promote certainty and consistency in the interpretation and application of standards. I also appreciate that in litigious environments, prescriptive detail is often seen as a necessary protective device for issuers.

However, there is ample evidence that an exponential increase in detail creates as many problems as it solves. Disclosure is supposed to inform the user. When disclosure requirements and practices start to be motivated more by a need to protect issuers from liability we are likely to come unstuck. There is evidence of this in primary issue disclosure, with IPO prospectuses becoming almost unreadable. And one might identify a similar tendency in financial reporting if the details of standards – or accompanying interpretative rules – overwhelm the fundamental principles at issue. That can lead to transactions being structured to the technical requirements of the rules but in a manner that abuses the underlying principle.

I am probably not able to state a totally consensus view on this issue by securities regulators. However, I think it is reasonable to assert increasing sympathy for the problem and growing support for the reinforcement of principles. Personally, I am strongly supportive of IASB's direction in this respect.

I think FASB's October discussion paper on this issue is an excellent document that well exposes the issues from a US perspective. It is encouraging that the timeframe for public consultation and response is tight and that the issue has some urgency. The outcome of that process will have widespread ramifications far beyond the USA.

My final point on this investor protection theme is to welcome the debate about our broader expectations of financial reporting. I think some of the recent discussion about the narrow parameters of financial reporting – and possibilities for extending the expectations of that reporting – is overdue. Concepts for exploring financial outlooks under varying assumptions; for identifying a broader range of financial performance indicators; and for mandating more informative management discussion and analysis – are all directed towards improving the value of financial reporting to shareholders and other users. The tricky parts will be to reconcile that objective with adequate containment of liability and to ensure that minimum acceptable standards of comparability are not prejudiced.

Substance over form

It seems a logical progression to say something now about the need for accounting standards to go to the substance of a transaction rather than its form.

In Australia recently we have had a new outbreak of how the "true and fair view" certification should interact with our mandatory requirement for compliance with standards. We have a system that tolerates no digression from applicable standards but requires supplementary notes, if necessary, to satisfy the "true and fair" certification.

There is nothing new about this debate and as I have better acquainted myself with its development and history, I have become persuaded that the paramountcy of compliance with standards is correct.

I am concerned that the debate about 'true and fair' or 'present fairly' may miss the point of a much more fundamental problem encountered by us as a compliance regulator – that is, whether as applied by the company and its auditors to a particular transaction the accounting standard has reported on the economic substance of the transaction. This is sometimes a vexed question, for example in complex technical areas such as some leasing and financing transactions. One might think that if the economic substance of a transaction has not been truly represented in the accounts, it would be difficult to provide a 'true and fair' certification. But if the standard itself – compliance with which is compulsory – lends itself to a construction around the form of the transaction, the dilemma is obvious.

More than once when confronted by this problem I would have welcomed a clear statement, in the terms of the standard itself and the law, that it must be applied to reflect the economic substance of relevant transaction. This is a principle that should drive and qualify all standards – whatever ultimate balance is adopted between principles and rules.

Compliance and enforcement

My final observations touch further on the vital importance to regulators of compliance and enforcement of financial reporting.

I could write a book on this subject – but it would have some unfinished chapters. It would start with the simple point that without effective measures for ensuring compliance with financial reporting requirements, the efforts of standard setters to achieve an internationally coherent regime of high quality reporting is certain to fail.

I believe absolutely that the absence of effective compliance and enforcement mechanisms has contributed to some of our recent problems. I believe that under-enforcement and over-regulation go hand in glove. I believe that the 'self' in self-regulation is the same 'self' as in self-interest. And I believe that my views are widely shared in the regulatory community and – I should say in fairness – throughout substantial sections of the accounting profession. The response of IFAC to this issue, for example, stands to their great credit.

Regulators are giving these issues increasing attention in the lead up to 2005. The Committee of European Securities Regulators (CESR) through its CESRfin sub-committee, published an important paper on the subject in September; IOSCO's Technical Committee published two statements of principle on auditor independence and auditor oversight in October; and IOSCO's Standing Committee on accounting and disclosure is meeting in Hong Kong over the next few days, with compliance and enforcement issues high on the agenda. That work is starting with a survey of the various regulatory mechanisms available for enforcing accounting-related rules, laws and interpretations across IOSCO membership jurisdictions.

The CESRfin paper is a draft statement of principles dealing with a range of enforcement issues. If I refer to just a few of the draft principles it will help to explain the regulatory perspective:

Principle 1	*Competent independent administrative authorities set up by member States should have the ultimate responsibility for enforcement of compliance of financial information …*
Principle 4	*Competent administrative authorities shall have adequate independence from government, and market participants, possessing the necessary powers and having sufficient resources.*
Principle 9	*The purpose of enforcement of financial information is to protect investors and promote market confidence by contributing to the transparency of financial information relevant to the investors' decision making process.* *With regard to financial statements, the above implies that enforcement contributes to a consistent application of the IFRSs in the EU financial regulated markets.*
Principle 16	*Where a material misstatement in the financial information is detected enforcers should take appropriate actions to achieve an appropriate disclosure and where relevant, correction of misstatement (in line with the requirements of the reporting framework).*
Principle 17	*Actions taken by the enforcers should be distinguished from sanctions imposed by the national legislation because:* • *actions are measures generally aimed at improving market confidence and integrity;* • *sanctions are mainly aimed at punishing the infringer.*
Principle 18	*Actions should be effective, timely enacted and proportional to the impact of the detected infringement.*
Principle 20	*In order to promote harmonization of enforcement practices and to ensure a consistent approach of the enforcers to the application of the IFRSs, coordination on ex-ante and ex-postal decisions taken by the authorities and/or delegated entities will take place.* *Material controversial accounting issues will be conveyed to the bodies responsible for standard setting or interpretation.* *No general application guidance on IFRSs will be issued by the enforcer.*

There is, I believe a laudable attempt in these principles to balance the need for timely and effective compliance intervention against the risk of de facto standard setting via regulatory rule making. I believe that there is much to commend the CESR framework and I am sure that it will be carefully considered by IOSCO as part of our work.