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COMMENTARY

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The Future Direction of Accounting

A number of changes are going to be needed to cope with public company financial reporting in what is increasingly an international capital market. In Ontario we have made numerous accommodations over time on foreign financial reporting because of the difficulties some foreign companies have encountered in trying to adapt to the Canadian system. In recognition of the demonstrated need to facilitate foreign offerings in Canada, we have recently published a proposal for world-class issuers entering the Canadian market that represents a more relaxed approach to foreign company disclosure, including financial statements.

We have also recently completed an assessment of the differences between Canadian and United States generally accepted accounting principles (GAAP) in order to determine if we should continue requiring reconciliation to our Canadian standards. I would like to share our experience and recent developments with you and explain why we see the need for some reciprocity today and the importance of harmonization for the longer term.

RECENT SITUATION

Capital markets have advanced rapidly beyond traditional geographic boundaries and those of us involved in the financial reporting process for public companies are clearly lagging behind in ensuring that meaningful financial reporting is available for investment decision-making purposes. Currently, international capital markets try to cope with several different financial reporting languages—United States, United Kingdom, and German reporting, to give a few examples of the more prevalent forms of financial communication in the international arena. These bases of reporting are not that comparable. Yet, significant investments are being made on the basis of financial information that is unfamiliar to the investor and probably not well understood.

So how should we cope with this situation? Should we penalize companies because we do not have an adequate international financial reporting system? Should we hinder large companies from accessing the international capital markets because they are well understood only at home? Should we limit the ways

The text is from a presentation to a breakfast roundtable of the New York Stock Exchange and the Brooklyn Law School, October 1, 1993. (On November 2, 1993, the Chairman of the OSC announced the appointment of Brenda Eprile to the position of Executive Director and Chief Operating Officer of the Commission. Ms. Eprile is responsible for all of the day-to-day activities of the OSC and its staff.)

in which investors can diversify their holdings because the language foreign companies use for financial reporting is not similar to ours? Or should investors rely on either a company's home or a major international market that follows the company because these are markets where the company is understood and securities are priced efficiently?

A short-term fix that seems to make sense is to determine that where there is a large international following for a particular world-class company, the company is understood in the international market. Thus Canadian investors can buy these securities based on the assessment made in the primary market that avidly follows the company. Local Canadian investors do not need to be able to make such an assessment themselves. They can and will rely on investment advice generated by the international investment community knowing that they will be able to trade these securities in a highly liquid market. There is no evidence to suggest that Canadian investors have suffered in the past as a result of a lack of Canadian-style disclosure when buying securities of world-class issuers outside Canadian borders.

A pragmatic approach to the accounting differences problem should involve short-term solutions to deal with today's situation, but at the same time focus sufficient attention on building an appropriate reporting system for international markets. This boils down to permitting some limited reciprocity now and eventually requiring harmonization. Lagging behind business reality is hardly something new for accounting standard setters, who are constantly playing catch-up. There are always new areas to be addressed. For example, consider the issue of other post-employment benefits (OPEBs) in the United States. Surely no one would have thought that financial statements should not be relied upon in the U.S. before the requirement for OPEBs was introduced, yet the marketplace must have known that some financial statements did not reflect material OPEB liabilities. Financial instruments is another good example of an important area that has not been adequately dealt with as yet. Financial instruments can have

a pervasive effect on the financial condition of a company even though many of these instruments are currently off-balance sheet. Although standard setters have not introduced full-blown reporting requirements in this area, undoubtedly the accounting profession in Canada and the U.S. would view their respective bodies of accounting standards as reasonably comprehensive. We are always in an improvement mode in financial reporting, but this should not unduly inhibit economic activity, such as international financing and investing.

SHORT TERM—RECIPROCITY

In the short term, I had hoped that we could have achieved reciprocity between Canada and the United States in the area of financial reporting. I am disappointed that this does not appear to be possible, at least in the next little while, as a result of a recent SEC decision to continue its GAAP reconciliation requirement for Canadian issuers. It is generally accepted that our two GAAPs are broadly comparable and so one would have thought that if ever there was a case for reciprocity, this is it. Hopefully reciprocity will be given further consideration at a later stage. As part of considering whether reciprocity made sense, my office conducted a study of differences between Canadian and United States GAAP last year and we published our findings for comment this past May. I would like to briefly outline the study's findings with you and the results of the public comment process.

OSC STUDY OF DIFFERENCES BETWEEN CANADIAN AND UNITED STATES GAAP

Although Canadian and United States GAAP are broadly comparable, there are a number of specific and significant differences between them. We undertook the study of these differences in order to assess GAAP reconciliation information and obtain the views of informed parties such as investors, reporting issuers, and analysts on the need for this type of disclosure. We also published eight

commentaries along with the study findings from a variety of different perspectives. This was done with the hope of stimulating discussion and debate.

The study itself, which looked at five years of reconciliation information, provided valuable insight into the significance of reported differences between the two GAAPs. However, it is difficult to conclude as to the usefulness of this information without conducting further research into the investment decision-making process. Understanding how investment decisions are made is an important issue that has also been raised in the context of several recent academic studies of GAAP differences both between Canada/U.S. and other GAAPs. In our study, we found that no industry is free from differences but some are more likely to have them than others. Both oil and gas and real estate companies have specific differences arising from accounting practices peculiar to their industries. In addition, the occurrence and magnitude of most GAAP differences are difficult to predict. Some relate to specific transactions such as a business combination, whereas others may be voluntary changes in accounting policies. Even where one can predict a difference, it is usually impossible to predict the quantum of specific adjustments. The impact on net income of the differences in our study was usually material, adjusting earnings by more than ten percent. About seven percent of the reconciliations converted a net income under Canadian GAAP to a net loss under U.S. GAAP.

We received comment letters from a cross section of the parties that have an interest in this issue. Unfortunately, many respondents did not address the cost of reconciliation, the approach to non-U.S. foreign issuer reconciliation, or the use of benchmark treatments in the International Accounting Standards (IAS). Most commenters addressed the basis of reporting for Canadian issuers, whether reconciliation should be required for U.S. issuers and the role of IAS. Consensus views exist only with respect to the use of Canadian GAAP by Canadian companies and the hope that in time, accounting standards will be harmo-

nized and IAS will become an acceptable alternative to reconciliation to various domestic GAAPs. On all other issues, the commenters had widely divergent views. As a result of the divergent views, we did not propose that changes be made to the existing reconciliation requirements in either the normal course offering system or the multijurisdictional disclosure system that was negotiated with the Securities and Exchange Commission in the United States. It is not clear that any particular changes to the existing reconciliation requirements are preferable to the status quo. The Ontario Commission agreed with the staff's recommendation.

While we do not propose any changes at this time, there is additional research that could be undertaken that might cause us to change our conclusions. A number of commenters noted that the benefits of GAAP reconciliation are unknown: we do not know how important the knowledge of GAAP differences is to investors. We encourage accounting academics and others interested in accounting research to undertake studies on this issue in order that we can all better understand how investors make investment decisions and modify financial reporting requirements, if appropriate.

FOREIGN ISSUER POLICY

A short-term solution for foreign issuers that want to enter our markets is a proposal of the Canadian Securities Administrators, which is an affiliation of securities commissions across the country. This proposal would provide easy access to our capital markets for world-class issuers offering securities in Canada as part of a global offering, provided that the Canadian tranche of the offering is quite small and the offering is made in one of the world's most liquid capital markets. The approach taken in this policy is generally one of acceptance of home jurisdiction documents or the documents used in one of the defined "acceptable markets." Consistent with this notion, the policy does not require that financial statements be reconciled to Canadian GAAP or IAS, as long as the issuer's financial

reporting regime contains four key requirements that are common to the Canadian securities regulatory regime. I elaborate on these requirements below.

The purpose of the policy is to reduce barriers to entry to the Canadian capital markets for world-class foreign issuers, to provide increased opportunity for Canadian dealers to participate in offerings by foreign issuers, and to increase the opportunity for investment by Canadians in the securities of these issuers, while maintaining an appropriate level of investor protection. A basic premise of the policy is that the securities of the world's most senior issuers have substantial liquidity and a market following in the world's most sophisticated capital markets. This is defined as the markets in Japan, United States, United Kingdom, Germany, Canada, France, and Italy. In aggregate, these stock markets represent approximately 90 percent of global market capitalization. The Canadian tranche must be limited to ten percent of the offering and the issuer must have less than ten percent of its equity securities held by Canadian residents. Under these terms, Canada will not be a principal market for the offering or secondary trading.

To meet the world-class test, issuers must have a market capitalization of not less than \$3 billion Canadian and a public float of not less than \$1 billion Canadian. Home jurisdiction financial statements will be accepted provided that the issuer's financial reporting regime meets certain parameters. These parameters include a requirement for an independent audit of annual financial statements, which is a cornerstone of financial reporting under our Canadian securities legislation. The second requirement is for periodic financial reporting on a timely basis. This contemplates annual financial statements as well as more frequent financial reporting on an interim basis, although not necessarily quarterly reporting. Issuers could satisfy this requirement with annual and semi-annual reporting, for example.

The third requirement is for narrative financial disclosure that includes a discussion of the issuer's results of operations, financial

condition, and prospects for the future. This information is much like Management's Discussion and Analysis disclosure (MD&A) familiar to investors in Canada and the U.S. However, the policy recognizes that not all issuers provide full MD&A in compliance with our detailed requirements. As a result, a more general discussion that addresses the three key MD&A areas is acceptable.

Finally, the issuer's basis of reporting must be based on well-established accounting and auditing standards. Without this last requirement, it would not be possible to accept home jurisdiction reporting. The issuer's financial statements would not be built on a reasonably comprehensive set of solid accounting principles and the credibility of this information would be in question without the application of rigorous professional standards for the conduct of an independent audit.

LONG TERM—HARMONIZATION

Although arguments are put forward that a single set of accounting standards will not be compatible with different business methods and practices, a universal basis of reporting is desirable. This does not mean that international standards will replace domestic reporting. In Canada, we have many companies that confine themselves to our local market and there is no need for them to be comparable to international companies. In terms of our large companies that are active in international markets, it will always be important for them to be evaluated in a Canadian context. As a result, they will continue to provide financial statements on a Canadian GAAP basis of reporting. I realize that a number of Canadian SEC registrants will be disappointed in this result because they are listed on a U.S. exchange where there is significant volume of trading in their securities, a substantial portion of their shareholders may be U.S. citizens, and they may have significant U.S. operations.

It is also important to keep in mind that many decisions accounting standard setters take do not reflect fundamental differences in economic (or socio/political) environments;

rather they reflect the compromise necessary to gain a certain level of consensus on a particular issue. Many of the differences between Canadian and U.S. GAAP can be attributed to the standard setting process itself rather than fundamental differences in the two business environments. I expect that eventually we will work together in developing North American accounting standards. Joint effort makes sense when you consider the ways in which the Canadian and United States markets and economies are combining. I am also not too worried about competition among national interests causing IAS to gravitate to the lowest common denominator or spur on a "race to the bottom" in the quality of financial reporting.

CONCLUSION

Should we be devoting the necessary resources to learn each other's domestic method of reporting financial information, or do we need a universal approach to conveying this type of information in an international investment forum? Is the multi-GAAP approach, where we rely on the different domestic GAAPs for the purposes of international investment decisions, an approach that is even practical given the significant differences between many of the domestic reporting regimes? In order to determine which approach is preferable, we need to have a good understanding of the investment decision-making process in an international context and its current limitations. Are investment alternatives selected from populations that include companies with different reporting standards? Do investors select investments from a specific industry around the world or are industry choices made within smaller markets, like the U.S. market? It may depend on where the investor resides. For example, Canada is a small market and many Canadians look to the U.S. for investments in what might be viewed as a North American portfolio. If individual investments are selected from a population that crosses national boundaries, a common benchmark is needed for comparison.

The Canadian experience tells us that we need to be flexible and come up with creative ideas to cope with existing dilemmas. In the short run we must cope with the differences in the ways in which companies from around the world report financial statements, but in the long run, an acceptable international approach makes much more sense. Not only are the differences between accounting models around the world too significant for investors and analysts to fully comprehend in assessing financial statements, domestic standards are constantly evolving. Although one can hope that the evolution of different domestic standards will be in the same direction, timing will vary and there is no clear evidence that domestic accounting standard setters will necessarily conform to the positions reflected in other countries or internationally. We need to continue to press on with addressing the information disadvantage created by different reporting standards by making the necessary improvements to IAS and narrowing the acceptable alternative accounting treatments. If the international approach is not strongly supported by the major international players, including the U.S., we will probably end up with a partial solution that is not very satisfactory. Perhaps the approach to financial reporting will depend on the trading block to which an issuer belongs. This would not be an optimal outcome since we would continue to face today's problem of coping with accounting diversity.

Can accounting standard setters deal with these challenges? Will they be able to respond to the needs of a dynamic business environment that is constantly evolving and becoming more global? New approaches are called for. A proactive approach that emphasizes a cooperative method of developing standards should be the way of the future. There are many different ways of approaching accounting issues and no one has a monopoly on the solutions. If we work together, we will benefit from each other's expertise and different perspectives. Ultimately we should end up with a result that maximizes the market's efficiency without compromising investor protection.

We also need to recognize that a major effort will be required to ensure compliance with International Accounting and Auditing Standards and uniform application around the world. As someone who is intimately involved in dealing with compliance problems in a Canadian reporting context, I believe this will

be a significant challenge and will require considerable resources and international cooperation and coordination. Attaining the objectives of adequate international standards and proper policing of practice will be a quantum leap forward, something that will not be achieved overnight.