# The Role of Financial Reporting: Discussion

**Marisa Lago***

S. P. Kothari's paper is based on a premise near to the hearts of securities regulators: that the quality of information provided to capital markets affects the allocation and pricing of capital. Kothari explores factors that have an impact on the effectiveness of disclosure:

- Corporate governance: especially diffuse versus concentrated share ownership, and the role of stakeholders;
- Legal system: common law versus civil code; and
- Enforcement: the existence and use—by both governments and the private sector—of laws regarding investor protection.

When I first started reading this paper I became quite concerned—not by the idea that high-quality financial reporting is important to efficient capital markets, or by the idea that high-quality financial reporting is a multidimensional issue and not just solely one of technical accounting standards. Rather, I was concerned that this would be an exceedingly dull session, with all of us nodding our heads in total agreement.

In international forums such as IOSCO (or, as the *Financial Times* calls it, the club of the world's securities regulators) or the Financial Stability Forum (FSF), participants are very comfortable discussing, debating, and analyzing standards—including accounting standards. But, in these international meetings, some want to end their discussion of financial

*Director, Office of International Affairs, U.S. Securities and Exchange Commission. The Securities and Exchange Commission disclaims responsibility for any private publication or statement of any SEC employee or Commissioner. This speech expresses the author's views and does not necessarily reflect those of the Commission, the Commissioners, or other members of the staff.

reporting issues at the level of standards. That approach is fundamentally flawed, because the issue is the product—the financial reporting that results from the application of standards—rather than the standards, in theory. Achieving this real-world analysis requires looking beyond the nominal adoption of the standards and focusing on their implementation and enforcement. Kothari's paper focuses our attention on this messier truth: The quality and effectiveness of financial reporting is a multi-dimensional issue, not a single-dimensional one.

As Gerhard Meuller notes, this same issue—the multifaceted nature of financial reporting systems—is recognized and addressed by the U.S. Securities and Exchange Commission in its *Concept Release: International Accounting Standards (2000)*, issued this past February. This concept release identifies a number of issues being considered by the SEC and poses about 25 questions, seeking public input to help shape further SEC actions.

When the SEC staff started working on the concept release, our initial focus was narrower: Should a foreign company's financial statements, prepared in accordance with standards issued by the International Accounting Standards Committee (IASC), be accepted by the SEC without requiring a reconciliation to U.S. GAAP? In other words, were the IASC standards of sufficiently high quality? But we quickly realized that looking just at the text of the IASC's accounting standards was not enough. From our experience with U.S. capital markets, we know that effective financial reporting is not solely the product of the high-quality standards issued by the Financial Accounting Standards Board (FASB). It also relies on company management preparing financial statements that faithfully apply those accounting standards, on effective audits of financial statements, and on regulatory oversight and enforcement of the activities of market participants. Therefore, the concept release that the SEC issued not only addresses the words of the IASC standards, but also raises questions about infrastructure issues:

- Are preparers and auditors adequately trained in IASC standards?
- Do audit firms currently have the capacity to identify and resolve issues arising in the implementation of IASC standards?
- What is the quality of audits worldwide?

And, looking at the quality of audits necessarily raises the question of how standards are enforced in jurisdictions outside of the United States. The Commission raised these broader issues because it wanted to make decisions about whether to accept IASC standards based on the way the standards are applied in the real world and around the world, and not just on how the standards would be applied in theory.

As I noted earlier, originally I was concerned that this session would be dull because the panelists would be in total agreement—but when I got to Kothari's conclusion, I realized that we would all be saved from

this fate! Kothari recommends removing requirements for disclosure and letting companies choose the quality and amount of disclosure that they make. In his view, this would permit companies to make firm-specific determinations of cost–benefit, weighing information-gathering and disclosure costs against the effect on their price of capital.

I must disagree with this conclusion. Why? Because it fails to recognize the importance of investor confidence in the market as a whole, and therefore would undermine the liquidity, stability, fairness, and success of U.S. capital markets. Kothari's suggestion would return the United States to the market conditions of the 1920s, when investors struggled time and time again to determine whether the information they were receiving about public companies was indeed full or fair disclosure. And today, the situation is even trickier than in the 1920s, because investors are now participants in a global capital market, rather than just a national one.

In securities markets it is critical that investors have confidence in the integrity of markets as a whole. And, to have that confidence, investors need to know the benchmarks—the minimum standards—to which market participants are held accountable. Kothari's approach instead asks investors to evaluate, on a company-by-company basis, whether the disclosure is complete and of high quality. Such an approach would, in my view, reduce investor confidence in the integrity of U.S. capital markets. This, in turn, would cause investors to increase the general risk premium that they apply to *all* market participants, including even those companies that had elected to make complete and high-quality disclosures.

Markets can and should compete on the basis of quality, and high-quality minimum disclosure standards are an emblem of U.S. capital markets. These high minimum requirements, combined with effective enforcement of the requirements, give investors a level of confidence that allows them to reduce the overall (that is, not specific to an entity or an industry) risk premium built into the cost of capital. The success of the U.S. capital markets in attracting foreign listings—well over 1,000—demonstrates that our markets are competitive. Foreign companies are not required to list in the United States and subject themselves to the exacting U.S. disclosure regime. Instead, it is something they elect to do in order to capture the advantages offered by U.S. capital markets—incredibly large, stable pools of capital, unavailable anywhere else in the world.

Let us look at Kothari's example of the German Neuer Markt, with its requirement that companies use either U.S. GAAP or IASC standards for financial reporting. Kothari views the Neuer Markt as an example of companies voluntarily moving to high-quality disclosure, and of the peaceful coexistence of in one economy of firms with high and low quality of public disclosure. I view the situation quite differently. To me,

the Neuer Markt is an example of a nascent market seeking to validate itself and establish immediate legitimacy by requiring use of the world's two most demanding and complete sets of accounting standards. The Neuer Markt, and the companies listing on that market, are seeking to establish credibility for the market as a whole on the basis of their high-quality reporting requirements.

U.S. disclosure requirements, including those for financial reporting, are a cornerstone of investor confidence, because they spell out a very real minimum of information that each investor has the right to expect from every company competing for her investment dollar. To remove this minimum, and instead just warn investors that each company is free to provide the level of disclosure that the company believes maximizes its cost-benefit computation, abandons the basic tenet of 65 years of U.S. market regulation: full and fair disclosure.

Having spent some time embracing and repackaging Kothari's argument to arrive at a different conclusion, I would like to end by reverting to an area where we are in complete agreement: the belief that *enforcement* is a key determinant of the quality of financial reporting and, ultimately, of securities markets. The activities grouped by Kothari under the label "enforcement" take place in several layers, each of which leverages and reinforces the other. First is the requirement that public companies file financial statements that have been audited by an independent auditor. This is the single most critical enforcement mechanism for ensuring complete and faithful application of U.S. disclosure requirements, in particular, U.S. accounting standards.

The SEC always has recognized the crucial role of auditors in the application of accounting standards. Auditors are, for example, the *only* outside professionals a company is required to hire before offering securities to the public. Because the role of auditors, and audits, is so critical, the SEC explored several different facets of effective audits in its concept release on international accounting:

- High-quality auditing standards;
- Auditing firms with effective quality controls worldwide; and
- Profession-wide quality assurance.

Questions in the release about these topics go to the issue of how accounting standards are in fact implemented in different national environments.

Meanwhile, the United States continues to look critically at audits in a domestic context, too. Initiatives are under way in several areas to raise the quality and effectiveness of audits. First, two weeks ago a group called the Panel on Audit Effectiveness[1] (also known as the O'Malley

[1] This report is available at <www.pobauditpanel.org>.

Panel) published a report aimed at strengthening the effectiveness of independent audits. The Panel was established in 1998 by the independent oversight body for the accounting profession, the Public Oversight Board (POB), at the request of SEC Chairman Arthur Levitt. The report includes recommendations for restructuring the POB and for strengthening the U.S. peer review process. And shortly, the SEC is due to consider a proposal to modify current auditor independence requirements.

The second layer of "enforcement" is the SEC's Division of Corporation Finance, or "Corp Fin" as we call it. Corp Fin is responsible for processing and reviewing the filings of all SEC registrants. These reviews involve a team of staff lawyers and accountants who review the financial and nonfinancial disclosures made by a company. The review team will write to the company with any questions about information that appears incomplete or inconsistent with our disclosure requirements, including the requirements of accounting standards. It is not at all unusual for this process to result in revisions to a company's filings—and enhanced disclosure for investors.

Corp Fin's review is important, both as a deterrent and as a problem identification process. It is a deterrent just as the threat of an IRS audit is a deterrent to cheating on a tax return—and the chances of a filing being reviewed by the SEC are much higher than the chances of being audited by the IRS. For example, in 1998 Corp Fin reviewed the filings of approximately 21 percent of U.S. registrants. I think that the SEC's international reputation as a "strong enforcement agency" stems in part from the fact that the SEC is one of the very few securities regulators that actively reviews the disclosure documents that are filed with it. In most other countries, a much less exhaustive review is carried out—and by the stock exchanges, rather than by the securities regulator.

The third, and by no means least important, element of the SEC's enforcement activities is the traditional, after the fact, investigation and prosecution that are carried out by the SEC's Division of Enforcement—that is, the SEC's law enforcement activity. About half of the SEC staff are involved in enforcement. Their work resulted in the initiation of over 475 cases in 1998. And the SEC's work is augmented by criminal investigations and prosecutions by the U.S. Department of Justice.

Together, audits, review and comment, investigation, and prosecution all add up to a powerful tool-kit for promoting rigorous enforcement of requirements. They work to back up the disclosure commitment made by companies to investors.

I hope that my remarks show how the issues raised by Kothari can be regarded as challenges to be addressed in delivering effective financial reporting rather than as an excuse for a return to a caveat emptor, free-for-all.