CORPORATE DISCLOSURE IN A GLOBAL AGE: NEXT STEPS

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It was only a short time ago, after the Asian financial crisis of 1997-98, that the American system of corporate disclosure—the combination of Generally Accepted Accounting Principles (GAAP), Generally Accepted Auditing Standards (GAAS), the professionalism of auditors, and the rules and practices of corporate governance that are designed to ensure the timely dissemination of relevant and accurate corporate financial information—was championed as a model for the rest of the world. How much has changed since then. A series of major corporate accounting scandals involving many former and current household names—Enron, WorldCom, Bristol-Myers-Squibb, and AOL/Time Warner, among others—rocked investors' confidence in the quality of financial information published not only by these companies, but by corporations generally. The flight from stocks helped drive their prices down by roughly 25 percent through the first half of 2002 (when uncertainties over the possibility of a war with Iraq became the more dominant force affecting stock prices).

Perhaps just as surprising as the scandals themselves, however, was the remarkably swift reaction by both the public and private sectors to remedy the flaws in the corporate disclosure and governance systems that the scandals revealed. Congress enacted and President Bush signed into law the Sarbanes-Oxley Act, which among other things, created a new body to oversee the auditing profession; made it difficult for auditing firms to engage in non-audit activities; and added a raft of new, tougher criminal penalties for financial wrongdoing. Less noticed, but equally important, were reforms by the major U.S. stock exchanges, the New York Stock Exchange in particular, which adopted new listing requirements: that a majority of the members of corporate boards be independent and that the hiring and firing of auditors be vested in audit committees of boards rather than in management.

1. This article draws on George Benston, Michael Bromwich, Robert E. Litan, and Alfred Wagenhofer, Following the Money: The Enron Failure and the State of Corporate Disclosure, AEI-Brookings Joint Center for Regulatory Studies 2003.

The body charged with setting accounting standards in the United States, the Financial Accounting Standards Board (FASB), also reacted: by proposing a change in the rules governing the consolidation of the kind of "special purpose entities" (SPEs) that Enron abused. More importantly, it promised to revisit the controversial issue of whether the cost of stock options at the time they are granted should be included as an expense rather than merely reported in footnotes in corporate financial statements. Although accounting for stock options was not directly implicated in any of the corporate scandals, many observers believe that excessive grants of options to corporate executives emboldened a number of them to "cook the books" in an effort to bolster their companies' stock price (so that they could exercise their options at high prices before they fell). If U.S. GAAP had required companies to report the grant of these options as an expense—as would have been the case had not Congress, at the behest of the business community, prevented the FASB from requiring in the 1990s—it is plausible that options would not have been so liberally granted to corporate officials, thus mitigating somewhat the incentives that led some to misreport their earnings.

Notwithstanding the various reforms—as well as the efforts under way in the private sector to improve disclosure—there is, at this writing, much skepticism about how effective all of the changes will prove to be. In part, the concern centers on the rocky start of the new audit oversight board and the failure of the former Chairman of the Securities and Exchange Commission, Harvey Pitt, to inform other Commissioners and the White House of a potential conflict of interest involving the individual initially chosen to be the board's first chairman, former FBI and CIA Director William Webster (who has since resigned his post). The episode apparently was the last straw that led to Pitt's resignation the day of the mid-term elections. Furthermore, many wonder whether the SEC, despite the budget increase of roughly 20 percent it received in fiscal year 2003, nonetheless has sufficient resources to carry out its mandate effectively: to write rules implementing Sarbanes-Oxley, to investigate corporate financial reports, and to bring and successfully conclude all of the enforcement actions against offending companies that may be necessary. [2]

The guess here is that the reforms adopted by the Congress and the exchanges will prove more successful than the skeptics fear, but less effective than the optimists would wish. Those who concentrate on just the legal reforms overlook the fact that much in the business and political environment has changed as a result of the corporate accounting scandals. At the same time, other elements of the system have not changed: notably, stock options still are not required to be expensed, while the media continue to report oddities in the earnings figures of major American companies. The widely derided practice of "earnings management"—brought to public attention by former SEC Chairman Arthur Levitt—apparently seems to persist, at least among some companies.[3]

As a result, issues relating to corporate disclosure and governance are not likely to disappear from the American political agenda, especially if the economy stays weak and stock market performance remains disappointing through the 2004 Presidential elections. Likewise, corporate disclosure should continue to be of interest in Europe, where international accounting standards promulgated by the International Accounting Standards Board are set to take effect in 2005, although EU members may endorse or reject individual international standards. Elsewhere around the world, disclosure issues may also remain salient, if for no other reason than countries that were lectured to by the United States will continue to watch with some interest as America struggles to deal with its own disclosure problems.

If corporate disclosure remains of interest, what further should be done about it? This paper attempts to provide one answer by drawing attention to a conundrum that existed well before the U.S. corporate accounting scandals of 2002 and that has since received more attention in the wake of those scandals. It is the disjunction between the globalization of equities markets and the continued existence of national accounting and corporate disclosure

2. During the summer of 2002, both the Senate and House voted to authorize a 60 percent increase in the agency's budget, but in the end they actually appropriated a 20 percent increase (after the Bush Administration signaled it preferred the lower figure).
3. Since leaving his chairmanship, Levitt has set forth his views about earnings management and many other subjects in his popularly acclaimed Take on the Street: What Wall Street and Corporate America Don't Want You to Know, New York: Random House, 2002.

standards. On the surface, the movement toward a single global capital market—which is well under way although still not complete—would seem to call for a single set of accounting standards so that investors in all countries will be able more easily to compare the earnings of companies headquartered in different nations. Easier comparisons, in turn, should facilitate the allocation of capital across national borders—to those companies that most deserve it and away from those companies that do not. Furthermore, greater transparency in financial statements, which a single set of accounting standards should make possible, in principle should lower the overall cost of capital for *all* companies in the capital markets by increasing investor confidence in the information available to make investment decisions. There also seems to be investor demand for a single world standard, although disagreement about which one. In a survey conducted by McKinsey and reported in the summer of 2002, 90 percent of large institutional investors worldwide wanted companies to report their results under a single world standard, although European and American investors had very different preferences. Seventy-eight percent of the Europeans favored the international accounting standards set by the IASB, while 76 percent of the Americans preferred U.S. GAAP.[4]

At this writing, two of the main accounting standards setters in the world—FASB and the IASB—in fact are working to harmonize the differences in their standards to achieve these very goals. The IASB's proposed rule on expensing of stock options, on which the FASB also has sought comment, should provide the first major test of whether the standards-setters can realize their more ambitious objective of harmonizing all of the other standards.

I take in this paper a contrarian and skeptical view of both the likelihood that the world in fact will soon see a single set of accounting standards and, just as important, whether that is a desirable outcome. Instead, I lay out an alternative vision, one involving a *competition* in standards, which I believe is likely to be more flexible in the face of change and even more investor-friendly than a single set of standards overseen by a single body. I also discuss the critical issue of enforcement. Even if somehow the reporting standards themselves are

4. See McKinsey Global Investor Opinion Survey on Corporate Governance, July 2002, http://www

harmonized, if the systems for assuring their enforcement produce different outcomes in different countries, then investors still will not be able have confidence that reported figures for different companies can be easily compared. Bringing greater consistency to enforcement of standards across countries is a critical, very difficult, and easily overlooked challenge that should be addressed regardless of what one believes about the merits of harmonizing reporting standards.

THE GLOBALIZATION OF THE EQUITIES MARKETS

But first it is useful to review exactly how "globalized" equities markets are or have become. If globalization is measured simply by purchases of equities by foreigners then indeed a world capital market has been developing over time. Total cross-border portfolio equity flows among developed markets, on a net basis, now exceed $1 trillion annually.[5] Gross purchases of equities are much greater in volume. For the United States alone, gross annual purchases by foreigners of U.S. equities in the year 2000 totaled $7 trillion. The comparable figure for gross purchases by U.S. residents of foreign securities in that year was $3.6 trillion. These figures are up by a factor of roughly 10 or more over the last decade.[6]

Another indicator of the growing integration of capital markets, at least among two of the world's major equities markets, is the rising number of cross-listings by corporations whose shares are traded on both the New York and London Stock Exchanges. Companies that cross-list incur the expense of complying with the rules of multiple exchanges, but nonetheless must believe that benefits—in terms of accessing a wider base of potential investors and being more attractive to customers and suppliers—more than justify these costs.

A substitute for cross-listings, at least for trading in U.S. and European markets, is for foreign companies to trade as a Depository Receipt (DR).[7] Trading in DRs in the United

.mckinsey.com/governance.
5. "The Hunt for Liquidity", The Economist, 28 July 2001, p. 65.
6. William L. Griever, et al., "The U.S. System for Measuring Cross-Border Investment in Securities: A Primer with a Discussion of Recent Developments," Federal Reserve Bulletin, October 2001, pp. 33-50, at 640.
7. A DR is a negotiable instrument backed by the shares of the foreign firm, which are typically placed

States in 2000 exceeded $1 trillion, or about 17 percent of trading in corresponding local markets. In that same year, 115 DR offerings took place in the United States and Europe, a 32 percent increase over 1999.[8]

To be sure, measures of cross-border integration based solely on the volumes of flows can be misleading because markets for equities are far from perfectly integrated, even among developed economies where one would expect political and legal risks as well as information disclosure to be roughly comparable.[9] Rather, investors tend to have a "home country" bias, in that they typically have far lower proportions of their portfolios invested in foreign stocks than is indicated by the relative valuations of those stocks as a share of the worldwide market.[10] Various factors—including language barriers, currency exchange risk, higher transactions costs on foreign stock purchases, variations in corporate governance, and risk aversion on the part of investors to putting their money into companies with which they are not familiar—help explain why investors tend to invest disproportionately in stocks listed on home country markets, but the disparity in the kind and quality of information disclosed by companies in different countries likely also plays a contributing role. By implication, therefore, if publicly held firms around the world all had to play by the same reporting rules—in the way they calculate their financial position and how published data are verified and audited—some of the home country bias very likely would be reduced. The net result, at least in principle, would be an improvement in the allocation of capital across national boundaries.

Why the focus on disclosure for the benefit of equity investors? The overriding reason is

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in a trust with a local (U.S. or European) bank.

8. Stijn Claessens, Daniela Kingebiel, and Sergio L. Schmukler, "The Future of Stock Exchanges in Emerging Economies: Evolution and Prospects," Brookings-Wharton Papers on Financial Services, Washington, D.C.: Brookings Institution Press, 2002.

9. In addition to the sharp rise of cross-border flows of portfolio capital, flows of more permanent equity (foreign direct investment), as well as debt capital (bonds and bank loans) also have risen sharply over the past several decades, faster than the growth of trade in goods and services (and GDP). For one guide to the data, see Ralph C. Bryant, Turbulent Waters: Cross-Border Finance and International Governance, Washington, D.C.: Brookings Institution Press, 2003. See also Benn Steil, Building a Transatlantic Securities Market, International Securities Market Association in cooperation with Council on Foreign Relations, 2002.

10. Ingrid Werner and Linda Tesar, "Internationalization of Markets: How Has It Affected Stability?" *Brookings-Wharton Papers on Financial Services,* 1998. For an excellent summary of the literature on "home country bias", see Karen K. Lewis, "Trying to Explain Home Bias in Equities and Consumption," *Journal of Economic Literature*, Vol. 37, 1999, pp. 571-608.

that the current system of disclosure—by law and by practice—has developed to satisfy the needs of equities investors in particular. A related reason is that equities markets are of increasing importance and interest, not just in the United States, but around the world. For example, in the United States, the share of households investing in stock directly or through mutual funds rose from 32 percent in 1989 to 49 percent in 1998. Excluding pension fund holdings, equities have also climbed sharply as a share of household financial assets: from a low of 11 percent in 1982 to a high of 46 percent in the first quarter of 2000, before falling back to 33 percent in the third quarter of 2001.[11] Table 1 illustrates that stock ownership also has risen in other countries. The increase in equity ownership in Canada looks very much like that in the United States. However, stock ownership in Europe and Japan still lags the United States significantly (Table 1).

TABLE 1
Change in Equity Ownership in Selected Countries

Country	Initial Share or Number	Later Share or Number	Definition
Canada	23% (1989)	49% (2000)	Share of adults who own directly or indirectly
China	11 million (2000)	55 million (2000)	Number of investors
Germany	3.5% (1998)	7% (1999)	Share of adults who own directly or indirectly
Japan	14% (1989)	5% (2000)	Equity ownership of individual investors
Korea	2-3 million (1990)	7-8 million (2000)	Number of investors
Norway	14% (1994)	17% (1998)	Direct or indirect ownership

Sources: Canada–*Canadian Shareowners Study 2000,* conducted by Market Probe Canada on behalf of the Toronto Stock Exchange, http://www.tse.com/news/monthly_22.html. China–"The Rise of a Global 'Shareholder Culture," *Christian Science Monitor*, July 2000, http://www.csmonitor.com/durable/2000/07/03/p14s2.htm. Germany–"Go Global," Kiplinger's Personal Finance, May 2000, www.kiplinger.com/magazine/archives/2000/May/investing/global1.htm. Japan–"Japan's Missed Opportunity," The Globalist, June 2001, http://www.theglobalist.com/nor/gdiary/2001/06-29.shtml. Korea–*Christian Science Monitor*, July 2000. Norway–"Stock Markets Win the Masses," *Christian Science Monitor*, March 1998, http://www.csmonitor.com/durable/1998/03/25/intl/intl.7.htm.

Equity investors, or at least the industry of analysts and brokers who advise them, are interested in information that enables them to project future cash flows of the companies in

11. E.S. Browning, "Where Is The Love? It Isn't Oozing From Stocks", *The Wall Street Journal*, 24 December 2001, p. C1.

which they hold stock. This is because, in principle, the value of a share of stock is simply the present discounted value of future dividends, which are derived from cash flows. Accounting information contained in income and cash flow statements and balance sheets is a critical input in most attempts to project future performance of firms. To the extent the market deems accounting information unreliable, investors confront information risk in making investment decisions. Higher information risks, in turn, make stocks less attractive than alternative investments, depressing stock prices.

Furthermore, equity holders (as well as creditors) have reason to be concerned about the validity of the numbers presented in financial reports. They cannot personally examine the books and accounts of corporations. Nor can they directly determine that corporate assets have not been misappropriated, liabilities understated, or net income falsified.

In short, investors have a very real interest in what corporations disclose, in the trustworthiness of the disclosure, and in how and when they disclose. Enron and the other accounting episodes, at least at this writing, have cast a pall over U.S. equities and until confidence in the numbers returns, that pall is not likely to be completely lifted.

THE CASES FOR AND AGAINST A SINGLE SET OF ACCOUNTING STANDARDS

Previously, I mentioned two of the key reasons for moving to a single set of accounting standards worldwide: to improve the allocation of capital across national borders and to lower the overall cost of capital for the corporate sector. In the minds of some observers (mostly outside the United States), the Enron affair has added a third argument for moving to a single standard: the adoption of IAS in particular would improve the quality of corporate reporting because international standards are *superior* to U.S. GAAP.

Three arguments have been or can be adduced to support the third claim. One is the assertion that had Enron been required to report under IAS, it would have had to consolidate its many SPEs and thus would have shown much higher leverage. This would have discouraged lenders from providing funds to the company, and while the firm may still have gone bankrupt, it would not have been so large and taken down so many creditors when it did. A second argument in favor of IAS is that the IASB, at least recently, has been more out front on the issue of stock option expensing than the FASB. To the IASB's supporters, this boldness demonstrates that the international board is less likely to be subject to political pressure than the FASB. The third, and the broadest, argument advanced in favor of international standards is that they tend to be written as general principles rather than as detailed rules. Somewhat paradoxically, greater discretion appears to some to be an advantage in accounting standards. Pointing to the Enron affair, advocates of IAS claim that the excessive detail written into the U.S. rules invites clever managers and their lawyers and accountants to obey the letter but not the spirit of the rules. If firms instead had to follow broad principles, it is claimed, they would not be so tempted to engage in the kinds of evasive bookkeeping favored by managers of Enron and other companies involved in recent scandals.

How valid is each of these arguments in favor of a single set of accounting standards? The seemingly obvious argument that a single set of standards would facilitate comparing financial statements of companies from different countries is undercut to some degree by the claim that IAS are superior to U.S. GAAP because they allow for more discretion. To the extent this is true, then companies reporting under this standard already have some significant degree of reporting discretion. The greater is this freedom, the less comparability there must be among financial statements of different companies. But to the extent that companies reporting under IAS have some significant degree of discretion, the less comparable their financial statements must be. Even with the more detailed U.S. GAAP rules, companies have more flexibility in reporting their financial results than is commonly realized. Among other things, they can choose different depreciation schedules for fixed assets, make varying estimates of uncollected accounts, use different assumptions to determine the value of inventories (first-in, first-out or last-in, first out), and make assumptions to estimate the cost of employee benefits that will be paid in the future. In short, because of the necessary flexibility built into both major sets of standards, companies' financial reports may be less comparable than advocates of a single set of world standards may realize or admit.

As for the alleged superiority of IAS—should they be chosen as the single set of standards—the verdict also is less clear than the IAS advocates claim. It may be true that on some issues—notably the expensing of stock options and consolidation of off-balance sheet entities—IAS indeed are superior to U.S. GAAP, at least at the current time. But the greater discretion that the principles-based IAS allow is not necessarily an advantage, especially in a legal system such as the one in the United States, where certainty of the rules can be important for firms and their managers and directors as a key to avoiding liability for financial negligence. Moreover, there is no reason why managers intent on manipulating earnings would be more constrained by flexible rules than by detailed guidance; indeed, it is quite possible abuses could be worse in a more flexible system.

In any event, standards-setters at both the FASB and the IASB hope to minimize any of these drawbacks associated with a single set of standards in order to improve both the quality of the existing standards and the comparability of the financial results of companies operating under different sets of standards. The new chairman of the FASB, Robert Herz, in particular, has publicly committed that the FASB will seek to harmonize its rules with IASB over the coming years.

Even if this is a worthy objective, however, there is reason to be skeptical about its practicality. Although the specific differences between the two sets of standards can be exaggerated, the philosophical difference between them is not easily bridged. The IAS principles are fundamentally different from some of the detailed guidance in U.S. GAAP. Rewriting one or both sets of standards to meet somewhere in the middle is likely to prove difficult.[12]

Of course, the practical problems could be surmounted if the FASB decided essentially to replace U.S. GAAP with IAS. But accounting standards do not exist in a static world. New business practices and especially new financial instruments—the proliferation of derivatives in recent years is a good example—constantly test the rule setters: how should the

12. A listing of some of the key topics on which the two sets of standards differ is provided in the

existing rules be interpreted to apply to new developments, or should the rules be rewritten to take account of them?

One danger of giving any single body what amounts to a monopoly in setting standards is that, like a private sector monopoly, it would have no incentive to move quickly. Just consider the pace of the rulemaking process as it is now at the FASB or the IASB. Except for the recent haste in revising the SPE consolidation rule, the FASB typically has taken years before changing or updating its rules. The IASB has shown no greater speed in rulemaking. If the FASB gave way to the IASB, either by going out of existence or by deferring to the international body, then IASB would have a worldwide monopoly over standards-setting. Is there any reason to believe that IASB would move more quickly in such an environment than it does now? I have my doubts and point to the extensive delays associated with the proposed refinements of bank capital standards by the Basel Committee, a group of central bankers from the major industrialized countries, as a good example. If the Basel Committee cannot speedily revise its rules for banks, which however complicated they have become are not nearly as comprehensive as the full body of accounting standards, then how can one expect the IASB, if given a monopoly, to move with haste?

Moreover, those who believe, as I do, that the main problem with FASB is that its rules can be too easily overturned by the Congress (which oversees the SEC, which in turn oversees FASB), will not necessarily find comfort in moving all standards-setting to the IASB.[13] The board of that institution has 14 members, from different countries, and thus different cultures. The size and composition of the board alone slows down its decision-making. Furthermore, IASB, too, can be subject to political influence, and indeed, this would be more likely if FASB were to become less important or even dissolve. American interests accustomed to lobbying FASB, directly or indirectly through the Congress, would simply cross the ocean to London. In so doing, they would join companies and other interests from around the world.

Appendix.

13. The best example of political influence defeating a standard, of course, is FASB's attempt in the 1990s to require expensing of stock options. The FASB has also been influenced in the past by the oil and gas and financial industries affecting those sectors.

In short, granting the IASB a monopoly on standard-setting will not remove politics from the process; if anything, it may intensify it.

If, as seems likely, the IASB were slow to adapt to new market-drive developments, there may be pressure on national accounting standards-setters—assuming they continue to exist—to assert themselves by issuing “interpretations” or “clarifications” of certain international standards. This pressure is especially likely to surface in the United States, where the liability system engenders a strong desire for certainty, but equal pressures may also exist elsewhere. For example, even though the EU has decided that IAS will govern reporting for stock exchange listing purposes by 2005, individual EU member states already remain free to accept or reject individual international standards. The net result is that if the IASB moves too slowly, the interpretations and even new rules set by the national standards-setters will gradually lead to a fragmentation of the international standards—or a situation very much like the status quo. Thus, while IAS may govern the world for a brief time, that result is likely to be unstable, much like the inexorable decay of a radioactive element.

In sum, moving to a single worldwide set of accounting standards is far more problematic than its proponents may claim. For one thing, attaining a harmonized set of standards is hardly assured. Melding the broad principles of the international standards with the detailed rules of the U.S. GAAP is likely to prove difficult, even with the best of intentions announced by the IASB and the FASB. Moreover, even if the two standards-setters could surmount their philosophical problem and arrive at a single set of standards, there is a good chance that it would fragment over time because the single world body charged with overseeing the standards is not likely to be responsive to future market developments. In the end, the quest for a single set of international accounting standards to be maintained through time is somewhat akin to the search for the Holy Grail—a topic of interest but a goal out of reach.

COMPETITION IN STANDARDS

If harmonization is impractical and undesirable, then what is the alternative? The answer I propose here is a true *competition* in standards. Before outlining how this might come about, I suggest the benefits of competition.

As in the private sector, competition should stimulate standard setters to keep pace with market developments and thus should help cure the foot-dragging problem that has troubled the FASB and that very likely would plague the IAS if it were given a worldwide monopoly over standard-setting. More importantly, I believe competition is the only system that is capable of diluting the role of political influence in standard setting. This is because, in a competitive environment, standard setters would have to please investors as well as reporting firms and their auditors if their standards were to have relevance in the marketplace and to be adopted by companies.

Competition among accounting standards-setters would differ in two respects from competition among firms, and admittedly these differences could be seen as limitations. First, standard setters would not have to satisfy the test of profitability that is the yardstick of success, if not survival, for private firms. In place of profits, though, competition between standard-setting bodies would be driven by members' desire to be relevant and to have their bodies continue to exist. In a competitive environment, they could not meet these desires unless they established standards that were valued by investors. Second, unlike private firms which typically have many competitors, in the situation I discuss shortly, standards setters would face a single other competitor. In other words, the accounting standards competition I envision is a duopoly, which is a very weak form of competition. Nevertheless, a choice between two standards is better than a choice of only one. Thus, despite these limitations, the standard-setting competition suggested here is preferable to a monopoly in standards.

A competition in standards could be introduced in one of two ways. One approach, pushed hard by many Europeans, would be for authorities in at least the industrialized countries to mutually recognize certain standards for stock listing purposes. Since the rest of the world outside the United States is moving toward or has already adopted IAS, as a practical matter this option amounts to allowing a competition only between IAS and U.S.

GAAP.[14] Key to this proposal is that the United States, which currently requires foreign companies using IAS to reconcile their accounts with U.S. GAAP, give up this requirement. At the same time, to keep companies from "gaming" the system, firms would have to continue reporting under the standards they choose for some set period of time (say 10 years).

An alternative way of introducing competition in reporting standards would be to allow more competition among *exchanges*. This could happen by permitting investors in participating countries to access foreign stocks directly from within their home country borders—for example, through computer screens based there—rather than having to engage a foreign broker to execute trades abroad. In a study published by the International Securities Market Association, Benn Steil recommends this option, not just for reporting standards, but also for the entire system of disclosure and corporate governance rules.[15] In particular, Steil suggests a system of mutual recognition of exchanges. Under this system a host country, such as the United States, would allow exchanges in other countries with acceptable disclosure regimes to impose their rules on corporations that they listed initially but that now also trade in the host country, provided those countries give exchanges in the host country reciprocal rights. In this way, competition among exchanges, each with different listing requirements, would bring about competition in disclosure systems, including accounting standards.[16]

The exchange-competition model has two substantive drawbacks relative to the firm-choice model, however. For one thing, embracing exchange competition requires a tolerance for competition among *entire systems* of corporate governance, insofar as these systems are the subject of the listing requirements of exchanges. In contrast, a policy of allowing firms on any exchange to choose their own reporting standard (from a predefined list) entails a much more limited form of competition. Second, in order for firms to choose among reporting

14. Although the regulation adopted by the European Commission (EC) requiring European firms to report only under IAS by 2005 would appear to obviate their choosing U.S. GAAP, it is possible that if the United States allowed companies from the EU listing on American exchanges to use IAS, the EU might return the favor at least by allowing U.S. companies to continue using U.S. GAAP if they chose..
15. Benn Steil, "Building a Transatlantic Securities Market", Zurich: International Securities Market Association (in cooperation with Council on Foreign Relations), 2002. Downloadable from http://www.isma.org/surveys/latest or http://www.cfr.org/publication.php?id=5353.
16. Steil, 2002. The main virtue claimed for exchange competition is lower trading costs, but Steil also

standards under the exchange competition model, they must actually list their shares on another exchange. While this may not be as burdensome as it once was, multiple listing still does entail some additional cost. In contrast, if firms that list on a single exchange are allowed to choose among reporting standards, they need not pay the additional expense associated with listing on another exchange simply to take advantage of its different disclosure system.[17]

Given the apparent momentum behind the current attempts to harmonize IAS and U.S. GAAP, I fully recognize that policy makers in the United States are not likely any time soon to embrace the competition-in-standards approach advocated here. Aside from the vested stake in pursuing the single set of standards, one predictable objection to a competition in standards is that it would lead to some loss in transparency because investors would have to interpret financial reports prepared under different sets of standards.

I believe that any such fear is overstated, however. As already argued, even under a single set of standards, firms have discretion in reporting their results, which means that investors do not now have the ability to make the "apples to apples" comparisons that advocates of the current system may believe are possible. Moreover, under a regime of competitive standards, private-sector analysts would have strong commercial incentives to translate or reconcile reports prepared under different standards. Admittedly, in the absence of a full reconciliation requirement, analysts would not have access to all of the information required to make totally accurate translations of financial results from one standard to the other, unless firms voluntarily provided the requisite data. But estimated reconciliations are still likely to be of use to investors. And corporations would provide the requisite data for more complete reconciliations if the markets rewarded them for doing so.

Another objection to a competition in standards might be that the "market" for

suggests that competition in disclosure regimes would encourage more disclosure.

17. Another possible objection to allowing mutual recognition of exchanges is that it could expose smaller, less sophisticated investors to greater risks (if the foreign exchanges so recognized did in fact contain higher risk stocks, with less transparent or effective corporate governance rules than apply in the home country). If this objection were valid, it could be addressed by restricting access to foreign exchanges doing business in a home country only to institutions and wealthy, sophisticated individuals.

accounting standards, like the one for operating systems in personal computers or videocassettes, is a natural monopoly. If this were true, it is conceivable that meaningful competition would be short-lived, resulting in a single winning standard. Such an outcome is indeed possible, but this possibility is not an argument against running a competitive race in the first instance and, in the process, realizing the benefits from that competition while it lasts. In any event, it is not at all clear that competition in accounting standards would reduce to monopoly.

ENFORCEMENT OF DISCLOSURE STANDARDS IN A GLOBAL AGE

I have argued elsewhere (with my colleagues) that the main problem revealed by the accounting scandals in the United States was not a defect in the accounting standards, but a defect in the mechanisms for *enforcing* those standards.[18] At first blush, the failure in enforcement seems confined to the auditors who should have detected the accounting irregularities in each case. But the public debate surrounding the scandals helped spread the blame to some of the other "gatekeepers" in the corporate arena as well: members of boards of directors who failed to properly supervise management or auditors; research analysts who "hyped" stocks when they knew better (and especially when their employers stood to benefit from large underwriting or merger and acquisition fees from the same companies the analysts covered); the credit rating agencies that failed to foresee financial problems in some of the companies; the self-regulatory body governing the auditing profession (the AICPA); and the principal regulator, the SEC, which to its credit helped uncover many of the earnings misstatements but has failed to discipline negligent auditors in the past.

As noted at the outset of this paper, various reforms have since been adopted in the wake of the scandals of 2002 to strengthen each of these gatekeeper functions. One of the controversial aspects of these reforms, of the Sarbanes-Oxley provisions in particular, is their application to foreign firms, especially foreign accountants, whose activities in the United States are subject to the new oversight board. Foreign firms view these provisions as an unjustified assertion of extraterritorial jurisdiction; Americans view them simply as an application of national treatment.

While this controversy may continue, a more interesting enforcement issue lying ahead, assuming the effort to harmonize accounting standards proceeds, is whether and to what extent nations and/or their exchanges will seek to harmonize accounting *enforcement or compliance* measures and procedures. Indeed, even if the world accepts a single set of reporting standards, the underlying objective of improving comparability of financial reports cannot be attained as long as the effectiveness of compliance with those standards differs significantly across (or even within) countries.

Note the emphasis on "effectiveness". It is not important that nations harmonize the *mechanisms* of enforcement—self-regulation, government regulation, corporate governance measures, and liability regimes. Rather, it is important that they harmonize the *results* of the measures they do employ.

This is far easier said than done. There are no well-defined metrics for assessing the quality of financial reporting by companies from different countries. Even if countries agreed to use the same compliance or enforcement mechanisms, there is no easy way to assure that these instruments, such as regulation or liability, are implemented with equal vigor and effectiveness across countries.

In principle, enforcement results could be harmonized if nations agreed to cede enforcement of the quality of audits to an international supervisory body. But this is highly unlikely to happen any time soon because governments are not keen on giving up their sovereignty on enforcement matters. Even the Basel Committee—which has carried out the most ambitious international effort at harmonizing financial regulation to date—does no more than promulgate standards (analogous in the disclosure realm to the IASB's development of international accounting standards). The Committee does not *enforce* them, leaving that job to national authorities.

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18. Benston, et al., *Follow The Money.*

Before the Enron scandal broke, there was an effort within the accounting profession, under the auspices of the International Federation of Accountants (IFAC), to ensure greater harmony among audit results. In September 2001, the IFAC's Forum of Firms (FOF), whose members comprise thirty of the world's largest accounting firms, proposed a system to periodically review members' audits of “transnational” companies. The proposal aimed initially at establishing some uniformity in audit results for companies doing business in different countries and then perhaps for a wider group of firms.

The FOF proposed to assure compliance by its members in two ways. First, peer reviews of randomly selected audits would be conducted. Second, if these reviews found that the audits were significantly below GAAS or that the numbers attested to were misleading in that they violated essential GAAP prescriptions, the firms would be fined and the individuals who carried out the audit would be disciplined. In addition, FOF member firms would pledge to dismiss their partners who were found to have been seriously negligent. The firms also would require auditing and confirming partners to sign statements attesting that they had conducted the audits appropriately and agreeing to abide by any Forum sanctions (such as the order to resign and/or pay monetary damages) if the Forum decided this was not so.

In selecting an auditor for its financial statements, a firm wanting an audit that conformed to the agreed quality standard could hire a Forum member. A firm unwilling to bear the risk of such an audit could hire another auditor. Investors could choose among firms with financial statements audited by FOF members, by members of competing groups, or by unaffiliated auditors. The market would determine which alternative was best.

The Forum exercise continues, but self-regulation appears to have been discredited in the wake of the various accounting debacles in the United States, at least for the time being and in the form in which it was undertaken. In the absence of any other constructive international effort to harmonize compliance with reporting standards, however, it would be a mistake to write off the Forum of Firms initiative. It may be the only practical way in the short run of bringing greater conformity to audit results, at least for the subset of companies with operations in multiple countries.

If national governments were to allow it, competition among exchanges would be an alternative, albeit indirect, way to harmonize enforcement among different countries. With competition, exchanges in countries known to require high-quality accounting standards for listed firms and known to enforce those requirements should attract both issuers and investors away from exchanges in countries with lower standards and less rigorous enforcement. Policy makers should therefore give more serious attention to promoting competition among exchanges, since this may also be an effective and practical way to bring about the greater harmonization in and reliability of reporting that investors appear to want. Indeed, one advantage of competition among exchanges is that it could produce greater conformity across a wider class of firms than just the multinationals that are the object of the Forum of Firms exercise. The untested element of exchange competition, however, is whether issuers and investors would value differences in the quality of accounting standards and in compliance with them when choosing among stocks listed on competing exchanges.

CONCLUSION

For those interested in the subject of corporate disclosure, these are interesting—and indeed exciting—times. But not by choice. The scandals surrounding the disclosure failures and shortcomings associated with Enron, WorldCom, and certain other large public companies have put the spotlight of public attention on accounting and disclosure policies in a way many may never have imagined, or certainly welcomed.

After the dust has settled on the reforms adopted in the United States in response to these developments, policy makers in that country and elsewhere are likely eventually to turn their attention to how disclosure rules and practices ought to be changed in light of the increasing globalization of equities markets. At this writing, there is momentum behind the harmonization of the very different rules of U.S. GAAP and IAS, and perhaps the replacement of the former with the latter.

This article takes a skeptical view of harmonized standards, questioning both the feasibility and the wisdom of the enterprise. Instead, it embraces the virtues of a competition in standards, either through mutual recognition of U.S. GAAP and IAS, in particular, or through recognition of the rights of exchanges from different countries to conduct business abroad.

Meanwhile, relatively little attention has been focused on ensuring greater conformity across countries in compliance with standards. As of this writing, the only practical way of furthering this objective, however discredited in the wake of Enron, is the peer review mechanism proposed by a group of multinational auditing firms. Greater competition among exchanges might also promote more conformity of audit results across national boundaries.

APPENDIX

KEY AREAS OF DIFFERENCE BETWEEN IAS AND U.S. GAAP

There are a limited number of areas in which international accounting standards differ from U.S. GAAP, although they are too numerous to discuss in detail. This appendix lists some of the more notable differences. Aside from the philosophical difference discussed in the text, the specific differences include:

- Methods of accounting for leases
- Rules for consolidating off-balance sheet entities
- Accounting for goodwill and other intangibles
- Accounting for mergers and acquisitions
- Recording of research and development expenditures (capitalization versus expensing)
- Differences over "fair value" accounting (although both sets of standards generally embrace the concept)
- Accounting for financial instruments
- Treatment of stock options
- Line of business, or segment, reporting
- Presentation of financial results (in financial statements)