

INTERNATIONAL HARMONIZATION OF ACCOUNTING STANDARDS FOR MULTINATIONAL ENTITIES

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Abstract

In this work paper we intend to present an overview of the Securities and Exchange Commission (SEC) and the laws and regulations that a publicly held company must follow. The need for regulation has gone hand in hand with the offering of securities to the general public. The ability of companies to raise capital in the stock markets and the hundreds of millions of shares that are traded daily both indicate the SEC's success in maintaining an effective marketplace for companies issuing securities and for investors seeking capital investments.

Key words: reporting requirements, multinational entities, accounting standards

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I. INTRODUCTION

The need for regulation has gone hand in hand with the offering of securities to the general public. In the thirteenth century, King Edward I of England established a Court of Aldermen to regulate security trades in London. In the latter part of the eighteenth century, England's Parliament passed several acts, termed the Bubble Acts, to control questionable security schemes that had become popular. In 1790, the New York Stock Exchange was created to serve as a clearinghouse for securities trades between members of the exchange. The need for additional sources of capital paralleled the advent of the industrial revolution and the growth of commerce in the United States. Some individuals took advantage of this situation and offered securities of fictitious companies for sale to the general public or used financial reports that were not factual about the offering company's financial picture. In 1911, because of the lack of any federal security regulatory laws, several states began passing what were called "blue sky laws" to regulate the offering of securities by companies made up only of "blue sky", that is, which did not have a sound financial base.

II. LITERATURE RIVIEW

Since 1920, one of heavy stock speculation by many individuals, Business executives, cabdrivers, and assembly-line workers all wanted to participate in the many stocks opportunities that existed at that time. Unfortunately, a number of abuses were occurring in the marketplace. For example, certain speculators sought to manipulate selected stock prices by issuing untrue press releases about companies' operations or managements. Companies were not required to be audited, and some of them issued false and misleading financial statements. Investors were using excessive amounts of margin; that is, they were borrowing heavily to invest in stocks. Some employees of companies were using inside information-information that had not been released to the public-to purchase or sell their company's stock for personal advantage.

The month of October 1929 is often viewed as the beginning of the Great Depression. Stock prices plunged to record lows within just a few weeks as panic took over the market it became obvious that some form of federal regulation was necessary to restore confidence in the stock market. The Federal Securities Acts of 1933 and 1934 were part of President Franklin D. Roosevelt's New Deal legislation. The Securities Acts of 1933 regulated the initial distribution of security issues by requiring companies to make "full and fair" disclosure of their financial affairs before their securities could be offered to the public. The Securities Exchange Act of 1934 required all companies whose stocks were traded on a stock exchange to periodically update their financial information. In addition, the 1934 act created the Securities and Exchange Commission (SEC) and assigned it the responsibility of administering both the 1933 and 1934 acts.

The SEC has the legal responsibility to regulate trades of securities and to determine the types of financial disclosures that a publicly held company must make. Although the SEC has the ultimate legal authority to establish the disclosure requirements, it has worked closely with the accounting profession to prescribe the accounting principles and standards used to measure and report companies' financial conditions and results of operations. The SEC's role is to ensure full and fair disclosure; it does not guarantee the investment merits of any security. Stock markets still operate on a *caveat emptor* ("Let the buyer beware") basis. The SEC has consistently taken the position that investors must have the necessary information to make their own assessments of the risk and return attributes of a security.

In 1935, its first year of full activity, only 284 new securities were registered for sale to the general public. Now the number of new securities being registered for sale is more than 5,000 per year. The SEC also regulates more than 10,000 securities brokers and dealers and must monitor stock exchange volumes often surpassing a billion shares a day.

III. INTERNATIONAL HARMONIZATION OF ACCOUNTING STANDARDS FOR PUBLIC ENTITIES

In the late 1980s, the Securities and Exchange Commission's urged the International Organization of Securities Commission (IOSCO) to increase its efforts to narrow the alternative accounting treatments allowed for international accounting standards. The SEC is examining the possibility of designating a set of accounting standards that could be used by overseas companies wishing to enter the U.S. capital market. Currently, foreign registrants must reconcile their financial reports to U.S. GAAP. The U.S.'s accounting principles are often more restrictive than those in other countries.

The worldwide economy has a number of major securities exchange in with firms can seek equity capital. The SEC seeks to preserve the international prestige of the U.S. capital markets by providing a wider forum for international firms. With the encouragement of the SEC and the IOSCO, the International Accounting Standards Board (IASB) is working with the Financial Accounting Standards Board (FASB) to develop a uniform set of accounting and financial reporting standards that could be used by all companies seeking financing through any of the world's major stock markets, including those of the United States. While the IASB and FASB continue their work, the SEC has formed a number of mutual agreements for cross-border filings, for example, to allow registrant to use domestically prepared financial statements for U.S. firms filing in Canadian capital markets and for Canadian firms filing in U.S. capital markets. However, these mutual agreements are only a steppingstone to the eventual acceptance of standardized accounting for securities offerings in any of the major international securities exchanges.

IV. SECURITIES AND EXCHANGE COMMISSION

4.1. Organizational Structure of the Commission

The SEC's five commissioners are appointed by the president of the United States with the advice and consent of the Senate. Figure 14-1 is an organizational chart of the Commission showing the four separate divisions and the major offices of the 18 that must report directly to the Commission. The four divisions, and their primary responsibilities, are as follows:

1. *Division of Corporation Finance.* Develops and administers the disclosure requirements for the securities acts reviews all registration statements and other issue oriented disclosures. This is the division with which accountants are most familiar because all registration forms are submitted to it.
2. *Division of Enforcement.* Directs the SEC's enforcement actions. This division has several options for enforcement ranging from persuasion to administrative proceedings to litigation. An administrative proceeding often is used to gather evidence and present findings on a specific issue, such as a significant shareholder not filing proper reports with the SEC. Many of the administrative proceedings result in a consent action by a registrant, stock market participant, or professional practicing before the SEC in which the party accepts the judgment of the SEC. Litigation is used for serious infractions of the laws administered by the SEC, such as when a securities broker engages in the fraudulent sale of securities.
Litigation can result in injunctions to discontinue actions as well as civil or criminal sanctions.
3. *Division of Investment Management.* Regulates investment advisers and investment companies.
4. *Division of Market Regulation.* Regulates national securities exchanges, brokers, and dealers of securities.

Several offices support these divisions, of which one of the most important for accountants is the Office of the Chief Accountant. This office assists the Commission by studying current accounting issues and preparing position papers for the SEC to consider.

The other major offices listed offer the Commission advice on a variety of economic and regulatory matters.

4.2. Laws Administered by the SEC

In addition to the Securities Acts of 1933 and 1934, the SEC is responsible for administering other laws established to regulate companies or individuals involved with the securities markets. The laws are as follows:

1. *Public Utility Holding Company Act of 1935.* This prohibits artificial pyramids of capital in public utilities and allows the SEC to restructure those "holding companies" whose only purpose is to concentrate the stock voting power in a few individuals.
2. *Trust Indenture Act of 1939.* This requires a trustee to be appointed for sales of bonds, debentures, and other debt securities of public corporations, thus bringing in a bonded expert and administer the debt.
3. *Investment Company Act of 1940.* This controls companies such as mutual funds that invest funds for the public. These companies must be audited annually, with the auditor reporting directly to the SEC.

4. *Investment Advisors Act of 1940*. This requires complete disclosure of information about investment advisers, including their backgrounds, business affiliations, and bases for compensation.
5. *Securities Investor Protection Act of 1970*. This created the Securities Investor Protection Corporation (SIPC), an entity responsible for insuring investors from possible losses if an investment house enters bankruptcy. A small fee is added to the cost of each stock trade to cover the costs of the SIPC.
6. *Sarbanes-Oxley Act of 2002*. This created the Public Company Accounting Oversight Board (PCAOB) and created a number of responsibilities for audit committees of publicly held companies and for public accounting firms.

The SEC is often asked for assistance in the administration of two other major laws, as follows:

7. *Foreign Corrupt Practices Act of 1977*. This amended the 1934 Securities Exchange Act. It requires accurate and fair recording of financial activities and requires management to maintain an adequate system of internal control.
8. *Federal Bankruptcy Acts*. The SEC provides assistance to the courts when a publicly held company declares bankruptcy. The SEC's primary concern in these cases is the protection of security holders.

4.3. The Regulatory Structure

Many people beginning a study of the regulatory structure of the SEC are overwhelmed by the myriad of the regulations, acts, guides, and releases the Sec uses to perform its tasks. It is easier to understand how the SEC operates after obtaining a basic understanding of these public documents and the nature of the SEC's pronouncements.

The Securities Act of 1933 and the Securities Exchange Act of 1934 are broken down into rules, regulations, forms, guides, and releases. The regulations establish compliance requirements; for example, the regulations of the 1933 act detail specific reporting requirements for special cases such as small companies. The forms specify the format of the reports to be made under each of the acts. The guides provide specified additional disclosure requirements for selected industries such as oil and gas, and banks. The releases are used for amendments or adoptions of new requirements under the acts.

Two major regulations, *Regulation S-X and Regulation S-K*, govern the preparation of financial statements and associated disclosures made in reports to the SEC. Specifically, Regulation S-X presents the rules for preparing financial statements, footnotes, and the auditor's report. Regulation S-K covers all nonfinancial items, such as management's discussion and analysis of the company's operations and financial position.

The SEC needed some reporting vehicle to inform accountas about changes made in disclosure requirements, regulatory changes in the auditor-client relationship, and the results of enforcement actions taken against participants in the financial disclosure or securities trading process. Before 1982, the SEC used Accounting Series Releases (ASRs) for this purpose and had issued 307 ASRs covering a wide range of topics. In 1982, these ASRs were classified as covering either financial accounting topics or enforcement actions. Regulatory actions of the SEC are now provided on the SEC's Website. Those governing reporting and financial accounting requirements are identified by a release number that begins with the number of the securities act being changed or amended (e.g., Release No.33-8545, Release No.34-51293, and so on).

The *Accounting and Auditing Enforcement Releases (AAERs)* present the results of enforcement actions taken against accountants, brokers, and other participants in the filing process. Most of these actions result from the filing of a false or misleading statement. The SEC can use administrative proceedings, in which case the hearings take place before an administrative law judge (ALJ) who is independent of the

Commission. Both the Sec and the defendant are allowed to present evidence. The administrative law judge then issues a report which includes the findings of act and the recommended sanction, such as barring a person from further participation in auditing publicly traded companies or from employment as a broker or a member of management of a publicly traded company. In more serious cases, the Sec may file a complaint with a federal court seeking injunctions prohibiting illegal acts or practices, or other court orders seeking civil monetary penalties or other forms of sanctions.

An interesting example of a civil action is presented in Litigation Release No.17588, on June 27, 2002. It is also identified as Accounting and Auditing Release No. 1585. The title of the release is, "SEC Charges WorldCom with \$3.8 Billion Fraud. Commission Action Seeks Injunction, Money Penalties, and Prohibitions on Destroying Documents and Making Extraordinary Payments to WorldCom Affiliates and the Appointment of a Corporate Monitor". This litigation release presents the initial SEC action against WorldCom for its massive accounting fraud in which the company capitalized and deferred, rather than properly expensing, approximately \$3.8 billion of costs. This fraud eventually led to the bankruptcy of WorldCom and the indictments of several of the company's top management.

The *Staff Accounting Bulletins (SABs)* allow the Commission's staff to make announcements on technical issues with which it is concerned as a result of reviews of SEC filings. The SABs are not formal actions of the Commission; nevertheless, most preparers do follow these bulletins because they represent the views of the staff that will be reviewing their companies' filings.

A recent example of a Staff Accounting Bulletin is SAB No.101, "Revenue Recognition in Financial Statements", issued in 1999. SAB No.101 focused on the several revenue recognition procedures the SEC staff found inconsistently applied by registrants. One special item was the discussion of revenue recognition by the "New Economy" Internet firms. These companies focus on revenue growth, and many do not report any positive income. Analysts and stock market investors gauge these companies based on their revenue growth. For example, Company A's Website. Customers place their orders and provide a credit card number to A's Internet site. Company A then forwards the order to Company T, which ships the goods to the customer. The goods normally cost \$200, for which Company A receives \$20 for facilitating the sale. The question is this: Can Company A record the entire \$200 gross sale and a \$180 cost of goods sold to report its profit of \$20, or should Company A record just the net \$20 sale commission as it revenue? SAB N0.101 states that the revenue should be reported on the net basis, not the gross basis that the SEC staff believes inflates both the reported revenue and cost of gross sold. As viewed by the SEC staff, Company A did not take title to the goods, did not incur the risks and rewards of ownership of the goods, and was only an agent or broker for Company T for which it received a commission or fee.

The 1933 and 1934 securities acts provided the SEC with broad regulatory powers to determine the accounting and reporting standards for publicly traded companies. The SEC has generally relied on the accounting profession to establish accounting standards through creation and support for a standard-making body, for example, the APB and the FASB. The cooperation between the SEC and the FASB has worked with varying levels of success. The FASB is sensitive to the changes in the business world and attempts to react quickly to these changes by promulgating new accounting standards when needed. The SEC, however, continues to fulfill its responsibility by issuing releases on subjects hat it believes must be addressed.

4.4. Accountants' Legal Liability in the Registration Process

Accountants play a key role in the preparation of the registration statement. The company's own accountants prepare the initial financial disclosures, which are then

audited by the company's independent accountants. The 1933 act created a very broad legal liability for all participants in the registration process, and this legal exposure is particularly high for accountants because financial disclosures make up the majority of the registration statement. Under section 11 of the 1933 act, accountants are liable for any materially false or misleading information to *the effective date* of the registration statement. The underwriters handling the sale of the securities often require a "comfort letter" from the registrant's public accountants for the period between the filing date and the effective date. This comfort letter provides additional evidence that the public accountant has not found any adverse financial changes since the filing date. Plaintiffs suing the accountant are not required to show they relied on the registration statement, only that the statement was wrong at the effective date! Accountants have a "due diligence" defense, the result of interpretation by the courts as to what is generally required in a reasonable investigation of the company's financial position; however, the broad legal exposure causes many anxieties for accountants involved with the offering of securities.

*SARBANES – OXLEY ACT OF 2002*¹ - a major law affecting auditors and publicly traded companies were signed into law on July 30, 2002. The proposed law gained impetus after the revelations about accounting and financial mismanagement at Enron, WorldCom, and others. Named after its two sponsors, Senator Paul Sarbanes and Congressman Michael Oxley, the *Sarbanes-Oxley Act* (broadly known as SOX) has a number of major implications for accountants. Its supporters hoped that the act would minimize corporate governance accounting and financial reporting abuses and help restore investor confidence in the financial reports of publicly traded companies.

CORPORATE RESPONSIBILITY:

- *audit committees* are composed of non management members of a company's board of directors. Generally the chair of the audit committee has financial experience. The Sarbanes-Oxley Act requires the auditor to report directly to, and have its work overseen by, the company's audit committee, not the company's management. The audit committee is responsible for the appointment, compensation, and oversight of the work of the public accounting firm employed by the company. Furthermore, the audit committee must approve all services provided by the auditor, and the auditor must report the following additional information to the audit committee; critical accounting policies and practices, alternative treatments within GAAP that have discussed with the company's management, accounting disagreements between the auditor and management, and any other important issues arising between the auditor and management.

- in the case of accounting restatements due to the material noncompliance of the issuer, the CEO and CFO must forfeit bonuses and incentive compensation provided on the basis of the incorrect accounting information.

SEC is charged with conducting various studies, including the factors leading to the consolidation of public accounting firms since 1989 and the impacts of that consolidation, the role of credit rating agencies in the securities markets, and whether investment banks and financial advisers assisted public companies in earnings manipulation and obfuscation of financial conditions.

CORPORATE AND CRIMINAL FRAUD ACCOUNTABILITY:

The act established severe penalties for anyone who destroys records, commits securities fraud, or fails to report fraud. The penalty for willfully failing to maintain all audit or review work papers for at least five years is a felony punishable by up to 10

¹ www.sec.gov/about/laws/soa2002.pdf

years. Section 802 of the act specifies that persons destroying documents in a federal or bankruptcy investigation are punishable by up to 20 years. The criminal penalty for securities fraud was increased to 25 years.

The statute of limitations for the discovery of fraud increased to two years from the date of discovery and five years after the actual fraud. Previously, it had been only one year from the date of discovery and tree years after the actual fraud. Section 806 provided “whistleblower protection” to employees of the company or the accounting firm who lawfully assist in an investigation or fraud or other criminal conduct by federal regulators, Congress, or supervisors.

V. CONCLUSIONS

All the reglementations mentioned above in this work paper, have played a significant role in the development of financial disclosures necessary for investor confidence in the capital formation process. We support the presentation in financial statements for full and fair disclosure of information it considers necessary so investors can assess the risks and returns of entities wishing to offer their securities to the public. All international bodies, in particular those to which we made reference, have the responsibility to develop and maintain accounting principles used for financial reporting.

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