STATEMENT OF

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BEFORE THE HOUSE COMMITTEE
ON FINANCIAL SERVICES

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE
AND GOVERNMENT SPONSORED ENTERPRISES

CONCERNING

PROMOTION OF INTERNATIONAL CAPITAL FLOW
THROUGH ACCOUNTING STANDARDS

JUNE 7, 2001

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Thank you, Chairman Baker, for allowing me the opportunity to share my perspective about the role accounting standards play in encouraging the global flow of capital.

It may be illustrative to use a rough analogy in opening our discussion of this very complex issue. International accounting standards to be used in the preparation of financial reports throughout the world are somewhat like international rules of driving. Both establish a fundamental, commonly understood language. The road signs signifying what is permissible, for example, are analogous to the rules governing what is presented in financial statements and what those presentations mean. Both lead to greater ease of movement — whether traffic or capital — across borders.

Now consider the quality of the rules. If we had common traffic rules across all nations, but they allowed people to misinterpret traffic signs or did not make clear which traffic had the right of way, the global total of accidents would likely rise. It is only when common rules represent a gain in quality that the reduction in incompatibility serves the common good. In the case of accounting rules, more compatible financial presentations make it easier for investors to compare companies and make it easier for companies to file in different markets. But that is not enough. The rules must also provide the information that gives investors a reasonable chance to make good decisions. Capital flows in the end are based on decisions by investors, not merely ease of securities registration. And capital flows do not serve economic growth unless they represent economically useful decisions.

Herein lies the issue. Common “rules of the road” are not enough. They must be effective. When the word “transparency” is used, those who use it typically assume that it means better quality information. That is assuredly the right goal. But mere uniformity in accounting rules will not guarantee better quality information. The uniform rules must require better quality information.

This point is especially important at this moment in the history of the world economy and in the development of accounting standards. The economy has changed in many ways, and accounting must adapt to provide the information investors need to make good decisions. I would like to pursue this issue with you, because it is, to my mind, vital to how we view international accounting standards.

The current financial reporting model — in the U.S. and overseas — is very much based on the assumption that profitability depends on physical assets, like plant and machinery; on raw materials, like coal, iron ore, sheet metal, electrical wire, and plastic; in other words, on the tangible assets needed to produce tangible products. This is the financial reporting model of the industrial age.

But, as we all know, we are no longer in an industrial age. We still have elements of it, of course, and we always will, but we have moved deeply into the information age.

Today's economy is different from anything we have dealt with before. It is founded upon new technologies, globalization, and the increasing importance of intangibles, such as brands, relationships, people, systems, and knowledge. Companies are creating value in different ways, using new combinations of tangible and intangible assets. In fact, it is the combination and interaction of various types of assets that will determine a business's economic success.

Alan Greenspan put it succinctly when he said that "virtually unimaginable a half-century ago was the extent to which concepts and ideas would substitute for physical resources and human brawn in the production of goods and services."

Those looking to deploy their capital do not restrict the kind of information they use to only financial information. They also use non-financial information, such as information about top executives, product developments, and capacity for innovation. There should be no surprise here that non-financial information has been considered useful. This Committee's predecessor in 1991 required insured depository institutions to begin to report on internal controls and auditors to express an opinion about management's assertions.

There is good reason to believe that the accounting model should not be limited to financial information. You may know of the AICPA Special Committee on Financial Reporting, the so-called "Jenkins Committee." It described investor information needs that go far beyond what is required by the current financial reporting model and included non-financial information. In fact, to capture the idea of reporting non-financial information, the Jenkins report adopted the broader term "business reporting."

Those with capital will not invest it if they are unable to estimate to their own satisfaction the potential returns on their investments. They depend on information to make these decisions. Thus the amount and quality of the information available to investors affects the volume of capital flows.

Now consider the effect of the amount and quality of information on economic growth. Capital must be deployed where it can be most productive, or it will not contribute maximally to economic growth. At the root of productive investment is information. Those with capital cannot select the most productive companies unless they have information that lets them pick winners — information that reflects how value is created by companies today. Yet most of these are not recognized by the current accounting model.

Important work is in progress by scholars. But looked at even nationally, our country's effort is far from what is needed. We are not addressing this issue in a manner commensurate with its importance to investors, the economy, and our future.

The timeliness of business information is as critical to its usefulness as its relevance. Investors cannot make effective decisions with out-of-date information. Yet corporate prospects don't just vary annually or quarterly. Thus the timeliness of business reports is also essential to the effective flow of capital around the globe. This is another area where progress can be made. The capabilities for more rapid disclosure are coming into being. The Internet provides a remarkable communications vehicle. Many companies already make investment information available on their Web sites. Computers, telecommunications, and increasingly powerful software are also revolutionizing internal corporate accounting. Cisco Systems, for example, can “close its books” — traditionally a process measured in weeks — in mere hours.

The capabilities I have been describing will allow a frequency and richness of disclosure that is more helpful to investors, because it is more closely aligned with the pace of change in corporate prospects.

I make my statement in favor of the need to improve the quality of accounting standards as a member of the AICPA, which has a strong record of support for international standard setting. The AICPA was a founding member of the International Accounting Standards Committee (IASC), and has used its best efforts to support the IASC’s work since 1973. Through its Accounting Standards Executive Committee, the AICPA has commented on all IASC proposals in the core standards work program. In addition, the AICPA appoints one of two U.S. delegates to the IASC, provides a technical adviser to the U.S. delegation, and has provided members of IASC steering committees.

The AICPA appreciates the efforts of the IASC, and we recognize the significant progress that has been made since the International Organization of Securities Commissions and the IASC initiated the core standards work program. We recognize the effectiveness of the IASC’s Framework for the Preparation of Financial Statements as a sound basis for the development of the core standards, although we believe that a reconciliation to U.S. GAAP for foreign filers should continue. We supported the recent restructuring of the IASC and believe it should be capable of producing high quality international standards. Nevertheless, we call upon all parties to recognize in the most forthright manner and with determination the urgent need to improve the quality of disclosure.

I previously cited the work of the Jenkins Committee and pointed out that it was based on research into investors' needs. The Jenkins Committee produced and recommended an accounting model that included non-financial information. It is hard to believe that the Committee's report was produced in 1994 and so little has been done in response. If investors' needs were not being met then, they are likely being met even less well today.

The information needs I have been describing were just recently underscored by the findings of the "Garten Task Force," an independent group formed by Dean Jeffrey E. Garten of the Yale School of Management at the request of former SEC Chairman Arthur Levitt. The report, "Strengthening Financial Markets: Do Investors Have the Information They Need?", concluded there was much room for improvement and made two recommendations: the Task Force called for the creation of a new framework for supplemental reporting of intangible assets and operating performance measures and, equally important, the fostering of an environment that encourages innovation in disclosure.

The SEC should heed the advice of the Jenkins Committee and the Garten Task Force and encourage registrants, auditors, and standard setters to develop and present more relevant and timely information to investors, and it should reduce regulatory barriers to useful innovations along these lines.

Clearly, I believe that more can and should be done to provide investors with relevant, timely financial and non-financial information, reflecting both tangible and non-tangible assets. Without doubt, internationally accepted accounting standards will help international flows of capital. But creating international standards alone is not enough to result in meaningful or sustained improvement. I ask all relevant parties — standard setters, regulators, and the profession at large — to carefully consider the need to modernize the business reporting model to provide investors of all kinds the information they need to assess how companies create value today — in the U.S. and around the globe. We owe it to all investors around the world, and to the economy, to make sure we adapt without great delay. ■

# Robert K. Elliott

## *Immediate Past Chairman, AICPA*

Robert K. Elliott is Immediate Past Chairman of the Board of Directors of the American Institute of Certified Public Accountants (AICPA), the 340,000-member voice of the American accounting profession. He is a partner in the global accounting and professional services firm of KPMG LLP in New York City, a member of its Office of the Chairman, and a Trustee of the KPMG Foundation.

As Chairman of the AICPA, Mr. Elliott championed modernization of accounting and securities-market disclosures, reengineering of auditing, adaptation of accounting and auditing to the new economy, strengthening of self-regulation of accountants, and repositioning of the global accounting profession for the post-industrial economy.

As a member of the SEC's Advisory Committee on Capital Formation and Regulatory Processes in 1995-6, he worked toward modernization of the Securities laws in recognition of the needs of modern global capital markets.

As a member of the AICPA's Special Committee on Financial Reporting (Jenkins Committee), he helped develop a new model of business reporting for the post-industrial economy.

Mr. Elliott has received many honors and awards, including the AICPA's Gold Medal Award, the accounting profession's highest honor, and the American Accounting Association Auditing Section's Life-time Achievement Award.

He has been named to "The 100 Most Influential People in Accounting" by the publication *Accounting Today* each year since the inception of the list.

Mr. Elliott has an AB from Harvard (1963) and an MBA from Rutgers (1964). His publications number more than one hundred books and articles.

U.S. House of Representatives
Committee on Financial Services

**Disclosure Requirement**
**Required by Clause 2(g) of Rule XI of the Rules of the House and the Rules of the Committee on Financial Services**

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| 1. Name | 2. Organization or organizations you are representing: |
| Robert K. Elliott | American Institute of Certified Public Accountants (AICPA) |
| 3. Business Address and Phone Number: | |
| American Institute of Certified Public Accountants<br>1211 Avenue of the Americas<br>New York, NY 10036-8775<br>Telephone: (212) 909-5766 | |
| 4. Have <u>you</u> received any Federal grants or contracts (including subgrants and subcontracts) since October 1, 1999 related to the subject on which you have been invited to testify? | No |
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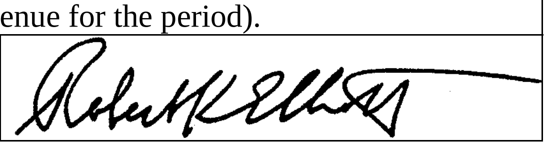
| Signature |  |

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