

INTERNATIONALIZATION

of the Securities Markets

CHAPTER IV

**Accounting and
Auditing Standards in Relation to
Multinational and International
Issues of Securities**

Prepared by the Office of the Chief Accountant

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Attachment A

CHAPTER IV

ACCOUNTING AND AUDITING STANDARDS IN RELATION TO MULTINATIONAL AND INTERNATIONAL ISSUES OF SECURITIES

A. Introduction

The accounting and auditing concepts discussed in this chapter concentrate on the United States, Canada, the Member Countries of the European Economic Community (EEC), and Japan. The markets in these countries account for the greater part of securities trading in the world today.

B. Standard Setting - Accounting Principles

The manner in which accounting principles are established varies between countries. Accounting principles are promulgated either by governmental bodies, private standard setting bodies, or a combination of the two. There are reasons for the different approaches to standard setting, including legal, cultural, economic and political. One factor that seems to have played a more significant role than others is the degree of diversity of ownership interests in business enterprises in a country. 1/ Where corporate ownership is concentrated in the hands of a few institutional holders, or where family held businesses predominate, there is often less impetus for the development of comprehensive, sophisticated financial reporting systems. Consequently, accounting professions in those countries may be less advanced and have less influence in the standard-setting processes. To the extent that

1/ John N. Turner, "International Harmonization: A Professional Goal," Journal of Accountancy (New York, NY: American Institute of Certified Public Accountants-(January, 1983)), 60.

there are generally accepted accounting principles and practices in those countries, they are promulgated largely by governmental agencies and embodied in various company laws or other statutes that are often driven by the information needs of the public sector. On the other hand, where corporate ownership is more diverse, audited financial statements take on much greater significance, and this in turn increases the influence of private sector bodies. In the United Kingdom and Australia, for example, accounting principles are broadly stated in company law and amplified through standards established by the accounting profession, generally under the oversight and with the backing of governmental entities. And, at the federal level in Canada, relevant statutory provisions defer to the recommendation of the Canadian Institute of Chartered Accountants for authoritative accounting standards.

1. Private Sector Standard Setting

Standard setting in the private sector is best illustrated by the process in the U.S. Although the government, through the SEC, does have the authority to set accounting standards, in general accounting principles are established in the private sector. 2/ The Financial Accounting Standards Board (FASB) is

2/ A detailed description of the process is contained in the "Statement of John S.R. Shad, Chairman of the Securities and Exchange Commission Before the House Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce," dated March 6, 1985.

recognized by the SEC as the private sector body having the designated authority to establish standards of financial accounting and reporting. The resulting general purpose financial statements are designed for investors and other users seeking timely, reliable information that fairly presents operating results and financial position.

In 1938, the SEC stated its policy, in Accounting Series Release (ASR) No. 4, that financial statements filed with the Commission, for which there was no substantial authoritative support, would be presumed to be misleading. This policy encouraged the accounting profession to establish standards narrowing the areas of difference in accounting practices. 3/ And, in 1938, the American Institute of Certified Public Accountants (AICPA) created the Committee on Accounting Procedure. This Committee was followed by the Accounting Principles Board (APB) in 1958, and, because of the APB's inability to narrow alternative accounting standards, 4/ by the FASB in 1972.

3/ John C. Burton, Russel E. Palmer and Robert S. Kay, Handbook of Accounting and Auditing (Boston: Warren, Gorham & Lamont, 1981), 41-8.

4/ Bruce Bublitz and Robert Kee, "Do We Need Sunset Requirements for FASB Pronouncements?" Journal of Accounting, Auditing and Finance (Winter 1984): 123

The SEC reiterated its policy of reliance on the private sector in ASR No. 150 upon creation of the FASB. The release stated, in part:

"... the Commission has historically looked to the standard-setting bodies designated by the profession to provide leadership in establishing and improving accounting principles. The determinations by these bodies have been regarded by the Commission, with minor exceptions, as being responsive to the needs of investors."

The FASB follows a multi-step process in developing an accounting standard, similar to the rule-making procedures used by government agencies. Initially, in-depth research is done. Typically, this is followed by a discussion memorandum, exposure draft, the receipt and review of comment letters from interested parties, public hearings, and the final promulgation of a standard. 5/

Although the Commission's expressed policy is to rely on the private sector for standard setting, the Commission has significantly influenced that process. The Commission exerts its influence through various programs, such as: rulemaking initiatives which supplement accounting standards, implement financial disclosure requirements and establish independence criteria for accountants; 6/ the review

5/ The Board also issues pronouncements other than standards (namely, interpretations and technical bulletins), following somewhat less extensive procedures.

6/ Many times these initiatives have triggered standard setting in the private sector. Example include lease disclosure, the moratoriums on the capitalization of interest and computer software costs, inflation accounting, and the development of supplemental oil and gas disclosures.

and comment process which results in improvement of filings, identification of emerging accounting issues (which can result in rulemaking or private sector standard-setting), and identification of problems warranting enforcement actions; the enforcement program, which imposes legal sanctions and serves to deter irregularities by enhancing the care with which registrants and their accountants analyze accounting issues; and oversight of private sector efforts to establish accounting and auditing standards and to improve the quality of audit practice. 7/

The SEC imposes requirements as to form and content of financial statements in addition to those required by generally accepted accounting principles (GAAP). These requirements are contained in Regulation S-X, 8/ which addresses those areas (generally disclosure as opposed to measurement principles) where GAAP is not explicit. 9/ Commission interpretative Financial Reporting Releases and Staff Accounting Bulletins issued by the Commission's staff also address areas where GAAP is not express.

2. Statutory Standard Setting

There are several problems that may result from the establishment of accounting principles by governmental bodies. First,

7/ U.S. Securities and Exchange Commission 1986 Annual Report.

8/ Chapter II, Title 17 of the Code of Federal Regulations, Part 210.

9/ ASR No. 280 (September 2, 1980).

tax regulations tend to influence the presentation of financial statements. This can be a significant factor in countries where the financial statements generally must agree with the tax returns. Because the objectives of fiscal authorities often conflict with the needs of investors, this conformity requirement often frustrates the fair presentation of financial condition and operating results. This is the situation in Japan, where government influence on business can be described as both pervasive and supportive. ^{10/} The Japanese government exercises its accounting standard setting authority through tax regulation, the Commercial Code, and the Securities and Exchange Law. ^{11/}

Under the tax regulations in Japan (and some other statutory countries), companies must incorporate special reserves in the financial statements in order to deduct them for tax purposes. The special reserves cause a distorted presentation of the financial statements and so would not appear in a balance sheet of a U.S. reporting entity. ^{12/} The Commercial Code, administered by the

^{10/} Leslie G. Campbell, Accounting and Financial Reporting in Japan (London: Lafferty Publications Ltd., 1985), 70

Interestingly, Japan is an exception to the general observation that statutory standard setting is most likely in countries where ownership of companies is concentrated in the hands of a few. Japanese individuals own a significant equity interest in listed Japanese companies. The 1984 Fact Book of the Tokyo Stock Exchange (P.41) places that ownership at 28% at the end of 1983. Japanese businesses accept government intervention as legitimate and necessary.

^{11/} Id. at 4.

^{12/} Id. at 5.

Ministry of Justice, is designed to emphasize the protection of creditors over that of investors. Accordingly, net worth and balance sheet strength are stressed over income measurement. 13/

Japan also has a Securities and Exchange Law which is in many respects modeled after the U.S. Securities Act of 1933 and Securities Exchange Act of 1934. Under the Japanese Securities and Exchange Law all publicly held companies must file a second set of financial statements with the Ministry of Finance, which administers the law and has the power to establish accounting and auditing standards applicable to financial statements filed with it. The Ministry has an advisory body called the Business Accounting Deliberation Council, whose members are drawn from industry, the accounting profession, government and the universities, and have an accounting background, or at least a strong interest in financial reporting. Consequently, while the net income of financial statements filed with the Ministry must be the same as statements prepared in accordance with the Commercial Code, the disclosure required under the Securities and Exchange Law is much greater. 14/ Perhaps the most significant differences under the Securities and Exchange Law and the Commercial Code are the requirements of the former for supplemental consolidated financial statements and audits by independent accountants.

13/ Id. at 8.

14/ Id. at 9.

The additional requirements of the Ministry of Finance are relatively recent and quite significant. While the Commercial Code is still extant, there seems to be a shift within the government towards acceptance of the views of the Ministry of Finance and a more economic approach in financial reporting. 15/

3. Problems Posed by Differences in Accounting Standards

Differences in accounting standards present significant obstacles to international capital raising efforts. There is the cost in terms of time and money incurred by multinational enterprises in order to consolidate divergent financial information when national laws or practice differ. 16/ In addition, capital flows may be impeded by the absence of comparable, timely financial information.

With specific reference to the U.S., the question arises whether investors are being deprived of investment opportunities because the more stringent U.S. accounting, auditing and disclosure requirements act as a deterrent to capital raising efforts by foreign issuers. For example, financial reporting for segments of an enterprise is a requirement of U.S. GAAP, but not of Japanese accounting principles. With certain exceptions, a foreign private issuer is required to provide segment information in a Securities

15/ Id. at 13.

16/ Infra, note 25.

Act filing in the U.S. 17/ Japanese issuers are reluctant to provide segment information; this appears to be one reason that some have avoided U.S. markets when selling new equity securities. In addition to their own country, those issuers have raised equity capital primarily in European markets where generally segment reporting is not required. 18/ An analysis of overseas financing by Japanese companies for the ten year period 1974 through 1983 shows the following: 19/

17/ See discussion in Part C, infra, for details of U.S. requirements for foreign issuers.

18/ Id.

19/ 1984 Fact Book, Tokyo Stock Exchange: 41.

OVERSEAS FINANCING BY JAPANESE COMPANIES

(In billions of Japanese Yen)

	<u>Stock</u>			<u>Bonds</u>						Total
	U.S.A.	Europe	Others	<u>Non-Convertible</u>			<u>Convertible</u>			
				<u>U.S.A.</u>	<u>Europe</u>	<u>Others</u>	<u>U.S.A.</u>	<u>Europe</u>	<u>Others</u>	
1974	-	-	1	3	54	-	6	10	-	73
1975	-	6	-	-	276	34	63	29	13	421
1976	30	39	5	-	250	44	26	179	5	576
1977	43	46	3	13	184	55	13	173	11	542
1978	-	6	-	14	180	30	10	328	-	567
1979	-	22	-	-	235	31	18	594	5	904
1980	12	-	96	-	173	39	13	482	-	815
1981	-	205	12	-	128	17	79	745	10	1,197
1982	42	70	8	-	539	5	70	574	36	*1,442
1983	-	75	-	-	1,147	-	-	1,063	-	*2,415

Note: Amounts include offerings by overseas affiliated or subsidiary companies.

*Including bonds with stock subscription warrants (99 billion yen in 1982, 129 billion yen 1983).

(Source: Yamaichi Research Institute)

The chart indicates that Japanese issuers have avoided U.S. markets. Although it is impossible to determine whether this results from U.S. segment requirements as opposed to other factors (e.g. interest rates in the Eurobond market are lower than in the U.S. 20/), certainly segment and other U.S. requirements are a factor. Many foreign issuers, particularly the Japanese, in comment letters written in response to the Form 20-F proposal, 21/ requested that the Commission adopt modified segment reporting. (See discussion in Part C, infra). One commentator, in a comprehensive treatment of international securities laws, 22/ states:

The principal obstacle to access by foreign issuers to U.S. capital markets in the past has been the Commission's insistence on compliance with U.S. GAAP and Regulation S-X with respect to financial statements included in 1933 Act registration statements. The new format for foreign issuers does recognize at least as a starting point what has been referred to in this Report as foreign GAAP. There has, nonetheless, been relatively little relaxation with respect to what foreign issuers find most vexatious--that is, such matters as segmental and geographic reporting which many foreign issuers claim would involve tremendous effort and expense since their books are not maintained in that fashion and which others are reluctant to disclose for competitive reasons.

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- 20/ Bartlett Naylor, "Executive Calls U.S. Securities Laws a Hindrance in World Capital Markets," American Banker, (February 28, 1986): 2.
- 21/ Edward F. Greene and Eric D. Ram, "Two SEC Actions Significantly Affect Foreign Issuers," Legal Times (December 6, 1982) 20. (See, Part C, infra, for a discussion of Form 20-F.)
- 22/ Harold S. Bloomenthal, International Capital Markets and Securities Regulation (New York: Clark, Boardman Company, Ltd.,) v. 10, 5-28, (1982).

Problems also arise because statutory accounting is inflexible. Detailed specificity in statutory systems compounds the problem, and accounting principles enacted into a country's laws can take years to change. The twelve countries which comprise the EEC 23/ illustrate this problem.

The EEC was established in 1957 to facilitate the flow of goods, services and capital throughout its Member States. Toward this objective, the EEC has sought to harmonize company law, including accounting requirements, within the Member States. This harmonization is achieved by means of directives which, when approved by the EEC Council of Ministers, obligates member countries to change their national legislation to comply with the provisions of the directive. The promulgation process is a long one, however, and implementation of the directives is sometimes delayed. For example, the Fourth Directive, adopted in 1978 and containing regulations regarding the form and content of annual reports, certain accounting measurement principles, the requirement for audits, and other matters, has yet to be enacted into law in Italy 24/ and was not enacted into German law until January 1,

23/ The twelve nations that comprise the Community are Belgium, Denmark, France, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, the United Kingdom and West Germany. Spain and Portugal became members on January 1, 1986, and have not yet adopted the accounting directives.

24/ The FAR International Omnibus 1985 (Stockholm: Foreningen Auktoriserade Revisorer FAR, 1985), 462.

1986. 25/ Work on the Seventh Directive, which requires companies to present consolidated financial statements, was begun in 1976. After a number of revisions, the EEC Council adopted the directive in 1983 and required incorporation in member countries' national legislation by 1988, with presentation of financial statements according to the directive to begin January 1, 1990. 26/

Thus, it is apparent that change may be a cumbersome, time-consuming process where accounting principles are incorporated into the laws of a country. This is exacerbated in the EEC where twelve countries are involved in the process of establishment and change.

C. U.S. Approach to Foreign Issuers

Despite many dissimilarities, some attributes of commonality do exist. Certain similarities are found in the majority of the twenty-four industrial countries which comprise the Organization for Economic Co-operation and Development. The following fundamental precepts are commonly found:

1. Accrual accounting, or the matching of costs and revenues is generally employed.
2. Accounting principles are used consistently from year to year, or the effects of changes in accounting principles are quantified and disclosed.
3. Under the theory of conservatism, profits are not anticipated, but losses are provided for.

25/ Frank Roberge, "Germans Launch Campaign to Soften European Directives," International Accounting Bulletin (January 1986): 5

26/ Supra, note 24.

4. Historical costs generally provide the basis for financial statements under the going concern concept, since it is assumed that assets will continue to be used in the business.

Such similarities provide the SEC with a basis to accept financial statements presented in accordance with accounting principles that are generally accepted in the issuer's home country if accompanied by a reconciliation to U.S. GAAP.

On the other hand, certain differences in the recognition and measurement principles applied to the elements of financial statements are troublesome. For example, a business combination accounted for under merger accounting in a European country may not satisfy the criteria for a pooling of interests under U.S. GAAP. If such transactions were effected some years ago, it may be impossible to reconstruct the accounting as a purchase and the company will be unable to reconcile the accounting to U.S. GAAP. Accounting for pensions by employers and hidden reserves (used primarily by European financial institutions) pose similar problems. On the disclosure side, segmentation of financial information by industry and geographic area poses problems because many countries require disaggregation of sales and revenues only (the only requirement under the EEC's Fourth Directive) and others require no breakdown. Since accounting systems are not designed to capture the information in the absence of a national requirement for such data, gathering the information for an initial registration with the SEC can be time consuming and costly. Additionally, as noted below, many companies object to

segmentation requirements for competitive reasons.

The accounting principles which are peculiar to specialized industries, such as oil and gas production, mining, forestry, rate regulated entities, and financial institutions may vary widely. Those differences, as well as those arising from linkage between financial and fiscal reporting, are usually susceptible to reconciliation to U.S. GAAP with varying degrees of difficulty.

The legislative history of the Securities Act indicates an intent to treat foreign private issuers the same as domestic issuers. 27/ Accordingly, the Commission generally has neither discriminated against nor encouraged foreign investment in the U.S., or investments in foreign securities by U.S. investors. 28/ The Commission has emphasized, however, that its rulemaking authority in this area is conditioned upon findings that the relevant rule or form is necessary for the protection of investors and in the public interest. 29/

During the SEC Major Issues Conference, held in Washington, D.C. in January 1977, the Commission indicated that the principal problems faced by foreign private issuers related to the accounting

27/ Hearings before the Senate Committee on Banking and Currency on S. 875. 73d Cong., 1st Sess. 89-90 (1933) and Hearings Before the Committee on Interstate and Foreign Commerce on H.R. 4314, 73d Cong., 1st. Sess. 12-13 (1933).

28/ Securities Act Release No. 6360 (November 20, 1981).

29/ Id.

and auditing requirements that must be met in order to register their securities under the Securities Act and to file appropriate reports under the Securities Exchange Act. The Commission also stated, however, that the financial information is generally the most important part of any prospectus, and indicated that the information supplied should be susceptible to comparison with that required of U.S. companies in order that investors may make informed investment decisions. Nevertheless, some accounting accommodations have been made.

In seeking comparability in financial statements, the Commission permits a foreign issuer, with certain exceptions, to prepare its financial statements in accordance with accounting principles that are generally accepted in the issuer's home country. If there are any material differences between such principles and the measurement principles of U.S. GAAP, the income statement and balance sheet must include a reconciliation of such differences to U.S. GAAP and Regulation S-X. 30/ Where a country does not have a comprehensive set of standards, or where such standards result in financial statements that are vastly different from those prepared in accordance with U.S. standards so that they are irreconcilable, the Commission requires preparation of financial statements according to U.S. GAAP. For example, until recently Japanese financial statements were sufficiently different

30/ Rule 4-01(a)(2) [17 CFR 210.4-01] of Regulation S-X.

from U.S. financial statements, particularly because the Japanese statements usually were not consolidated, that financial statements in compliance with U.S. GAAP were required. 31/

The Commission has made other accommodations in the area of financial reporting. In November 1979, the Commission adopted Form 20-F as a combination registration and periodic reporting form for foreign private issuers filing under the Securities Exchange Act. 32/ Form 20-F requires reconciliation of material differences between the financial statements included in the filing using non-U.S. accounting principles and financial statements prepared in conformity with recognition and measurement principles under U.S. GAAP. Under the minimum requirements of

31/ The staff has recently reconsidered this position in view of a subsequent requirement by the Ministry of Finance in Japan that public companies provide consolidated financial statements. The staff will accept financial statements of Japanese companies prepared on the basis of Japanese GAAP assuming that the consolidated statements are the primary financial statements, that they are prepared in conformity with sound principles, that complete footnotes are included, and that the disclosures and reconciliations required by the applicable forms are included. The financial statements will continue to be audited in accordance with U.S. generally accepted auditing standards.

32/ Securities Exchange Act Release No. 16,371 (November 29, 1979). Canadian issuers who have voluntarily entered the U.S. markets are treated the same as U.S. companies for registration and reporting purposes. Supra, note 28.

Section 12 of the 1934 Act requires the registration of securities of an issuer having more than 500 shareholders and \$5 million in total assets (Section 12(g)), and issuers listing securities on a U.S. stock exchange (Section 12(b)).

the Form, 33/ issuers are not required to include any additional disclosures required by U.S. GAAP and the Commission's Regulation S-X.

The Commission further accommodated foreign issuers by relaxing the requirement as to the age of the financial statements included in Commission filings. In adopting Form 20-F the Commission recognized that foreign issuers needed more time than domestic issuer's to prepare their reports since they must first comply with applicable foreign regulations before preparing the report on Form 20-F. Consequently, Form 20-F must be filed within six months of a foreign issuer's year-end as compared to three months for U.S. issuers. 34/

33/ Form 20-F contains alternative items regarding the disclosures (but not recognition and measurement principles) required as part of the financial statements included in a filing using the Form. The minimum requirements, Item 17, apply to annual reports and specified securities registered under the Securities Act. Generally, that Item addresses only the material variations that arise from the use of accounting recognition and measurement principles that differ from U.S. standards. Item 18 of the Form provides for the same reconciliation specified in Item 17, as well as all other disclosures required by U.S. GAAP and Regulation S-X. For example, disclosure of information by industry and geographic segment is required by Item 18, but not by Item 17. However, Item 1 of the Form calls for certain segmented information about sales and revenues.

Consequently, some of the financial information included in the annual report of such issuers will not be fully comparable to the information which U.S. issuers publish and with which U.S. investors are familiar.

34/ Infra, note 40.

In a rulemaking proceeding in November 1982, the Commission adopted an integrated disclosure system for non-Canadian, foreign private issuers which parallels to a large extent the integrated disclosure scheme adopted for domestic issuers. The new rules permit foreign private issuers meeting certain criteria to use abbreviated disclosure documents under the Securities Act for registration of newly offered securities. Certain "world class issuers" 35/ may incorporate by reference information from the Form 20-F into a Securities Act prospectus (Form F-3), and foreign issuers who have filed periodic reports with the Commission for three years may attach their Form 20-F to a Securities Act prospectus (Form F-2) instead of including certain information directly in the prospectus.

To effectuate this integration, the new rules permit the incorporation of information by reference to Form 20-F if the issuer has elected to include the additional financial information specified in optional Item 18 of Form 20-F. 36/ The new rules

35/ A world class issuer is described as a foreign private issuer that has voting stock, held by non-affiliates, with an aggregate market value worldwide of no less than \$300 million, or that is registering "investment grade debt securities." Securities Act Release No. 6437 (November 19, 1982). Investment grade debt securities are those that at least one nationally recognized statistical rating organization has rated in one of the four highest categories.

36/ Foreign issuers may amend previously filed Forms to include segment data if the data were not included with the original filing and the issuer later wishes to incorporate the Form 20-F financial statements in a Securities Act filing.

exempt from Item 18 foreign offerings of investment grade debt and certain offerings to existing shareholders. Although full segment information is not required in reports filed under the the Securities Exchange Act as discussed above, the Commission determined, with the limited exceptions noted above, to require it in Securities Act filings because of the increasing acceptance of segment information as an international disclosure practice. 37/

In connection with the adoption of the integrated disclosure system for foreign private issuers, 38/ the Commission continued the practice of allowing financial statements of foreign issuers to be less current than statements of domestic issuers. The Commission recognized that foreign issuers "... are often not required to nor do they prepare quarterly or other interim financial statements." 39/ Generally, statements of foreign issuers must be as of a date within six months of the effective date of a registration statement, except in cases where the issuer makes public more current interim information pursuant to foreign laws, stock exchange requirements or otherwise. Financial statements of domestic issues are generally required to be within 135 days

37/ Supra, note 28. See also International Accounting Standards Committee, International Accounting Standard 14, "Reporting Financial Information by Segment," London, England (August 1981), calling for information similar to that specified in U.S. GAAP.

38/ Ibid.

39/ Securities Act Release No. 6361 (November 20, 1981).

of the effective date of the registration statement. 40/

The integration system now in place represents a significant, practical step in the process of internationalization of the world's securities markets. The system parallels the system for domestic issuers but also takes into account the different circumstances of foreign registrants, in order to accommodate foreign issuers while at the same time providing adequate protection to investors relying on the U.S. securities laws. The staff's experience in processing and reviewing the disclosure documents of foreign issuers, both registrants and those exempt by Rule 12g3-2(b), 41/ suggests that the disparity between the accounting and disclosure practices of the U.S. and many other countries is narrowing. 42/

D. Efforts Toward Harmonization

The accounting professions of the U.S. and various other countries have been involved in several projects to encourage voluntary harmonization of accounting principles. The first, and perhaps most significant of these groups, is the International Accounting Standards Committee (IASC), which was formed in 1973 by

40/ Rules 3-12 and 3-19 of Regulation S-X provide the requirements concerning age of the financial statements in an SEC filing.

41/ The exemption permits foreign issuers not listed on an exchange or the National Association of Securities Dealers automated quotation system (except for certain "grandfathered" companies) to furnish to the Commission, for public inspection, copies of material information made public in their home countries.

42/ Supra, note 28.

the U.S. and eight other industrialized countries with the express purpose of articulating international accounting standards. Membership has grown to 91 organizations representing accountants from more than 66 countries.

By July 1987, the IASC had issued 26 accounting standards and had 9 other projects underway. Many IASC standards provide for alternative measurement methods in determining asset, liability, equity, revenue and expense amounts. 43/ Viewed in the light of the wide variety of acceptable accounting practices worldwide, the IASC standards, if implemented in members' countries, would result in a substantial reduction in alternative measurement and reporting standards throughout the world.

Implementation of the IASC standards, however, is a problem. The IASC has no effective means to enforce compliance with its pronouncements, but must depend on the best efforts undertaking of its member organizations to promote acceptance and compliance. 44/

43/ For example, IAS 9 allows either the expensing of research and development expenditures as a period cost or the conditional deferral of development costs with amortization over the related revenue-generating period, and IAS 12 provides for either the comprehensive or partial allocation of income tax expense. Because IASC standards have narrowed, but not completely eliminated, accounting alternatives, there are no fundamental differences between IASC standards and generally accepted accounting principles in the United States.

44/ IASC members are pledged to use their best efforts to seek general acceptance and observance of IASC standards internationally. Additionally, members must endeavor to have auditors satisfy themselves that financial statements comply with those standards, and if not, to disclose the fact of noncompliance in the financial statements or in the auditor's report.

The alternatives allowed by IASC standards generally encompass the best practices and thus should obtain substantial acceptance by the IASC constituency. To date, voluntary implementation has achieved a certain amount of success. Many of the companies listed on the Toronto Stock Exchange, for example, have been persuaded to comply with IASC standards. 45/ In Europe, listed companies in Italy (a small but important group) are required to follow IASC standards in the absence of local requirements 46/ and the listing requirements of the London Stock Exchange likewise call for compliance with IASC standards or disclosure and explanation for any deviation. 47/

Another effort at voluntary harmonization was begun in 1977 with the formation of the International Federation of Accountants (IFAC). IFAC presently has a membership of 91 accountancy bodies from 66 countries. Its purpose is the development and enhancement of a coordinated world-wide accountancy profession with harmonized standards. Like the International Accounting Standards Committee, IFAC must depend on voluntary acceptance of its guidelines. Harmonization of standards is dependent upon the undertaking of member bodies to work towards implementation of IFAC pronouncements in their particular countries, when and to the extent practicable.

45/ Professor Chris Nobes, "Is the IASC Worthwhile?" International Accounting Bulletin (February 1986): 14

46/ Ibid.

47/ An exception is that companies incorporated outside the U.K. are not required to comply with IAS 14 (segment reporting). See, International Securities Law and Practice (London: Euromoney Publications Limited (1985): 256)

In October 1982, IFAC and IASC entered into an agreement formalizing the relationship between the two international accountancy bodies. Under that agreement the membership of the two organizations was unified on January 1, 1984, and the IFAC was given the authority to nominate the thirteen countries represented on the IASC board. Further, the agreement recognizes the IASC as the sole body with responsibility and authority to issue pronouncements on international accounting standards and the promotion of world-wide acceptance and observance of those standards.

Both the United Nations and the Organisation for Economic Co-operation and Development 48/ have established intergovernmental working groups on financial accounting and reporting. Those groups seek to foster harmonization and accounting and reporting standards by calling attention to the discordance which differing recognition, measurement, and reporting requirements cause in comparisons of financial information across national and regional boundaries. The working groups, like the IFAC and IASC, depend largely on persuasion and member support for effectiveness. The U.S. is a member of OECD working group, and was a member of the U.N. group but withdrew in 1986 for budgetary reasons following a cost/benefit assessment. The IASC, and a limited number of other international and regional organizations, are observers or advisors

48/ The OECD is an organization composed of 24 industrial countries including the United States.

to the U.N. and OECD working groups.

A notable consequence of the work of the OECD and UN working groups has been the voluntary restructuring of the IASC. In response to dissatisfaction expressed by a number of countries about the dominance of founding members and the inability of others to participate in its activities, the IASC has seen changes in its structure. It has established a consultative group within the IASC 49/ and has provided for broader representation on the IASC Board. 50/

The influence of the EEC on the harmonization process has also been substantial. Although the company law directives to date

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- 49/ The Consultative Group (formed in 1981) is composed of representatives from the following organizations:
- Federation Internationale des Bourses de Valeurs (the International Federation of Stock Exchanges);
 - International Association of Financial Executives Institutes;
 - International Chamber of Commerce;
 - International Confederation of Free Trade Union;
 - The World Bank.
 - International Banking Associations (November 1985)

In addition, representatives from the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting of the United Nations and from the Working Group on Accounting Standards of the OECD are invited participants. The Group participates in IASC Board activities related to the selection of projects to be undertaken and the review of exposure drafts prepared by steering committees.

- 50/ The eight founding members of the IASC will continue to control the IASC Board until 1987. After that, the recently expanded Board of 17 members will not necessarily include representatives from all the founding bodies. In addition, the Board has the power to invite up to four international

(footnote continued)

provide options from which member countries may choose in the process of incorporating directive provisions into national law, member countries are bound by the Treaties of Rome 51/ to enact directive provisions into national law. Thus, unlike the private sector and intergovernmental bodies referred to above, the EEC is able to implement its pronouncements. Nevertheless, EEC directives set forth only minimum requirements which member countries may require, for example, a statement of changes in financial position (or cash flows), or an expansion of the minimal segmentation requirements of the Fourth Directive.

E. Standard Setting - Auditing

Auditing standards have developed in much the same manner as accounting principles. Governments generally have been a major factor in setting the scope, objectives and standards of the audit, as well as requiring the independence and qualification of auditors in those countries where they have been a factor in

 / (footnote continued)

organizations, which are not accountancy bodies but have an interest in financial reporting, to be represented on the Board. The International Co-ordinating Committee of Financial Analysts' Association ("ICCFAA") joined the Board on January 1, 1986, as the the first non-accountancy body member. Prior to that date, ICCFAA was a member of the Consultative Group.

51/ These are treaties signed by the six original countries in Rome in 1951 establishing the EEC, the European Coal and Steel Community, an the European Atomic Energy Community.

establishing accounting principles. Statutory auditors (as opposed to independent financial auditors which may be retained separately) in those countries attest to the conformity of the company's accounts with the law and not necessarily with a true and fair view of the company's financial position and results of operations.

The objective of an audit in countries that rely on a statutory audit process often contrasts sharply with the objective in those countries where standards are set by professional organization of accountants. In the latter, the objective is the expression of an opinion on the fairness with which the financial position and results of operations are presented in conformity with GAAP.

Over the years the U.S. has taken the lead in the area of developing auditing, as well as accounting and reporting standards. These standards have had a substantial effect on international practice, both because of the head start the U.S. has had in this area and because U.S. business enterprises have played a leading role internationally in the post World War II era. 52/

52/ Belverd E. Needless, Jr. and Felix Pomeranz, "Comparative International Auditing," (International Accounting Section of the American Accounting Association): (1985) 61

Prior to the early 1930's, audits and audit reports in the U.S. were directed mainly to a company's management. As a result of the stock market crash of 1929, audits of companies offering securities to the public were mandated by the Securities Act, and annual audits of the financial statements of major investor-owned companies was required by the Securities Exchange Act. It was not until the late 1930's, however, that comprehensive audits became the norm. (Supra, note 3 at 41-15) This change was brought about by the fraud uncovered at McKesson & Robbins, Incorporated,

The AICPA's Auditing Standards Board ("ASB"), under SEC oversight, sets auditing standards in the United States. The AICPA, through the ASB and other units, has adopted standards that govern the practice of auditing, including ethical standards and rules requiring that auditors remain independent of the audited client. For the most part, the SEC has permitted the public accounting profession through the AICPA, under SEC oversight, to lead the way in setting auditing standards. However, the SEC administers its own requirements regarding auditor independence. A detailed discussion of this process is contained in the "Statement of John S.R. Shad, Chairman of the Securities and Exchange Commission before the House Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce", dated March 6, 1985.

F. Problems Posed by Different Approaches and SEC Response

As discussed, statutory standard setting and private sector standard setting sometimes have different objectives. Consequently, auditing standards differ among nations. For example, confirmation of accounts receivable and observation of inventory are often not performed in statutory audits. Yet, these procedures are basic to

52/ (footnote continued)

which involved, among other things, fictitious inventory and accounts receivable. As the details of the scandal began to emerge, the accounting profession, through the predecessor to the American Institute of Certified Public Accountants, initiated work on audit procedures designed to restore the public's confidence in "certificates" of independent accountants. That work resulted in a requirement that auditors observe inventory and confirm accounts receivable when either of those classes of assets represent a significant portion of current or total assets (see discussion in Part E, infra).

the audit process in the U.S. and other private sector standard-setting countries, and have been for some time.

Because of these different objectives, significant accommodations have not been made to foreign issuers in the area of auditing as has been the case with accounting principles. The Commission's staff has taken the position that while accounting principles can be reconciled, auditing standards cannot. In view of this position, the Commission's staff endeavors to assure that (as discussed supra) financial statements of foreign entities included in filings with the Commission are comparable to those of domestic issuers. Financial Statement comparability is sought either directly, through the application of consistent accounting principles, or indirectly through reconciliation of material accounting recognition and measurement differences that arise from the use of differing principles. Steps are taken to provide assurance that the examinations of financial statements by foreign auditors are as extensive and complete as those conducted by U.S. auditors. 53/ In this regard, the staff requires foreign auditors to demonstrate that:

- (1) the accounting firm is professionally qualified and in good standing in the jurisdictions where its offices are located;

53/ Auditing in one of the world's leading financial centers has come under criticism recently from that country's own accounting profession. Professor Chris Nobes reports (supra, note 45, P. 16) that one of Japan's senior accountants has called for the MOF to require improvement in audit quality, including the introduction of peer review. This accountant expressed concern over the poor quality of audits in Japan and stated that the profession is dominated by older practitioners, many of whom do not possess the qualifications necessary to begin practice today.

- (2) the firm's members and professional staff are knowledgeable with regard to:

accounting principles generally accepted in the U.S.

auditing standards generally accepted in the U.S. ("U.S. GAAS");

the Commission's rules and other pronouncements with respect to accounting and auditor independence; and

- (3) U.S. GAAS and the Commission's rules and other pronouncements concerning independence have been followed in connection with the engagement.

The staff has found that an applicant can best demonstrate knowledge of U.S. accounting and auditing standards by using an accounting firm currently practicing before the Commission as consultant or co-auditor on the initial SEC audit engagement. Such a consultant can represent to the staff that the audit was properly planned and conducted in accordance with U.S. GAAS and that all material accounting differences were identified and quantified. Further, the consultant's letter generally describes the procedures carried out and the extent to which guidance was required.

The audit burden imposed by the SEC is not as onerous as it might first appear. Many foreign auditors do meet the SEC's requirements and actively practice before the Commission. For example, there are five major Israeli firms that have met the SEC's requirements and have been the certifying accountants in a number of filings with the Commission. In addition, the large international accounting firms are available to perform U.S. GAAS audits. Some of these firms have had a significant effect on international practice by introducing U.S. audit standards in foreign countries,

since auditors in those countries must be familiar with U.S. audit standards to serve the needs of foreign subsidiaries of large multinational U.S. parents.

Notwithstanding the efforts at harmonization, and the influence and spread of U.S. auditing concepts, statutory audits continue to be the norm in many countries. Issuers that have had only statutory audits, or do not otherwise conform to U.S. standards, are not permitted to raise capital, or register for trading in the U.S., until the financial statements for the latest three years have been audited on a basis equivalent to U.S. GAAS, as required by the Securities Act.

Actual numbers are not available, but the staff is aware of only three large international issuers that have been denied access to U.S. markets within the past two years because their audits were not in compliance with U.S. GAAS. These issuers had requested waivers of the U.S. GAAS three year audit requirement prior to filing with the Commission. Of course, it is possible that some issuers did not seek waivers because they were aware of the Commission's requirement. Nevertheless, there is no evidence that U.S. auditing standards present a significant deterrent to foreign issuers. Most potential foreign registrants are aware of the U.S. requirements and can plan ahead to mitigate the problems.

G. Efforts Toward Harmonization

By July 1, 1987, the International Audit Practices Committee of IFAC had issued guidelines on (i) professional ethics, (ii) pre-qualification education and training, and (iii) twenty-four auditing guidelines (plus three exposure drafts). Although the IFAC's

auditing guidelines are impressive, they are not coordinated in the manner of the auditing standards generally accepted in the United States. However, each of the ten standards comprising generally accepted auditing standards ("GAAS") 54/ in the United States is addressed in some depth by one or more international guidelines (see, IAG Nos. 3, 4, 6, 7, 8, and 13).

IFAC's ethics guidelines include the following on independence:

When in public practice an accountant should both be and appear to be free of any interest which might be regarded, whatever its actual

54/ The generally accepted auditing standards as approved and adopted by the membership of the American Institute of Certified Public Accountants are as follows:

General Standards

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

Standards of Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.

(footnote continued)

effect, as being incompatible with integrity and objectivity.

Explanatory notes on independence elaborate:

In establishing ethical requirements relating to independence, the criterion should be whether reasonable men, having knowledge of all the facts and taking into account normal strength of character and normal behavior under the circumstances, would conclude that a specified relationship between an accountant and a client poses an unacceptable threat to the accountant's independence. It is not feasible within the scope of this Guideline to deal with all such situations which may jeopardize the independence of an accountant in public

54/ (footnote continued)

3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Standards of Reporting

1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.
2. The report shall state whether such principles have been consistently observed in the current period in relation to be preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

practice. Those responsible in each country will need to develop ethical requirements relevant to the circumstances of their country. The following are some of the matters which, in the view of the Federation, should be considered:

- (i) Financial involvement, direct or indirect in a client's affairs, e.g., shareholdings, loans to and from clients.
- (ii) Involvement by the accountant in public practice in a client's business in an executive capacity or as an employee under management control.
- (iii) What other business or occupations, engaged in concurrently with public practice, could lead to a conflict of interest or are inherently incompatible or inconsistent with the practice of public accounting or are incompatible with the need to retain the appearance of independence.
- (iv) Effect of family and personal relationships on independence.
- (v) The circumstances in which fees received from a client constitute an unacceptably large proportion of the total income of a sole practitioner or firm of accountants in public practice.
- (vi) The acceptance of assignments on a contingency fee basis.

Development of specific independence requirements, on the basis of broad philosophical guidance, is left to each country.

United States GAAS requires the confirmation of receivables and the observation of inventories. 55/ Those procedures are

55/ Statements on Auditing Standards, AICPA, at § 331, New York (1986). See also the discussion of Standard Setting-Auditing in Section III.

contained in the statements on auditing standards (of which forty-three are presently effective) which augment GAAS by specifying the acts to be performed to comply with GAAS. IAG No. 8, in discussing audit evidence, states at paragraph 14:

Observation consists of looking at a process or procedure being performed by others. For example, the auditor may observe the counting of inventories by client personnel or the performance of internal control procedures that leave no audit trail.

At paragraph 16, IAG No. 8 states:

Confirmation consists of the response to an inquiry to corroborate information contained in the accounting records. For example, the auditor normally requests confirmation of receivables by direct communication with debtors.

The principal difference between U.S. GAAS requirements and IAG No. 8 is that the IFAC guideline cites those audit procedures as examples of what an auditor may do; by contrast, they are required procedures under U.S. GAAS in appropriate circumstances. The absence of compulsion distinguishes the IFAC guidelines from U.S. GAAS. It is consistent with the Preface to International Auditing Guidelines, which states that national regulations or pronouncements govern the audit of financial statements in a particular country. 56/

The staff has recently encouraged IFAC to codify its existing auditing guidelines, and to identify and take steps, where necessary,

56/ See Appendix A for a comparison of International Auditing Guidelines with Generally Accepted Auditing Standards in the United States.

to make those guidelines into a comprehensive set of auditing standards. The goal is to facilitate internationalization by allowing the Commission to permit compliance with IFAC standards instead of requiring compliance with U.S. GAAS. The staff understands that IFAC is working toward this goal and believes it could be accomplished in the relative near future.

A somewhat different but related matter is the question of quality control standards for accounting firms. The AICPA issued its Statement on Quality Control Standards No. 1 in November 1979. That Standard requires firms that provide professional services to have a system of quality control that conforms with professional standards. Further, the AICPA established the Division of Firms and instituted a peer review program. The Commission oversees the peer review program for members of the SEC Practice Section of that Division, and has strongly endorsed the peer review concept. The Commission has recently published for comment proposed rules (Release No. 33-6695) that would require financial statements included in filings with it to be certified by an independent accountant which has undergone a peer review. The comment period closed in July 1987. The rules as proposed, however, would specifically exempt financial statements examined by foreign auditors because of the impracticality of imposing the requirements.

International Auditing Guideline No. 7, "Control of the Quality of Audit Work," broadly covers quality control. Although the organizational nature of the IFAC would accommodate the establishment of a peer review program, it appears that implementation could

be carried out only on a national basis in accordance with the requirements of each member country. No such mechanism currently exists in the IFAC. In future discussions with IFAC, the Commission staff will suggest that it consider the issue of peer review.

H. Approach of Other Countries to U.S. and Other Foreign Issuers

The most rapid internationalization of the capital markets has taken place in the debt markets, with a substantial amount of this activity occurring in the Eurobond markets. 57/ Equity raised by U.S. companies in the Euromarket has been significantly less than amounts raised through debt offerings. However, equity offerings are increasing at a significant rate (see Chapter II).

Listing either debt or equity securities in Europe brings foreign issuers under the requirements of the EEC listing directives, 58/ the EEC accounting and auditing directives, and the various stock exchange requirements. However, neither the EEC Directives nor the stock exchanges require financial information as extensive as that required in the U.S. by either GAAP or the SEC. Reconciliation to U.K. or other GAAP is not required. And, as discussed previously, the London Stock Exchange (LSE) although it requires foreign issuers to comply with IASC standards, makes an

57/ Securities Act Release No. 6568 (February 28, 1985).

58/ Directives of March 5, 1979, 79/279/EEC, O. J. Eur. Comm. No. L/66/21, (March 5, 1979); Directive of March 17, 1980, 80/390/EEC, O.J. Eur. Comm. No. L100/1, (April 17, 1980); and Directive of February 15, 1982, 82/121/EEC, O. J. Eur. Comm. No. L 48/26, (February 20, 1982).

exception for segment reporting.

In the final analysis, financial statements prepared in accordance with U.S. GAAP and the requirements of the SEC are accepted when included in a document for purposes of selling debt or equity in Europe either on a listed or unlisted basis. In fact the LSE listing requirements state that financial statements of U.S. companies listed on the New York or American Stock Exchanges satisfy the accounting requirements of the LSE provided such companies observe the requirements of the U.S. exchanges combined with those of the SEC. The LSE requirements further state that an audit report which conforms to auditing practice in the U.S. is acceptable.

The Unlisted Securities Market (USM) came into existence in 1980 when members of the LSE decided there should be a way for emerging companies to gain access to public capital markets (see Chapter III). The USM now includes approximately 340 companies with total capitalization of \$5.4 billion. 59/ In the past two and a half years, eight U.S. companies have gone public in this market; others are now giving it serious consideration. 60/

The offering document used on the USM contains the same financial statements as those required for formal listing on the LSE with one significant exception--a profit forecast for the current

59/ N.Y. Times, May 16, 1986, at D1, col. 1.

60/ Id.

year is included, accompanied by a compilation report of the independent accountants. 61/

As discussed previously, the sale or listing of securities in Japan is governed by the Securities and Exchange Law (SEL) modeled after the Securities Act and the Securities Exchange Act of the U.S. The Ministry of Finance (MOF), which has the power to establish accounting and auditing standards applicable to financial statements filed with it, administers the SEL.

Financial statements included in a registration in Japan may be prepared in accordance with U.S. GAAP. (Certain other countries accounting principles have also been accepted). 62/ Differences between U.S. GAAP and Japanese GAAP must be explained, but the differences are not required to be quantified. The financial statements must be translated into Japanese and all amounts converted into yen at a current average exchange rate.

The financial statements included in the registration statement are required in Parts I and II of the document. The financial statements submitted in Part I must be for the most recent two full

61/ The London Stock Exchange requires a statement as to the financial and business prospects of a company, which takes the form of a profit forecast (which must be reported on by the auditors of the company) for those companies entering the USM. Apparently a compilation report satisfies this requirement.

62/ Supra, note 20 at 168. The Tokyo Stock Exchange, the only Japanese exchange on which foreign securities may be listed, will not accept a company for listing with a qualified audit report.

business years, the last day of which must be within eight months of the date of filing of the registration statement. If the last day is not within eight months of the filing date, then semi-annual financial statements must also be included. Part II requires financial statements for the past five years from which the statements included in Part I may be omitted. 63/

I. Accountants' Liability

1. Introduction

Professional liability is a current problem for accountants not only in this country but around the world. 64/ According to information gathered by the SEC and reported to the House Subcommittee on Securities in March 1985, over a five-year period members of the eight largest U.S. accounting firms paid in excess of \$179 million in judgments and settlements of audit-related litigation. In addition, claims in pending cases in the U.S. and abroad total hundreds of millions of dollars. The April 1985 edition of the International Accounting Bulletin noted several pending cases, such as a 167 million pound claim in the U.K. against Arthur Young regarding Alexander Howden; a liquidator's writ for 100 million pounds in the U.K. against

63/ Id.

64/ In this country, legislative proposals have been made concerning possible amendments in the tort liability system to help solve these problems. Amendments are also reportedly being considered in the U.K. and Australia.

Arthur Andersen regarding De Lorean Motors; and other cases pending in Ireland, Australia and New Zealand.

2. Accountants' Liability in the United States.

On July 2, 1985, the Commission furnished the House Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce, House of Representatives, with a comprehensive report on accountants' liability under the federal securities laws. 65/ This report discussed accountants' liability under the Securities Act of 1933 and the Securities Exchange Act of 1934, and disciplinary actions under the Commission's Rules of Practice.

In addition to liability under the federal securities laws, accountants practicing in the U.S. face potential liability under state law for gross negligence or recklessness in the performance of their accounting and audit work. There is diversity among the states, however, as to which parties may bring such a negligence claim. In New York, before an accountant may be held liable in negligence to a noncontractual party who relies to its detriment

65/ See Hearings Before the Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce, House of Representatives, 99th Cong., 1st Sess., on Oversight of the Accounting Profession and the Securities and Exchange Commission: Effectiveness, Independence, and Regulation of Corporate Audits, February 20 and March 6, 1985, Serial No. 99-17, page 1020.

on an inaccurate financial report, a plaintiff must prove that: (1) the accountants preparing or certifying the report were aware that the financial reports were to be used for a particular purpose; (2) plaintiff would rely for this purpose on the financial report; and (3) there must have been some conduct on the part of the accountants linking them to that party, which evidences the accountant's understanding of the party's reliance. 66/ If these conditions are satisfied, then the court may find that there is a relationship resembling privity of contract between the accountant and the damaged party and permit a negligence action against the accountant. Since the privity requirement was first adopted in New York in 1931 67/, it has become the majority position among the states, and one state - Illinois - has adopted legislation codifying this requirement. Recently, however, several state courts have rejected the privity requirement and applied the traditional "foreseeable plaintiff" test in cases involving accountants' liability for negligence. 68/

66/ Credit Alliance Corporation v. Arthur Andersen & Co., 65 N.Y. 2d 536, 483 N.E.2d 110 (1985).

67/ Ultramares Corporation v. Touche, 174 N.E. 441 (1931).

68/ See, e.g., International Mortgage Company v. John P. Butler Accountancy Corporation, 177 Cal. App. 3d 806 (1986).

Foreign accounting firms auditing financial statements to be used in the sale of securities in this country are primarily concerned with liability under the federal securities laws, 69/ although the Racketeer Influenced and Corrupt Organizations Act (RICO), state and other laws may affect accountants' exposure to liability depending on the particular circumstances of each case.

3. Accountants' Liability Overseas.

U.S. accounting firms preparing or certifying financial statements used in securities offerings in foreign countries will generally be subject to the laws of those countries. Many of these

69/ When an issuer makes a registered offering in this country, the accountant's consent regarding the use of its report is filed as an exhibit to the registration statement. The filing of this consent and the accountant's preparation or certification of the issuer's financial statements provides a basis for the accountant's exposure to liability under Section 11 of the Securities Act. Many other provisions of the federal securities laws which are broader in scope than Section 11 (and pertain to "any person" who engages in the proscribed conduct) would concern a foreign accounting firm to the same extent they would concern a U.S. firm. For example, Section 10(b) of the Securities Exchange Act and Rule 10(b) thereunder prohibit fraud by all persons in connection with the purchase and sale of securities. These provisions would apply to foreign accountants.

In addition to considering the laws of the nation where securities are to be offered, the extraterritorial application of other nations' laws must also be considered. The application of such laws may depend on where the securities being sold are likely to "come to rest," and the preparatory activities concerning the filing that occur in the country asserting its jurisdiction. See Chapter VII.

nations, however, have laws similar to those in the U.S. The following is summary of major provisions of the laws of countries in which significant capital is raised by U.S. companies, as those laws relate to the potential liability of accountants and their firms.

Canada

The provinces of Canada have separate securities laws. Many of these laws, however, are similar to U.S. laws. The Ontario statute, for example, has a provision similar to Section 11 of the Securities Act. In Ontario, each financial statement filed pursuant to the securities laws must include an auditor's report and the auditor must file a written consent to the use of his report. The filing of this consent triggers potential liability for the accountants with respect to any "misrepresentation" contained in his report. As in the U.S., the accountants have a "due diligence" defense provided they have conducted a reasonable investigation to provide reasonable grounds for a belief that there had been no misrepresentations. 70/ Liability under these provisions of the Ontario law is joint and several; however, a defendant is permitted to seek contribution from any person who, if sued separately, would have been liable to make the same payment. 71/ The United States Securities Act contains similar provisions in Section 11(f).

70/ Ontario Securities Act, section 126 (4).

71/ Ontario Securities Act, section 126 (8).

United Kingdom

Several pieces of legislation in the United Kingdom touch upon the regulation of the sale of securities. It is the Companies Act of 1985, however, which specifically requires a report by the auditors of the company to be included in the prospectus 72/ and the auditors' consent to the issuance of the prospectus containing their report. 73/ Once they have given their consent, the auditors may be liable for any untrue statement made by them in the report. 74/ The accountants have a defense, however, if they can prove that they were competent to give the report and had a reasonable ground to believe, and up to the time of the allotment of the shares or debentures, as the case may be, did believe that the statement was true. 75/

In addition, accountants issuing reports in the U.K. could be subject to a common law action for fraud. Recklessness on the part of the accountant is sufficient to prove scienter. 76/ However, plaintiffs must show that the fraudulent statement was addressed to them. This requirement has been deemed to be satisfied where the plaintiffs are subscribers for shares and those publishing the

72/ Companies Act of 1985, section 56 and Part II of the Third Schedule to that Act.

73/ Companies Act of 1985, section 61.

74/ Id., section 68(4).

75/ Id., Section 68(5)(c).

76/ Bloomenthal, International Capital Markets and Securities Regulation, section 6.11 [3][a] (1st ed. 1986 revision). Accountancy Corporation, 177 Cal. App. 3d 806 (1986).

prospectus knew that the prospectus was likely to be relied on by market purchasers. 77/

Australia

In Australia, accountants may be held liable under the National Companies Code, as persons who authorized or caused the issuance of a prospectus, for untrue statements purported to be made by them as experts, and for any material nondisclosure for which they are responsible in their capacity as experts. 78/ Generally, however, they cannot be held responsible for the untrue statements or omissions of others. As in other countries, accountants in Australia have a defense if they can prove they were competent to make the report and that, on reasonable grounds, they believed their report to be true up until the allotment or sale of the securities. 79/

In addition to these liability provisions, the national Securities Industry Code contains general antifraud provisions. 80/ One of these sections prohibits the dissemination of information that is materially false or misleading and is likely to induce the purchase or sale of a security or to have an effect on the market price of the security. 81/ Under this section, recklessness may be

77/ Id.

78/ National Companies Code, section 107(2).

79/ Id., section 107(7).

80/ National Securities Industry Code, sections 123-127.

81/ Id., section 125.

sufficient to prove scienter. 82/

Japan

Three statutes concerning accountants in Japan are The Securities and Exchange Law, the Law Concerning Exceptions from the Commercial Code with Regard to Auditing Stock Corporations (the "Special Audit Law"), and the Certified Public Accountants Law.

The Securities and Exchange Law covers both primary and secondary offerings of securities, and was modeled after the United States Securities Act and Securities Exchange Acts. A statutory prospectus filed under the Securities and Exchange law must contain audited financial statements and related financial information. Periodic reports must also contain audited financial statements. 83/ Under this statute, a purchaser of securities may bring an action against a certified public accountant who gave an unqualified opinion with respect to false or misleading financial statements contained in a registration statement or periodic report. 84/ Accountants, however (as in the U.S.), may have a defense if they can prove they acted with due diligence. 85/

Under the Special Audit Law, certain corporations must have their financial statements audited before they may be presented for

82/ Supra, note 76 at section 10.06[1].

83/ Id., sections 11.06[3] and 11.09[1].

84/ The Securities and Exchange Law, Section 1, item 3; and art. 24-4.

85/ Id. at section 2, item 2.

approval at the annual meeting of shareholders. If the auditor's report contains an untrue statement of a material fact, the auditor may be liable to third parties damaged by the misstatement unless the auditor exercised reasonable care in preparing the report. 86/ If the directors of the company are found to be liable with the auditor, the liability of all defendants is joint and several. 87/

The Certified Public Accountants law governs many areas related to the qualifications and supervision of accountants, including disciplinary actions. In order to protect the public interest and investors, the Finance Minister may discipline accountants. 88/ Also, if false financial statements are filed with the Finance Minister, the Securities Bureau may take disciplinary action against the accountant, and may refuse to accept all or any part of registration statements and periodic reports containing financial statements audited by that accountant. 89/

J. SEC Initiatives in Internationalization

In February 1985, the SEC published a concept release soliciting public comment on methods of harmonizing disclosure and distribution practices for multinational offerings by non-governmental

86/ Special Audit Law, art. 10.

87/ Id., art. 11.

88/ CPA Law art. 32 section 4.

89/ CPA Law arts. 30 and 34-21, section 1; The Securities and Exchange Law art. 193-2, section 5.

issuers. 90/ (See Chapter III, supra.) To provide a framework for public comment, the Commission published two conceptual approaches designed to facilitate such offerings in the U.S., the U.K., and Canada. The two approaches are: (1) an agreement by the three countries that a prospectus accepted in an issuer's domicile which meets certain standards would be accepted for offerings in each of the participating countries ("reciprocal approach"); and (2) the development of a common prospectus which would be simultaneously filed with each country's respective securities administrators ("common prospectus approach"). The Commission requested commentators to express their views regarding which of these approaches, or alternative approaches, would be practical and consistent with investor protection. To facilitate responses, the Commission posed seventeen specific questions.

The Commission took the initiative in issuing the concept release because of the rapidly expanding international securities markets. In the release, the Commission stated that although significant accommodations have already been made in its disclosure requirements to facilitate foreign offerings in the U.S., it believes that the proposed conceptual approaches may lead to

90/ Securities Act Release No. 6568 (February 28, 1985). The Commission also published a concept release requesting comment on other aspects of the internationalization of the securities markets. See Securities Exchange Act Release No. 21958, Request for Comments on Issues Concerning Internationalization of the World Securities Market (April 18, 1985).

increased harmonization. The release refers to a recent article 91/ that identified approximately 236 issuers that have an active international trading market in their equity securities. According to this article, a company with an active international trading market must have daily active trading outside its home market. Of the 236 issuers identified, 84 are U.S., 49 are Japanese, 17 are German, 16 are Australian, 13 are British, 12 are Canadian, 10 are Swedish, 7 are South African, 5 are Swiss, 2 are Italian, 2 are Belgian, 2 are New Zealanders and 4 are from Hong Kong. France, Denmark, Norway, Singapore and Malaysia each had one issuer identified by the article as having an internationally traded security.

Seventy commentators responded to the issues raised by the concept release. Respondents included issuers, law firms, accounting firms, stock exchanges, broker-dealers, and regulatory agencies. Two general observations of the commentators should be highlighted. First, the reciprocal approach was the means favored by fifty out of fifty-seven commentators to facilitate multi-national offerings, at least on an evolutionary basis. Although the common prospectus approach was considered ideal by twenty-one of these commentators, they were skeptical because its implementation would be costly, subject to substantial time delays and, as a practical matter, difficult to achieve because of differences in standards, customs

91/ See Yassukovich, "The Rise of International Equity," *Euromoney*, May 1984 at 63.

and procedures. Second, cost savings were generally anticipated under a multi-national offering system by twelve commentators with respect to expert fees and printing costs. Other possible areas of savings mentioned included management time, underwriting fees and distribution costs. Two commentators believed that cost savings, if any, would be insignificant. No cost savings were anticipated with respect to accounting and auditing matters. The Commission has not yet determined whether to propose rulemaking for adoption of either of these approaches.

The primary question to be addressed is whether SEC requirements act as impediments to foreign issuers in entering U.S. capital markets. As this study has shown, the most onerous requirements placed on foreign issuers are the requirements to reconcile to U.S. GAAP in both Securities Act and Securities Exchange Act filings, and to provide full segment information in Securities Act filings. The SEC's reconciliation provision is not required in any of the major financial centers discussed herein, other than in Canada. Profit and loss information by business segment is not otherwise required of foreign issuers in European markets or in Tokyo.

There is little evidence to suggest that the reconciliation requirement has provided a serious obstacle to foreign issuers entering U.S. markets. The requirement was severely criticized when

92/ Supra, note 33.

the revisions to the Form 20-K 92/ were proposed, and in fact preparation of the information does impose an additional burden on issuers. Yet, respondents to the multinational proposal did not indicate that there would be a significant cost saving in a reciprocal offering document (which would exclude a reconciliation). In addition, foreign issuers continue to raise substantial amounts of capital in U.S. markets.

Sixteen commentators addressed the reconciliation requirement in response to the SEC's multinational proposal. The views were evenly split. Eight commentators including Merrill Lynch, the New York Stock Exchange Advisory Committee on International Capital Markets, J. P. Morgan Co., and several accounting firms envisioned the necessity for a reconciliation. Several others suggested that differences be explained but not quantified.

Among companies from the major financial centers of the world, segment profit and loss information appears to be of primary concern in the case of the Japanese. As previously discussed, capital raised by Japanese companies in the U.S. has been small in relation to the amounts raised in Europe. 93/

However, in addition to U.S. issuers, profit and loss information by segment is required of Canadian, U.K., and Italian issuers, and is a requirement of International Accounting Standards. Thus,

93/ The Japanese MOF has recently determined to study the contents and method of disclosure for segment reporting with a goal of requiring it prospectively in financial statements beginning in 1988.

segment reporting has achieved substantial acceptance in international financial reporting. As a measure of this acceptance, underwritten foreign debt and equity offerings in the U.S. have averaged \$5 billion per year since 1975 (segment reporting became a requirement of U.S. GAAP in 1977).

Segment reporting did not generate significant comment from those responding to the multinational release. There were only four commentators who addressed this matter, and they were divided. This may be indicative of the fact that profit and loss information by segment is not a significant issue in the U.K and Canada.

As noted, there is little evidence to suggest that U.S. audit requirements constitute a serious impediment to foreign issuers raising capital in U.S. markets. U.S. audit requirements were developed in many cases in response to specific audit failures, and have become imbedded not only in U.S. GAAS, but in a number of foreign audit standards as well. These standards serve to protect investors, and to provide confidence in the world's largest financial market.

Comments with respect to auditing standards were received from eight respondents in connection with the SEC's multinational release. The broadest standards were proposed by Merrill Lynch Capital Markets ("Merrill Lynch") and the New York Stock Exchange Advisory Committee on International Capital Markets. Both stated that U.S. distribution of foreign securities should require certification by independent auditors and use of auditing standards equivalent to U.S. GAAS. Several respondents suggested application of the IFAC standards as the international benchmark. Finally, one

Canadian accounting firm, Clarkson Gordon, indicated that under the multinational offering system, auditors may be required to comply with standards in effect in countries where their reports are relied upon or with common standards. Further, they opined that compliance with foreign auditing standards or the development of common international standards would be considerably less difficult than dealing with differences in accounting standards.

Approaches to Standard Setting and
Comparison of Major Accounting Principles

	<u>United States</u>	<u>Canada</u>	<u>United Kingdom</u>	<u>European Economic Community</u>
Approaches to Standard Setting	<p>Set primarily in the private sector for both investor-owned and privately owned enterprises. As a general rule, only investor-owned entities must publish financial statements. SEC requirements are not applicable to the larger number of non-investor owned enterprises. Therefore, a single set of generally accepted accounting principles is achieved, by having changes made through the private-sector body--the FASB. Currently, the SEC's Regulation S-X specifies measurements standards for oil and gas producers only. However, the SEC has statutory authority to set accounting standards for public companies and closely oversees the activities of the FASB.</p>	<p>The Act under which a company is incorporated specifies the disclosure requirements (and sometime other aspects of accounting principles) with which a company must comply in preparing financial statements. The requirements of the various Federal and Provincial Acts are not identical and at times differ from the Accounting Recommendations in the CICA Handbook. Canadian companies that offer securities to the public are also subject to requirements set out in the relevant Securities Acts and in pronouncements of the Provincial Securities Administrators. The Handbook of Canadian Institute of Chartered Accountants is controlling only in those jurisdictions in which it is specifically incorporated by reference and in the case of Federally Chartered enterprises.</p>	<p>Accounting standards in the UK are established and implemented by the accounting profession within a broad framework laid down by legislation. Principally, legislation on company accounts is restricted to the Companies Acts of 1948, 1967, 1980 and 1981. The latter Act gives effect to the Fourth Directive of the European Economic Community. The ten Member States of the EEC are bound under the treaties of Rome to adopt national legislation to give effect to the Directives of the EEC. The accounting standards formulated by the Accounting Standards Committee are issued by the six principal UK accountancy bodies (England & Wales, Scotland, Ireland and three other UK bodies). In general, all limited liability entities are required to publish annual financial statements.</p>	<p>The Company law directives specify minimum requirements which supplement those of the Member States. Directives are required to be implemented into national law by each of the Members States within the prescribed time specified in each directive. It is not unusual for those periods to be exceeded.</p>

Approaches to Standard Setting and
Comparison of Major Accounting Principles

Italy

Netherlands

W. Germany

Approaches
to Standard
Setting

Not Available.

Statutory requirements concerning annual accounts are stipulated in the Civil Code. The law lays down general principles that are to be observed in the preparation of annual accounts. Any interested party who considers that a set of annual accounts does not conform to the stipulations of the Civil Code may apply to have them changed to a court that specializes, inter alia, in matters relating to annual accounts: the Companies Division of the Court of Justice in Amsterdam. A certain amount of jurisprudence is starting to be built up in this field. Delegations from the employers' organizations, the employees' organizations, and the Netherlands Institute of Chartered Accountants have together formed a "Tripartite Consultative Body" whose task is to provide a guide for practice, but it has no legal force.

Accounting standards in Germany have always been established as provisions required by law, particularly in the "Aktiengesetz" (company law). In filling out this legal framework, fundamental accounting principles have been developed. There is no institution, however, except the courts, which can - though in single cases only - determine such principles. In decisions concerning these principles the courts consider not only business practice but also recommendations developed by the accounting profession.

Approaches to Standard Setting and
Comparison of Major Accounting Principles

Switzerland

Approaches
to Standard
Setting

Principles of accounting are established and implemented by law. The "Code of Obligations", part of the Swiss commercial law, contains some rules on sound bookkeeping practice to be followed by all business enterprises and more detailed rules on accounting by joint stock companies. These regulations lay down a relatively small number of basic principles. This broad legislative framework permits considerable freedom in decisions on disclosure, presentation and valuation, which in turn has led to diverse and even conflicting practices. In fact, the only generally accepted accounting principle, in the Anglo-Saxon sense, is that of "prudence" or conservative estimation. However, it must be emphasized that the (comparatively few) major multinationals, which are organized as joint stock companies, have developed accounting practices, especially with respect to disclosure, which go far beyond Swiss legal requirements to align themselves with the generally accepted standards of international business.

France

The establishment of accounting standards is the responsibility of the "Conseil National de la Comptabilite", an official body of concertation on which representatives sit of:

- a) those who keep accounts (accountants and bookkeepers in service of an employer,)
- b) those who scrutinise accounts (auditors, the tax administration, the "Commission des Operations de Bourse", etc);
- c) those who use accounts (firms, banks, statisticians, etc.);
- d) and those who teach accountancy.

Thus, the "Conseil national de la Comptabilite" acts:

- at the stage when standards are prepared, before the legislative and regulatory provisions come into being;
- at the stage when such provisions are implemented, by means of interpretations and recommendations.

As for the accountancy profession, it acts:

- within the "Conseil National de la Comptabilite", in which it plays an important role,
- at the time when standards are implemented, in order to establish the rules of professional ethics in the matter.

Approaches to Standard Setting and
Comparison of Major Accounting Principles

Japan

Approaches
to Standard
Setting

Companies in Japan are required to follow the provisions of Commercial Law. Those companies which offer shares of stock for public subscription, such as companies listed on the securities exchange, are required to disclose their financial statements and other relevant information by way of securities reports, etc. Such requirement is stipulated in the Securities Exchange Law, which aims at protecting investors. The accounting standards which form the basis of the preparation of financial statements are published in the "Financial Accounting Standards for Business Enterprises", and other means. These standards represent those which the Business Accounting Deliberation Council, an advisory body to the Minister of Finance, recognizes to be generally fair and adequate in nature. Among the above-mentioned accounting standards, those which are considered to be relevant and necessary are legalized in the Commercial Law and the Securities Exchange Laws.

Australia

In Australia "accounting standards", as such, are established and implemented by the accounting profession. These standards may best be regarded as complementing extensive provisions in the companies legislation and in the Stock Exchange Listing Requirements which deal with disclosure in financial statements (and which, in effect, are accounting standards in their own right). Failure to comply with existing standards is regarded by some State Corporate Affairs Commissioners as "prima facie" evidence that accounts do not give a "true and fair" view.

Approaches to Standard Setting and
Comparison of Major Accounting Principles

Principal
Accounting
Differences

	<u>United States</u>	<u>Canada</u>	<u>United Kingdom</u>	<u>European Economic Community</u>
Inventory Valuation	Weighted average cost, first-in-first-out, and last-in-first-out cost flow assumptions allowed.	Same as U.S.	LIFO cost flow assumption is not allowed.	Essentially the same as in the United States.
Research and Development Costs	All such costs are expensed in the period in which incurred.	Certain development costs are capitalized and amortized.	Same as Canada.	If permitted by Member State, such amounts may be included in assets. Unless contrary to Member State requirement, capitalized amounts must be amortized over a period no greater than 5 years.
Segment Information	Extensive disclosures are required by Statement of Financial Accounting Standards (SFAS) No. 14 and Regulation S-K.	Requirements are roughly equivalent to those in the United States.	The Companies Act of 1981 implemented the EEC's Fourth Directive. The Act requires disclosure of sales and pretax income for each class of business, and sales (but not pre-tax income) disaggregated between markets.	Only sales are required to be "broken down by categories of activity and into geographical markets in so far as these categories and markets differ substantially from one another".

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Approaches to Standard Setting and
Comparison of Major Accounting Principles

Principal
Accounting
Differences

	<u>Italy</u>	<u>Netherlands</u>	<u>West Germany</u>
Inventory Valuation	Essentially the same as in the U.S.	Essentially the same as the U.S. except that inventory may include interest cost incurred during manufacture. Inventories may also be valued at current value under the EEC's Fourth Directive if necessary to present a true and fair view (however only one major company - Philips N.V. - utilizes the method). The base stock method is also permitted.	Essentially the same as in the United States since adoption of the Fourth Directive.
Research and Development Costs	Deferred and amortized in certain circumstances.	Deferred and amortized in certain circumstances.	Same as U.S.
Segment Information	Segment information not required.	Segment information not required.	Segment information not required.

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Approaches to Standard Setting and
Comparison of Major Accounting Principles

Principal
Accounting
Differences

	<u>Switzerland</u>	<u>France</u>	<u>Japan</u>
Inventory Valuation	Same as West Germany.	Essentially the same as the U.S. except that the LIFO cost flow assumption is not allowed.	Essentially the same as the U.S.
Research and Development Costs	Deferred and amortized in certain circumstances.	Deferred and amortized in certain circumstances.	Deferred and amortized in certain circum- stances.
Segment Information	Segment information not required.	Segment information not required.	Sales by segment and geographic area are required.

Approaches to Standard Setting and
Comparison of Major Accounting Principles

Principal
Accounting
Differences

Australia

Inventory Valuation	LIFO cost flow assumption is not allowed. Cost may exclude overhead, include only variable cost, or include variable and fixed overhead based on a normal level of capacity.
Research and Development Costs	Deferred and amortized in certain circumstances.
Segment Information	Segment information not required.

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Approaches to Standard Setting and
Comparison of Major Accounting Principles

Principal
Accounting
Differences

	<u>United States</u>	<u>Canada</u>	<u>United Kingdom</u>	<u>European Economic Community</u>
Business Combinations	Any goodwill resulting from a business combination accounted for as a purchase must be amortized over a period that is not greater than 40 years.	Same as United States. Pooling-of-interest accounting is permitted only in rare circumstances where it is not possible to identify one of the parties as the acquirer.	A current exposure draft suggests a maximum period of 20 years for the amortization of goodwill resulting from the purchase of a business. The EEC Seventh Directive permits amortization over a period longer than 5 years if it does not exceed the asset's economic life, and is disclosed together with the reasons therefore.	No specific provision. However, Article 37 of the 4th Directive provides for the inclusion of goodwill as an asset if allowed by the Member State, with amortization over a maximum of 5 years, or longer economic life where permitted by the Member State.
IV-A-9 Oil and Gas Producers	The successful-efforts and full-cost methods of accounting are equally acceptable. If full-cost accounting is used, cost centers must be established on a country-by-country basis.	Cost center under the full-cost method of accounting may be determined on other than a country-by-country basis.	Both the full-cost method of accounting, essentially similar to the U.S. method, and the successful efforts method are acceptable in the U.K.	No specific provisions.
Foreign Currency Translation	Gains and losses on monetary assets and liabilities are recognized currently.	Translation gains and losses on long-term debt is deferred and amortized over the remaining life of the issue.	Essentially equivalent to U.S. requirement.	No specific provisions.

Approaches to Standard Setting and
Comparison of Major Accounting Principles

Principal
Accounting
Differences

	<u>Italy</u>	<u>Netherlands</u>	<u>West Germany</u>
Business Combination	Goodwill resulting from a business combination can be either the excess of cost over fair value or book value of assets acquired, and may be carried forward indefinitely.	Principals are similar to the U.S. except that goodwill may either be written off immediately to equity or earnings, or be amortized over a period not to exceed 10 years.	Goodwill can be either the excess of cost over (i) fair value or (ii) book value of net assets acquired, and is reduced by earnings of the net assets acquired until exhausted.
Oil and gas Producers	The extent to which full cost accounting is acceptable is not known to the staff, but the industry is not significant.	The extent to which full cost accounting is acceptable is not known to the staff, but the industry is not significant.	The extent to which full cost accounting is acceptable is not known to the staff, but the industry is not significant.
Foreign Currency Translation	No specific requirements.	The concept of the functional currency contained in U.S. GAAP is implied in Netherlands GAAP. However, for practical reasons, Netherlands GAAP allows the functional currency of the most significant foreign operation to be applied to the total group. In addition exchange gains on long-term monetary items may be deferred and amortized to income over the period of the item, and exchange losses on loans may be set off against deferred gains.	No specific requirements.

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Approaches to Standard Setting and
Comparison of Major Accounting Principles

Principal
Accounting
Differences

	<u>Switzerland</u>	<u>France</u>	<u>Japan</u>
Business Combination	Same as Italy.	Same as Italy.	Goodwill resulting from a business combination is the excess of cost over the book value of the net assets acquired. Goodwill is amortized within a five year period.
Oil and Gas Producers	The extent to which full cost accounting is acceptable is not known to the staff, but the industry is not significant.	The extent to which full cost accounting is acceptable is not known to the staff.	The extent to which full cost accounting is acceptable is not known to the staff, but the industry is not significant.
Foreign Currency Translation	No specific requirements.	No specific requirements.	Monetary assets and liabilities plus all assets carried at current values are translated at the closing rate, and all other items are translated at historical rates.

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Approaches to Standard Setting and
Comparison of Major Accounting Principles

Principal
Accounting
Differences

Australia

Business
Combination

Same as Italy.

Oil and Gas
Producers

The "area of interest" method is the prescribed method. It represent a cross between full cost and successful efforts. It permits capitalization of all costs associated with an area of interest if there is a reasonable chance of recovery. An area of interest means an individual geological area which is considered to constitute a favorable environment for the presence of minerals.

Foreign
Currency
Translation

No specific requirements.

Approaches to Standard Setting and
Comparison of Major Accounting Principles

	<u>United States</u>	<u>Canada</u>	<u>United Kingdom</u>	<u>European Economic Community</u>
Leases	Finance-type leases must be capitalized in a manner equivalent to purchased property.	Essentially equivalent to U.S. requirements.	All leases are treated as operating leases--none capitalized.	No specific provisions.
Valuation of Fixed Assets	Property, plant and equipment is carried at depreciated historical cost.	Same as U.S., except that the sinking-fund method of depreciation is acceptable.	Real property is revalued periodically and depreciated on such basis. Income producing real estate usually is not depreciated.	Fixed assets are defined as "those assets which are intended for use on a continuing basis for the purposes of the undertaking's activities". Fixed assets must be valued at purchase price or production cost, if permitted by Member State, increased by value adjustments.
Specialized Industries	Certain accounting principles are peculiar to particular industries. For example, specialized practices are found in financial institutions, mining, retailing, construction, and farming.	The extent to which various practices differ between countries is not known.	Differences have not been identified. However, it is known that hidden reserves are permitted in the UK. Movements in such reserves are not disclosed.	A Fourth Directive equivalent for banks was issued during 1986. A similar draft directive for insurance companies is scheduled for 1987. A contemplated draft directive for investment companies is not expected to be published before 1987 at the earliest.

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Approaches to Standard Setting and
Comparison of Major Accounting Principles

	<u>Italy</u>	<u>Netherlands</u>	<u>W. Germany</u>
Leases	Finance-type leases need not be capitalized.	Principles are similar to those in the U.S. except that in practice leases are not capitalized to the same extent as the U.S.	Finance type leases need not be capitalized.
Valuation of Fixed Assets	Property, plant and equipment is carried at depreciated historical cost.	Property, plant and equipment is normally stated at cost, but may be written up to replacement value. If depreciable assets are revalued, depreciation must be based on the revalued amount.	Property, plant and equipment is carried at depreciated historical cost.
Specialized Industries	The extent to which various practices differ between countries is not known.	The extent to which various practices differ between countries is not known.	The extent to which various practices differ between countries is not known.

Approaches to Standard Setting and
Comparison of Major Accounting Principles

	<u>Switzerland</u>	<u>France</u>	<u>Japan</u>
Leases	Finance-type leases need not be capitalized.	Finance-type leases need not be capitalized.	Finance-type leases need not be capitalized.
Valuation of Fixed Assets	Property, plant and equipment is carried at depreciated historical cost.	Property, plant and equipment is carried at depreciated historical cost.	Property, plant and equipment is carried at depreciated historical cost.
Specialized Industries	The extent to which various practices differ between countries is not known.	The extent to which various practices differ between countries is not known.	The extent to which various practices differ between countries is not known.

Approaches to Standard Setting and
Comparison of Major Accounting Principles

Australia

Leases	Finance-type leases need not be capitalized.
Valuation of Fixed Assets	Fixed assets may be carried at historical cost or appraised value.
Specialized Industries	The extent to which various practices differ between countries is not known.

Comparison of Audit Requirements and Specific Auditing Standards */

	<u>United States</u>	<u>Canada</u>	<u>United Kingdom</u>
Licensing Procedures	An applicant must pass the Uniform CPA Examination, hold a bachelor's degree, and have one to two years experience.	To become a Chartered Accountant, one must hold a degree with at least two years experience, and pass a national exam, administered by the CICA. Certified General Accountants must meet education and experience requirements specified by the provinces, pass courses or a national examination. RIAs meet requirements similar to those of a Certified General Accountant, but the examination is administered by the Society of Management Accountants of Canada.	The applicant must be a member of one of the following: <ol style="list-style-type: none"> a. The Institute of Chartered Accountants (either in England and Wales, or in Scotland, or in Ireland) b. The Association of Certified Accountants.
Training	At least equivalent to a bachelor's degree with study in accounting. Continuing professional education is required or recommended in most cases.	A university degree is required to become a Chartered Accountant, but not for the other accounting designations.	Three years of practical experience under a training contract during which several professional examinations must be passed.
Auditing Standards	GAAS, AICPA Statements on Auditing Standards (SAS), AICPA Interpretations of SAS, AICPA industry guides SEC Accounting Series Releases.	The Canadian Business Corporation Act; GAAS (Covered in the Canadian Institute of Chartered Accountants' Handbook)	The Auditing Practices Committee of the Consultative Committee of Accountancy Bodies; requirements of the Companies Act and auditing standards.

*/ Belverd E. Needless, Jr. and Felix Pomeranz, "Comparative International Auditing," (International Accounting Section of the American Accounting Association): (1985) 6-32

Comparison of Audit Requirements and Specific Auditing Standards

France

Netherlands

Switzerland

Licensing
Procedures

The applicant is placed on an official list after meeting these qualifications:

- a. 25 years of age
- b. good moral character
- c. citizenship in France or the European Economic Community
- d. passaged of the competency exam
- e. two years' experience in auditing.

After passing either a university or Netherlands Institute of Registeraccountants (NIVRA) examination, the applicant must show that he or she is:

- a. not bankrupt
- b. not under court guardianship
- c. not under a court order preventing practice.

The applicant must also produce a birth certificate and good conduct certificate.

There is no licensing requirement for auditors. Qualified auditors must pass the examination ("diplomierter Bucherexperte/expert comptable diplome").

Training

Academic diploma which qualifies one to sit for a competency examination.

There is no requirement for continuing education, but a minimum of ten days of continuing professional education every two years is recommended by NIVRA.

No special requirement for auditors. Qualified auditors must attend Auditor Schools, but not degree is required.

Auditing
Standards

No mandatory standards; closely regulated by law, with recommendations made by the Guide published by the Compagnie Nationale des Commissaires aux Comptes.

No official guidelines; NIVRA publications assist the auditor's judgment and expertise; the Law Relating to Annual Accounts of Companies tells what information must be included, but not its scope.

The Swiss Handbook of Auditing with recommendations issued by the Special Committee of the Swiss Chamber.

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Comparison of Audit Requirements and Specific Auditing Standards

West Germany

Japan

Licensing
Procedures

The applicant must be publicly appointed and sworn in after meeting personal and professional qualifications and following a government-regulated admission and examination procedure, which includes a heavy experience requirement (minimum of five years).

An applicant must pass three levels of examinations, show general knowledge of accounting, sufficient expertise as a junior CPA, and professional competency.

Training

A university course in business economics, economics, law, engineering, or agriculture. Experience may be substituted.

University degree

Auditing
Standards

Commercial laws are the primary basis, but the Institute of Wirtschaftsprufers issues professional standards and guidelines.

No commercial Law Code.
The Securities and Exchange Act requires:

- a. experience, ability, no special interest in the company;
- b. a fair, impartial attitude;
- c. due care;
- d. refusal to use or reveal confidential information;
- e. planning, execution, supervision;
- f. the extent of tests depends on internal controls;
- g. sufficient evidence for a reasonable opinion.

Comparison of Audit Requirements and Specific Auditing Standards

	<u>United States</u>	<u>Canada</u>	<u>United Kingdom</u>
Objective or Purpose of Audit	To give an opinion on the fairness with which financial statements present the financial position and results of operations of the company.	To attest to the fairness of financial statements presented by the organization's management.	To give an independent examination and opinion on financial statements, establishing compliance with statutory obligations and accordance with true and fair view.
Ethical Standards	Each state adopted a code of professional ethics under its Public Accountancy Act. Most resemble the AICPA Code of Professional Ethics, which calls for independence; objectivity; integrity; observance of general and technical standards; responsibility to colleagues; and other responsibilities and practices.	The Chartered Accountants for each province have their own codes, but the codes tend to be similar. The other two accounting bodies have their own national codes.	The Institute of Chartered Accountants in England and Wales publishes an Ethical Guide, which stresses professional independence, confidentiality, advertising limits, and limitations on fees, especially in multi-disciplinary practices.
Enforcement	The Professional Ethics divisions of the American Institute of CPAs and of the individual state societies may discipline, suspend, or expel a member for violation of an ethical rule. The individual state boards control the licensing of CPAs.	In Ontario province, for example, the Professional Conduct Committee is partially responsible; the Disciplinary Committee presides over more serious breaches of ethics; and the Practice Inspection Commission ensures that practice meets the standards set in codes.	Each professional body may impose sanctions on members for violations. The Auditing Practices Committee provides a joint disciplinary committee.
Legal Liability	Liable to client for breach of contract or if report is not timely, for failure to detect fraud or error (including ordinary or gross negligence, negligence causing loss). Liable to a third party by Commercial Law for foreseeable errors and for gross negligence which caused a loss. The 1933 Statute covers ordinary and gross negligence on the issuance of an auditor's report whereas the 1934 Statute covers negligence on continuing reports. Answerable to client and third party for fraud. Also under liability associated with a fiduciary relationship.	Liable under common law to third parties if should have been aware that the third party was part of a limited class that would rely on the financial statements. Liable for fraudulent financial statements.	Liable to third party if financial loss is clearly attributable to reliance on negligently prepared document, and the party preparing the document knew its purpose and knew (or should have known) that it would be relied on.

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Comparison of Audit Requirements and Specific Auditing Standards

	<u>France</u>	<u>Netherlands</u>	<u>Switzerland</u>
Objective or Purpose of Audit	To certify that all reports and financial statements conform to existing rules and regulations and have been applied in good faith.	To ensure that balance sheets and accompanying notes present a true and fair view of the size and composition of capital and reserves; and that profit and loss statements and notes give a true and fair view of the size and composition of a company for the relevant fiscal year.	To enable auditors to give an opinion on the conformity of financial statements to legal requirements. Auditors are bound by law to pass judgment on the legality of available profit. Auditors must recommend approval or rejection of the accounts at the general meeting of the shareholders. There is no attestation to the true or fair view.
Ethical Standards	Set both by law and by the Code of Professional Ethics adopted by the Compagnie Nationale, including rules on independence, incompatible functions, advertising, use of title or firm name, relationships with colleagues, connection between predecessor and successor, and fees set by law.	The Rules of Conduct for Registeraccountants (GBR) prohibit discrediting the profession, the use of information for one's own gain, the use of information from the predecessor, as well as advertising. It requires preserving records for ten years and keeping information about a client confidential.	No general code. The Ethical Code of the Swiss Chamber, which applies to members only, requires due care, independence, secrecy, careful choice of collaborators, loyalty, teamwork, promotion of the rising generation, continuing education, responsibility for making clients' documents available on request, and respect for the Fees Convention.
Enforcement	Penalties set by law, and in some cases by the Compagnie Nationale.	Complaints received by the Disciplinary Board and the Board of Appeal, elected by NIVRA.	A Special Committee of the Swiss Chamber has the power to fine or expel members.
Legal Liability	Violation of laws which regulate the profession, subject to Penal Code; requirements stated by law; auditors required to carry liability insurance.	Criminal and civil liability for criminal offense (fines to imprisonment), for negligence, acts discrediting the profession; for violating professional rules (resulting in written warning, suspension, and expulsion).	Firms can be sued for damages.

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Comparison of Audit Requirements and Specific Auditing Standards

West Germany

Japan

Objective or Purpose of Audit

To determine that financial statements comply with German law and the company's statutes.

The Commercial Law Code does not specify the purposes of an audit; the Securities and Exchange Act specifies that it is to protect stockholders and creditors, to confirm that the financial statement fairly and appropriately shows the present position and results, and that it is prepared in conformity with A Statement of Business Principles.

Ethical Standards

A Code of Ethics covers legally required audits. Detailed guidelines issued by the Chamber of Auditors include independence, professional care, partial responsibility, discretion, impartiality, professional conduct, and elimination of incompatible duties.

The CPA Law and the JICPA Code prohibit the impairment of trust, and require independence, secrecy, and restrictions of advertising. Punishment may be administered for false and unreasonable attestation.

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Enforcement

A self-regulatory body can warn, reprimand, fine or expel an auditor who is guilty of not performing duties in accordance with professional law and standard.

Under CPA law, the Minister of Finance is empowered to investigate violations and to assess penalties, including warning, suspension, or withdrawal from registration. The CPA has the right to vindicate himself. The JICPA Punishment Committee also enforces ethical standards. The President of the JICPA determines penalties according to the views of the committee and the board.

Legal Liability

Unlimited liability to clients and third parties for false statements or other intentional violations. Liability is limited in case of negligence. Breach of confidentiality is a criminal offense.

Under the Securities and Exchange Act, if investors lose because of material errors in audited financial statements, auditor or firm must compensate for an error unless can prove lack of intention and that the attestation was made with due care. Under the Commercial Law Code, must compensate client for breach of contract, and third parties for damage from materially false items in an audit report if cannot prove due care.

Comparison of Audit Requirements and Specific Auditing Standards

United States

Canada

United Kingdom

Responsibility for Detection of Fraud

Within inherent limits must plan examination to search for errors and irregularities that would have a material effect on financial statements. Must form reasonable assurance through complying with GAAS that material fraud or error is not present.

Reasonable assurance through complying with GAAS that material fraud and error are not present in the financial statements. No separate other responsibilities (but management has its own responsibilities).

Obligated to pursue matters of a suspicious nature.

Concept of Independence

Must meet in fact and in appearance. Rules specified by the Code of Professional Ethics.

Defined by rules of professional conduct of the Institute of Chartered Accountants and by incorporating acts.

Discussion Doctrine on Professional Ethics focuses on compromises of independence.

Functions Generally Not Allowed

Serving as an employee of the client, holding direct or material indirect interests being an officer of client, or having a loan to or from the client, making decisions if serving as a management consultant, or performing unethical functions that impair independence.

Serving in any function that lessens, independence, taking part in decision making in a management consultant engagement; auditing a corporation where stock in the client is owned.

Being partner or member of the board of a client, or a government employee; being a shareholder, with a large part of income from one client; or providing related financial, consulting, or tax services; compromising personal relationships.

Audit Reports

Must indicate the scope of the examination and whether or not the audit complied with generally accepted accounting principles. Must state whether the financial statements present fairly in accordance with GAAP and whether GAAP have been consistently observed in relation to reports of previous years. Must express an opinion on the financial statements as a whole, or assert that an opinion cannot be expressed. Disclosures of information shall be regarded as reasonably adequate unless stated otherwise.

Must refer to the scope of the examination, and express an opinion of the financial statement or assert that an opinion cannot be stated (giving the reasons why). The opinion should indicate whether the financial statements present a fair picture in accordance with an appropriately disclosed basis of accounting which normally would be generally accepted accounting principles. The basis of accounting must be consistently applied.

Includes both scope and opinion paragraphs. By statute, must present views on balance sheets (true and fair view at their date), profit and loss statements (true and fair view), and accounts (as to whether prepared in accordance with the Companies Act). Must report "by exception" on whether proper records have been kept, whether proper and adequate returns were received from unvisited branches, whether balance sheets and profit and loss statements agree with records, and whether the auditor has received all required information.

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	<u>France</u>	<u>Netherlands</u>	<u>Switzerland</u>
Responsibility for Detection of Fraud	No responsibility; but liable to client and third parties for fraud and negligence; must report known illegal acts by client.		Not bound to search for fraud; not responsible if due care is observed.
Concept of Independence	Appearance as well as fact of independence; relationships to avoid are detailed by law.	Independence from audit clients is required. Appearance of independence is emphasized.	Not defined. Independence in fact is more important than independence in appearance. Independence is not required by present Company Law (although it is by a new draft of the law, especially in regard to the board of directors and principal shareholders).
Functions Generally Not Allowed	Receiving any special benefit from a client or holding an incompatible position as a board member, a part of management, or an employee.	Drawing contracts or articles of association, acting in a managerial capacity, accepting an executive appointment in business or industry, acting as an insurance agent or broker, carrying out work affecting independence or impartiality, performing accountancy, taxation, or management consulting while employed as an auditor.	Serving as a member of the board or as an employee of the corporation, carrying out management duties. Fees from one client cannot exceed 10 percent of total income.
Audit Reports	Must certify the financial statements, or inform readers that it cannot be certified. The report may be qualified or unqualified. A second report is required, if applicable, detailing agreements entered into between company directors and the firms, or between company directors, and outside firms. There is no standard format for either report.	The wording is not specified by law, but NIVRA recommends reference to a "true and fair view" without reference to auditing standards. Under the Commercial Code, must make report available to shareholders 15 days before the annual meeting; must submit the financial statement and report to the Business Gazette within eight days of the meeting for public inspection; not required to include references to other investigations into accounts or corporate affairs; customarily, must give a more detailed report to executive and supervisors.	Presents to an ordinary shareholders' meeting the short form (attest function), containing scope and opinion paragraphs without reference to "true and fair" views. Presents the long form (with detailed audit information) to the board of directors. Presents special reports (covering extraordinary matters, such as fraud) to the board, and, in case of emergency, to an extraordinary shareholders' meeting; gives an oral report to the general shareholders' meeting.

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Comparison of Audit Requirements and Specific Auditing Standards

West Germany

Japan

Responsibility for Detection of Fraud Expected to conduct examination in an impartial and conscientious manner. Liabile if failure to discover fraud results from negligence.

Concept of Independence Appearance as well as fact of independence. Relationships to avoid are detailed by law.

Functions Generally Not Allowed Exercising management functions by acting as an employee. Independence is impaired when the auditor prepares the financial statements, has a financial interest in the client, serves on the supervisory board or board of management, or is an employee of the client.

Audit Reports Prescribed by law. The recommended wording is "The accounting and the annual financial statements, which I (we) have audited in accordance with professional standards, comply with German law and the company's statues.

Auditor must use due care to detect causes of material difference in financial statement; auditor may be punished by law. Must report actions that contradict directors' duties to the Auditing Commission.

Concept of independence (fair and impartial attitude) set forth in professional standards. Specific rules set forth in CPA Law.

An auditor or spouse cannot be independent if serving as an official of the corporation or responsible for financial affairs within one year of an auditing report; employed within one year of a report; holding a material interest in the corporation; connected closely, in present or past, with the corporation through duties as a government official; providing tax services or management consultant services.

Must outline the work performed and state an opinion on the financial statements, expressing whether the statements fairly present the results. Must state, in addition, matters materially affecting the financial statements in subsequent periods, but not present in the current financial statement.

COMPARISON OF IFAC AUDITING GUIDELINES WITH
GENERALLY ACCEPTED AUDITING STANDARDS IN THE U.S.

U.S. GAAS*	General Content	IFAC GUIDELINE
STATEMENTS ON AUDITING STANDARDS--INTRODUCTION		
Responsibilities and Functions of the Independent Auditor	Distinguishes between responsibilities of auditor and management, and refers to professional qualifications.	IAG No. 1 contains similar language about management's responsibility for financial statements. IAG No. 3 refers briefly to auditor skills and competence.
The Relationship of Generally Accepted Auditing Standards to Quality Control Standards	Stipulates that a firm should establish quality controls and procedures to provide it with reasonable assurance of conforming with GAAS in its audit engagements.	IAG No. 7 provides guidance regarding the procedures to be followed in the delegation of work to assistants. That Guideline also covers the policies and procedures to be adopted by an audit firm to provide reasonable assurance regarding the quality of audit work generally.
THE STANDARDS OF FIELD WORK		
Relationship Between the Auditor's Appointment and Planning	Stresses the importance of early auditor appointment to proper planning and execution of audit procedures.	Not referred to in IAG No. 4, "Planning".
Planning and Supervision	Recounts the matters which an auditor should consider in planning and supervising the audit.	Planning aspects addressed in IAG No. 4. Supervision alluded to in IAG No. 7.
Audit Risk and Materiality in Conducting an Audit	Cautions auditor on audit risk and materiality when statements in accordance with GAAS.	Not addressed.
Substantive Tests Prior to the Balance-Sheet Date	Sets forth factors to be considered in applying substantive tests at an interim date and extending that work to the balance sheet date.	Not addressed.
Communications Between Predecessor and Successor	Provides guidance on communications between auditors when a change has taken place or is in process.	Not addressed.
Analytical Review Procedures	Describes the timing, objectives, and timing of analytical review procedures and investigation of significant fluctuations.	IAG No. 12 is substantially equivalent to U.S. GAAP.

The Auditor's Study and Evaluation of Internal Control	A comprehensive statement which includes definitions and basic concepts, the scope of the auditor's study and review, the timing and extent of tests, and the evaluation of the management's system of internal control.	IAG No. 6 captures the essence of subject in a relatively lengthy document which is more in a philosophical vein than a handbook approach.
The Effect of an Internal Audit Function on the Scope of the Independent Auditor's Examination	Discusses the influence of the work done by the internal auditors on the planning and execution of the external auditor's procedures.	IAG No. 10 is essentially equivalent to U.S. GAAS.
Required Communication of Material Weaknesses in Internal Accounting Control	States the requirement for the auditor to communicate to senior management and the board of directors or its audit committee material weaknesses in internal accounting control that came to the auditor's attention.	A single paragraph in IAG No. 6 states that material weaknesses should be communicated, usually in writing, to senior management on a timely basis.
Special Purpose Reports on Internal Accounting Control at Service Organizations	Audit considerations where an audit client utilizes a service organization and another auditor issues a special purpose report on certain aspects of internal accounting control of that organization.	Not addressed.
Evidential Matter	Describes the nature, competence, and sufficiency of evidential matter, as well as guidance on evaluation of evidence used to test the assertions of management.	IAG No. 8 describes considerations bearing on audit evidence. Succinct but adequate treatment.
Errors or Irregularities	Provides guidance on the auditor's responsibility for detecting errors or irregularities. It also discusses procedures that the auditor should perform when his examination indicates that material errors or irregularities may exist.	IAG No. 11 is similar to U.S. requirement.
Illegal Acts by Clients	Provides guidance when client acts which appear to be illegal come to the auditor's attention during an audit.	Not addressed.
Receivables and Inventories	States that the confirmation of receivables and observation of inventories are generally accepted auditing procedures. Provides guidelines to carry out those procedures.	IAG No. 8, Audit Evidence, in the paragraph on observation, "For example, the auditor may observe the counting of inventories...." Included in the two short paragraphs on inquiry and confirmation is, "For example, the auditor normally requests confirmation of receivables by direct communication with debtors. No other references are made to those matters.

Long-Term Investments	Furnishes guidance for audits of companies with long-term investments accounted for under either the cost or equity methods.	Not addressed.
Client Representations	Establishes a requirement that the independent auditor obtain written representations from management as part of a GAAS audit.	IAG No. 22 states that the auditor should obtain evidence that management acknowledges its responsibility for the appropriate presentation of the financial statements and has approved them. It goes on to say, "The auditor can obtain evidence of management's acknowledgement of such responsibility and approval from relevant minutes of meetings of the management board or similar body or by obtaining a written representation from management or a signed copy of the financial statements.
Related Parties	Provides guidance on procedures that should be considered by the auditor to identify related party relationships and transactions and to satisfy himself concerning the required financial statement accounting and disclosure.	IAG No 17 refers to International Accounting Standard 24 for definitions and required disclosures regarding related party transactions. The guidance provided is similar to that under U.S. GAAS.
Using the Work of a Specialist	Recites instances in which the auditor may find it desirable to use the work of a specialist; discusses the selection, use of findings, and the effect of the specialist's work on the auditor's report.	IAG No. 18 is at least as complete as U.S. statement.
Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments	Sets forth guidance on the procedures an auditor should consider for identifying litigation, claims, and assessments and for satisfying himself as to the financial accounting and reporting for such matters.	Not addressed.
Working Papers	Discusses the functions and nature of working papers, as well as their content and ownership and custody.	IAG No. 9 is more demanding than U.S. requirement in that it refers to working papers "sufficiently complete and detailed for an experienced auditor to obtain an overall understanding of the audit." It also refers to permanent files included in the working papers. U.S. auditing literature does not refer to permanent files.

The Auditor's Considerations When a Question Arises About an Entity's Continued Existence	Matters to be considered by the auditor when information comes to his attention that raises a question about an entity's ability to continue in existence.	Not addressed.
Audit Sampling	Provides guidance for planning, performing, and evaluating audit samples.	IAG No. 19 provides adequate guidance in somewhat less detail than U.S. statement.
Consideration of Omitted Procedures After the Report Date	Describes considerations and procedures to be applied by an auditor who, subsequent to the date of his report on audited financial statements, concludes that one or more necessary auditing procedures were omitted.	Not addressed.
THE FIRST, SECOND, AND THIRD STANDARD OF REPORTING Adherence to Generally Accepted Accounting Principles	Construes the term "generally accepted accounting principles" to include not only accounting principles and practices but also the methods of applying them. It requires a qualified opinion if scope limitation makes it impossible for the auditor to form an opinion about conformity with GAAP.	Not addressed.
The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report	Explains the meaning of the phrase "present fairly...in conformity with generally accepted accounting principles" in the independent auditor's report.	Not addressed.
IV-A-29 Consistently of Application of Generally Accepted Accounting Principles	States the objective of the second reporting standard regarding the requirement to state whether accounting principles have been consistently applied between periods.	Partially addressed in IAG No. 13 which suggests identification of the framework of accounting principles within which he has reached his opinion, there is no reference to consistency of application.
Adequacy of Disclosure in Financial Statements	Elaborates the third standard of reporting regarding the adequacy of informative disclosures in financial statements.	Not addressed.
Segment Information	Provides guidance to an auditor in examining and reporting on financial statements that are required to include segment information in conformity with FASB Statement 14.	Not addressed.
THE FOURTH OF REPORTING Association With Financial Statements	The objective of the fourth standard of reporting is to prevent misinterpretation of the degree of responsibility the accountant assumes when his name is associated with financial statements. This statement defines "association" as that term is used in the fourth reporting standard.	Not addressed.

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Reports on Comparative Financial Statements	This statement provides guidance to an auditor on financial statements of one or more prior periods that are presented on a comparative basis with financial statements of the current period.	Not addressed.
Reports on Audited Financial Statements	This statement distinguishes the types of report, describes the circumstances in which each type of auditor's report ate and gives examples.	IAG No. 13, "The Auditor's Report on Financial Statements", treats the same subject matter.
Dating of the Independent Auditor's Report	Covers audit reporting dating initially, for subsequent events, and upon reissuance.	IAG No. 13 simply states that the report should be dated.
Other Conditions Which Preclude the Application of Necessary Auditing Procedures	Calls for a qualified or disclaimed opinion when auditor is unable to satisfy himself as to opening inventories or material amounts of long-term investments.	Not addressed directly although IAG No. 8, "Audit Evidence" should be sufficient for an auditor to reach appropriate conclusion.
Part of Examination Made by Other Independent Accountant	Sets forth the matters for an auditor to consider in deciding whether he may serve as principal auditor and use the work and reports of other independent auditors who have examined the financial statements of one or more of the components or investments, and the form and content of the principal auditor's report in those circumstances.	IAG No. 5 is similar in content to U.S. statement.
Lack of Conformity with Generally Accepted Accounting Principles	States that GAAP also applies to companies whose accounting practices are prescribed by governmental regulatory authorities or commissions. An auditor's report on regulatory based principles ordinarily will contain a qualified or adverse opinion if the financial statements are to be used for other than filings with supervisory agencies.	Not addressed
Inadequate Disclosure	Calls for a qualified or adverse opinion where financial Missing information, where practicable, is to be provided in the auditor's report, unless GAAS permits omission.	Not addressed.
Reporting on Inconsistency	Provides guidance for modification of auditor's opinion where there has been a change in accounting principle.	Not addressed.
Other Information in Documents Containing Audited Financial Statements	States that the auditor's responsibility for information in a document does not extend beyond the financial information identified in his report. However, the auditor should read the other information to assure himself that it is not materially inconsistent with information in the financial statements.	IAG No. 14 is sufficiently similar to U.S. requirement

Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents	Provides guidance on the form and content of reporting when an auditor submits to his client or to others a document that contains information in addition to the client's basic financial statements and the auditor's standard report.	Not addressed.
Reporting on Condensed Financial Statements and Selected Financial Data	Provides guidance on reporting in a client-prepared document on (a) condensed financial statements derived from audited financial statements of a public entity that is required to file, at least annually, complete audited financial statements with a regulatory agency, and (b) selected financial data derived from audited financial statements of either a public or a nonpublic entity and that are presented in a document that includes audited statements.	Not addressed.
Supplementary Information Required by the Financial Accounting Standards Board	Provides guidance on the nature of procedures to be applied to supplementary information required by the FASB, and describes the circumstances that would require the auditor to report concerning such information.	Inapplicable.
Supplemental Information on the Effects of Changing Prices	Expands on the guidance provided in the section on supplemental information required by the FASB.	Not addressed.
Supplementary Mineral Reserve Information	Expands on the guidance provided in the section on supplemental information required by the FASB.	Not addressed.

Supplementary Oil and Gas Reserve Information

Expands on the guidance provided in the section on supplemental information required by the FASB. Not addressed.

Subsequent Events

Describes the effect of post-balance sheet events on financial statements and the auditor's report. It also addresses auditor consideration of transactions occurring after the balance sheet date but before completion of the field work. IAG No. 21 is essentially equivalent to U.S. GAAS.

Subsequent Discover of Facts Existing at the Date of the Auditor's Report

Describes procedure to be followed by the auditor who, subsequent to the date of his report upon audited financial statements, becomes aware that facts may have existed at that date which might have affected his report had he then been aware of such facts. Not addressed.

Not applicable.

Not applicable. The subject matter of IAG Nos. 2, "Engagement Letters" and 15, 16, and 20, each dealing with some aspect of data processing are addressed in various U.S. auditing statements.

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*Codification of Statements on Auditing Standards, American Institute of Certified Public Accountants, New York, New York (1985).

The statements on auditing standards are organized in the Codification in a manner which conforms to the specification of generally accepted auditing standards; namely, the general standards, the standards of field work, and the standards of reporting.

COMPARISON OF IFAC AUDITING GUIDELINES WITH
GENERALLY ACCEPTED AUDITING STANDARDS IN THE U.S.

IFAC GUIDELINE	COMPARISON WITH U.S. GAAS */
No. 1--Objective and Scope of the Audit of Financial Statements	N/A
No. 2--Audit Engagement Letters	International Auditing Guideline 2 may be more demanding or conflict with generally accepted auditing standards in the United States in the following respects: This international Auditing Guideline provides guidance on the preparation of an audit engagement letter. Although the guideline does not explicitly require the auditor to send an engagement letter, the guidance is provided in a manner that presumes the use of an engagement letter. Generally accepted auditing standards in the United States do not require the auditor to send engagement letters and do not provide guidance on the preparation of such letters.
No. 3--Basic Principles Governing an Audit	International Auditing Guideline 3 may be more demanding or conflict with generally accepted auditing standards in the United States in the following respects: Paragraph .21(b) of this Guideline requires the auditor to conclude whether the financial information complies with relevant regulations and statutory requirements. Although generally accepted auditing standards in the United States do not require the auditor to form a similar conclusion, the auditor should be aware that certain governments may require the auditor to form such conclusions as a statutory obligation.
No. 4--Planning	SAS No. 22, Planning and Supervision, states that the auditor "should prepare a written audit program (or a set of written audit programs)" as part of planning his examination. SAS No. 22 does not require that the auditor prepare a written audit plan, but states, "the auditor may wish to prepare a memorandum setting forth the preliminary audit plan." International Auditing Guideline No. 4, Planning, requires the auditor to prepare both a written audit program and a written audit plan.
No. 5--Using the Work of an Other Auditor	Paragraph 9 of this IAG specifies certain matters related to using the work of an other

auditor that the principal auditor must document. Although auditors complying with generally accepted auditing standards in the U.S. generally document such matters, there is no explicit requirement to do so.

No. 6--Study and Evaluation of
the Accounting System
and Related Internal
Controls in Connection
With an Audit

No apparent conflict.

No. 7--Control of the Quality of
Audit Work

No apparent conflict.

No. 8--Audit Evidence

No apparent conflict.

No. 9--Documentation

IAG 9 is more specific than U.S. GAAS as to the form and content of working papers. It requires, among other things, that working papers be "sufficiently complete and detailed for an experienced auditor to obtain an overall understanding of the audit." It also requires that "all significant matters which require the exercise of judgment, together with the auditor's conclusion thereon," be included in the working papers. Those requirements are more demanding than the standards established by SAS No. 41, Working Papers. SAS No. 41 states that working papers are the "principal record" of the work performed and the conclusions reached concerning significant matters, but allows the auditor to support his opinion and his representation as to compliance with auditing standards "by other means in addition to work papers." IAG 9 also identifies several specific items that are normally to be included in working papers which are not specifically required by SAS No. 41 or other Statements on Auditing Standards. For example, IAG 9 states that permanent files included in the working papers should be updated currently with "information of continuing importance to succeeding audits." U.S. GAAS does not discuss permanent files.

No. 10--Using the Work of an Internal
Auditor

No apparent conflicts

No. 11--Fraud and Error

No apparent conflicts

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No. 12--Analytical Review

No apparent conflicts.

No. 13--The Auditor's Report
on Financial Statements

IAG 13 may be more demanding or conflict with generally accepted auditing standards in the U.S. in the following respects:

IAG 13 requires that an appropriate title, such as "Auditor's Report," be used to identify the auditor's report and to easily distinguish it from reports that might be issued by others. Generally accepted auditing standards in the U.S. do not require that the auditor's report be titled, even though it is customary to do so.

IAG 13 requires the auditor's report to be signed in the name of the audit firm, the personal name of the auditor, or both, as appropriate. U.S. GAAS does not address signing auditors' reports.

IAG 13 requires that the auditor's report name a specific location, which is usually the city in which the auditor maintains his office, as the auditor's address. U.S. GAAS does not require the auditor's report to include disclosure of the auditor's address.

IAG 13 would prohibit the auditor from accepting an audit engagement when a scope limitation imposed by the client in the terms of the engagement is such that the auditor believes he would need to issue a disclaimer of opinion. U.S. GAAS states that when restrictions that significantly limit the scope of the audit are imposed by the client, the auditor generally should disclaim an opinion on the financial statements. They do not, however, prohibit the auditor from accepting the engagement.

No. 14--Other Information in Documents
Containing Audit Financial
Statements

No apparent conflicts.

No. 15--Auditing in an EDP Environment

No apparent conflicts.

No. 16--Computer-Assisted Audit
Techniques

IAG 16 addresses a subject that is not addressed in U.S. GAAS. Nonetheless, the guideline does not include any statements that appear to conflict with procedures normally applied when computer-assisted audit techniques are used by auditors in the United States.

- | | |
|---|------------------------|
| No. 17--Related Parties | No apparent conflicts. |
| No. 18--Using the Work of an Expert | No apparent conflicts. |
| No. 19--Auditing Sampling | No apparent conflicts. |
| No. 20--The Effects of EDP
Environment on the Study and
Evaluation of the Accounting
System and Related Internal
Controls | No apparent conflicts. |
| No. 21--Date of the Auditor's Report;
Events After the Balance Sheet
Date; Discovery of Facts After
the Financial Statements have
Been Issued | No apparent conflicts. |
| No. 22--Representations by Management | No apparent conflicts. |

*/ As identified by the American Institute of Certified Public Accountants, AICPA Professional Standards, at Section 8000, Commerce Clearing House New York (1986)

INTERNATIONAL AUDITING PRACTICES COMMITTEE**International Auditing Guidelines - (IAG's)**

- **IAG 1 Objective and Scope of the Audit of Financial Statements**
The Guideline describes the responsibility for financial statements and the overall objective and scope of the audit of financial statements of an entity by an independent auditor.

- **IAG 2 Audit Engagement Letters**
The Guideline says that an auditor's engagement letter to the client is designed to document and confirm the auditor's acceptance of the appointment, the scope of the auditor's work, and the extent of the auditor's responsibilities and the form of any reports. The guideline describes the principal contents of an engagement letter, and the appendix contains an example of a letter.

- **IAG 3 Basic Principles Governing an Audit**
This Guideline describes the basic principles governing an auditor's professional responsibilities which should be exercised whenever an audit is carried out. The basic principles identified involve: integrity, objectivity and independence, confidentiality, skills and competence, work performed by others, documentation, planning, obtaining audit evidence, reviewing accounting systems and internal control, reviewing conclusions reached, and reporting. These basic principles are the cornerstone for all succeeding International Auditing Guidelines.

° IAG 4 Planning

This Guideline applies to the planning process of the audit of both financial statements and other financial information. It is framed in the context of recurring audits, identifies key elements in the planning process and provides practical examples of items which should be considered when planning an audit. Adequate audit planning helps to ensure that appropriate attention is devoted to important areas of the audit, that potential problems are promptly identified, and that the work is completed expeditiously. Planning also assists in proper utilization of assistants and in coordination of work done by other auditors and experts.

° IAG 5 Using the Work of an Other Auditor

This Guideline describes considerations to be made when intending to use the work of an other auditor. It applies when an independent auditor reporting on the financial statements of an entity uses the work of another independent auditor with respect to the financial statements of one or more divisions, branches, subsidiaries or associated companies included in the financial statements of the entity. For the purposes of this Guideline, offices of the principal auditor's firm in a different country, affiliated firms, correspondents, and unrelated auditors who are involved in the audit of components of the entity are considered as other auditors.

• IAG 6 Study and Evaluation of the Accounting System and Related Internal Controls in Connection with an Audit

Management is responsible for maintaining an adequate accounting system incorporating various internal controls to the extent appropriate to the size and nature of the business. However, the auditor needs reasonable assurance that the accounting system is adequate and that all the accounting information which should be recorded has, in fact, been recorded. Internal controls normally contribute to such assurance. This Guideline describes accounting systems, elements, objective and limitations of internal control and the audit procedures for the study and evaluation of internal control.

• IAG 7 Control of the Quality of Audit Work

Controlling the quality of audit work is essential in maintaining the high standing of the profession. This Guideline distinguishes between controls on individual audits and general quality controls adopted by an audit firm. While recognizing the interrelationship of the two types of controls, the Guideline states that general quality controls "augment and facilitate" controls on individual audits but do not replace them. This Guideline deals with the controls over delegation of work to assistants on an individual audit in order to comply with the basic auditing principles, and provides practical assistance to an audit firm in controlling the general quality of their practice. The Guideline also contains an appendix with examples of procedures to assist a firm in implementing quality control policies.

• IAG 8 Audit Evidence

Audit evidence is information obtained by the auditor in arriving at the conclusions upon which an opinion on the financial information is based. This Guideline describes the nature and sources of audit evidence, sufficiency and appropriateness of audit evidence and the methods by which it is obtained by the auditor in the performance of compliance and substantive procedures.

• IAG 9 Documentation

This Guideline provides guidance on the general form and content of working papers as well as specific examples of working papers normally prepared or obtained by the auditor. It also contains a discussion of the ownership and custody of working papers.

• IAG 10 Using the Work of an Internal Auditor

When an entity has an internal audit department, management may delegate to it some of its supervisory functions, especially with respect to the review of internal control. The internal audit function constitutes a separate component of internal control undertaken by specially assigned staff within an entity. The objective of the internal auditor is to determine whether internal controls are well designed and properly operated. Much of the work of the internal audit department may be useful to the independent auditor for the purpose of his examination of the financial information. This Guideline provides guidance as to the procedures that should be considered by the independent auditor in assessing the work of the internal auditor.

• IAG 11 Fraud and Error

This Guideline defines fraud and error, and indicates that the responsibility for the prevention of fraud and error rests with management. The auditor should plan the audit so that there is a reasonable expectation of checking material misstatements resulting from fraud and error. The Guideline also suggests procedures which should be considered when the auditor has an indication that fraud or error may exist and includes an appendix which gives examples of conditions or events which increase the risk of fraud or error.

• IAG 12 Analytical Review

This Guideline provides the auditor with an understanding of the nature of analytical review procedures as well as guidance on the objectives, timing and extent of reliance to be placed on such procedures in performing an audit. It also discussed the auditor's investigation of unusual fluctuations.

• IAG 13 The Auditor's Report on Financial Statements

This Guideline provides guidance to auditors on the form and content of the auditor's report issued in connection with the independent audit of the financial statements of an entity. The Guideline includes suggested wording to express an unqualified opinion and discusses circumstances that may result in other than an unqualified opinion. An appendix to the Guideline sets forth examples of an unqualified, qualified, and adverse auditor's report and a denial of opinion.

• IAG 14 Other Information in Documents Containing Audited Financial Statements

This Guideline defines "other information" as financial and non-financial information included in a document which contains an entity's audited financial statements together with the auditor's report thereon. An entity usually issues such a document on an annual basis which is frequently referred to as the "annual report". In certain circumstances, the auditor has a statutory obligation to report on other information and in other circumstances he has no such obligation. This Guideline deals with the auditor's consideration of other information on which he has no obligation to report and provides guidance on the actions he should undertake if a material inconsistency or material misstatement of fact is discovered.

• IAG 15 Auditing in an EDP Environment

This Guideline provides guidance to auditors on the additional procedures necessary to comply with IAG 3, "Basic Principles Governing an Audit", when auditing in an EDP environment. The Guideline describes the skills and competence required of the auditor as well as his responsibility when he delegates such work to assistants or uses work performed by others.

• IAG 16 Computer-Assisted Audit Techniques

This Guideline provides guidance to the auditor when using computer-assisted audit techniques (CAATs) - particularly audit software and test data. The IAG outlines instances when CAATs may be used, factors to consider in determining whether to use a CAAT and the major steps to be performed in CAAT application. In addition, the

Guideline highlights special considerations when using CAATs in a small business computer environment.

• **IAG 17 Related Parties**

This Guideline provides guidance to auditors on the procedures to be considered in obtaining sufficient appropriate audit evidence concerning the existence of and transactions with related parties. This Guideline is premised on the definition and disclosure requirements set out in IAS 24, "Related Party Disclosures." IAG 17 provides guidance to assist auditors in determining whether management of an entity has properly disclosed related party relationships and transactions with such parties in accordance with the provisions of IAS 24.

• **IAG 18 Using the Work of An Expert**

This Guideline provides guidance to the auditor in instances when using the work of an expert (specialist) engaged or employed by the client or auditor. The IAG outlines examples of cases when an auditor may need to use the work of an expert and provides guidance on considerations relating to the expert's skills, competence and objectivity. IAG 18 outlines considerations that should be made by the auditor for communicating with the expert and offers specific guidance on evaluating the work of an expert.

• **IAG 19 Audit Sampling**

This Guideline identifies the factors that an auditor should consider when designing and selecting an audit sample and evaluating the

results of audit procedures. The IAG contains guidance that applies to both statistical and non-statistical sampling methods. The Guideline provides fundamental yet practical guidance on such matters as sampling risk, stratification, selection methods and projection of errors.

• IAG 20 The Effects of an EDP Environment on the Study and Evaluation of the Accounting System and Related Internal Controls

This Guideline provides guidance to the auditor on the study and evaluation of the accounting system and related internal controls in an EDP environment. The Guideline is an extension of the guidance contained in IAG 6, "Study and Evaluation of the Accounting System and Related Internal Controls in Connection with an Audit" and IAG 15, "Auditing in an EDP Environment".

The Guideline describes the common characteristics of an EDP environment, including the factors that affect the organization and structure, nature of processing and design and procedural aspects of the system of accounting and internal control.

The IAG differentiates and explains the interrelationship of general EDP controls (those that affect the EDP environment) and EDP application controls (those that affect accounting applications). The Guideline explains to the auditor operating in an EDP environment, the steps involved in a) making a review and preliminary evaluation, b) performing compliance procedures, and c) making a final evaluation, of the accounting system and related internal controls. The IAG reminds the auditor to communicate to client management weaknesses in EDP internal control and weaknesses that affect the safeguarding of data and continuity of processing.

• IAG 21 Date of the Auditor's Report; Events After the Balance Sheet Date; Discovery of Facts After the Financial Statements Have Been Issued

This Guideline provides guidance on dating of the auditor's report; the auditor's responsibility in relation to subsequent events, which are significant events occurring after the balance sheet date, and the auditor's responsibility in connection with the discovery of facts after the financial statements have been issued. This Guideline describes steps the auditor generally performs to identify subsequent events, responsibilities in relation to events after the date of the auditor's report but before the financial statements are issued, and discovery of facts after the financial statements are issued. An appendix to the guideline sets forth an example of an auditor's report on revised financial statements.

• IAG 22 Representations By Management

This Guideline provides guidance to the auditor on using management representations as audit evidence, procedures the auditor should apply in evaluating and documenting them, and circumstances in which written representations should be obtained. The Guideline indicates that with regard to representations for material financial statement matters, the auditor should seek corroborative evidence, evaluate the representations for reasonableness and consistency with other audit evidence and other representations, and consider whether the individual making the representation can be expected to be well-informed. The Guideline notes that representations can be documented in the working papers by summarizing oral discussions or by obtaining written representation. The Guideline also notes the conditions for obtaining letter from management and considerations of the auditor

when management refuses to provide or confirm representations on matters considered necessary.

• IAG 23 Going Concern

This Guideline provides guidance to auditors in discharging their responsibilities in situations in which the appropriateness of the going concern assumption as a basis for the preparation of financial statements is in question. The Guideline notes that an entity's continuance as a going concern is assumed in the absence of information to the contrary. If this assumption is unjustified, an entity may not be able to realize its assets at the recorded amounts and there may be changes in the amount and dates of maturity of liabilities resulting in the need for financial statements to be adjusted. IAG 23 provides examples of indications that continuance as a going concern should be questioned, outlines the standard for collecting audit evidence when such a question arises, and describes the audit procedures that may be performed to obtain such evidence. In addition, it sets out the auditor's reporting considerations in such circumstances.

• IAG 24 Special Purpose Audit Reports

This Guideline provides guidance to auditors that issue audit reports that are other than those covered by IAG 13, notably

- Financial statements prepared in accordance with a comprehensive basis of accounting other than international accounting standards or relevant national standards.
- Specific accounts, elements of accounts, or items of a financial

statements.

- Compliance with contractual agreements.
- Summarized financial statements.

The appendices to the proposed IAG contain illustrations of special purpose audit reports.

Exposure Draft - (ED's)

- ED 25 Materiality and Audit Risk

This proposed Guideline defines and describes the concepts of materiality and audit risk, their interrelationship and application to planning and executing an audit and evaluating audit procedures. In the exposure draft, materiality is defined as the magnitude or nature of an omission or misstatement of financial information either individually or in the aggregate that, in the light of surrounding circumstances, makes it probable that, as a result of the misstatement the judgment of a reasonable person relying on the information would have been influenced, or his decision affected. It is noted in the proposed Guideline that the assessment of materiality is a matter of professional judgment that is influenced by an auditor's perception of the needs of a reasonable person who will rely on the financial information. The audit is planned and executed in order to have a reasonable expectation of detecting material misstatements. Audit risk is defined as the risk that an auditor may give an inappropriate opinion on financial information. Audit risk is considered at the financial statement level and the account balance and class of transactions level. ED 25 describes and illustrates the interrela-

tionship between materiality and the level of audit risk, and states that they should be considered together when determining the nature, timing and extent of auditing procedures and evaluating the results of those procedures. The proposed Guideline states that the audit should be planned so that audit risk is kept at an acceptably low level. It also states that the auditor's preliminary judgment of materiality should be related to specific account balances and classes of transaction enabling the auditor to decide such questions as what items, if any, to examine one hundred percent and whether to use sampling or analytical review techniques. The Guideline contains two appendices, one providing an illustration of the interrelationship of the components of audit risk and the other giving examples of rules-of-thumb that can be used to measure materiality.

(Comment period ending November 30, 1986.)

° ED 26 Audit of Accounting Estimates

This proposed Guideline provides guidance to auditors on the procedures that should be performed in order to obtain reasonable assurance as to the appropriateness of accounting estimates contained in financial information. The Guideline recognizes that accounting estimates are an important element of financial reporting and are often dependent upon management judgment and thus are subject to bias. The ED describes the nature of accounting estimates and provides examples of simple and complex estimates encountered in an audit. The Guideline describes five main steps involved in an audit of accounting estimates as follows:

- ° examination of the data and assumption on which the estimate is

based,

- examination of calculations involved in the estimate,
- comparison of previous estimates with actual results,
- examination of management's approval procedures, and
- assessment of the results of the audit procedures.

Because of the imprecision of accounting estimates, evaluating errors can often be more difficult than in other areas of the audit. Thus the proposed Guideline on materiality and audit risk provides good background for applying the principles contained in the audit of accounting estimates guideline.

(Comment period ending November 30, 1986.)

◦ ED 27 Basic Principles Governing Limited Assurance Engagements

ED-27 is the first of the IAPC's proposed pronouncements on limited assurance services and establishes the basic principles for such engagements. ED-27 is a parallel document to IAG 3, Basic Principles Governing an Audit, setting out the basic principles and general and reporting guidelines for limited assurance engagements. ED-27 notes that in an audit engagement the auditor will use more extensive audit procedures than in a limited assurance engagement because his objective is to express a high but not absolute level of assurance on the reliability of the financial information.

The proposed guideline notes that in order to perform a limited assurance engagement the auditor should:

- Possess or obtain a knowledge of accounting principles and practices of the industry in which the entity operates,

- ° Possess or obtain an understanding of the entity's business and procedures,
- ° Carry out inquiry and analytical procedures, and
- ° Carry out additional or more extensive procedures when deemed necessary to achieve limited assurance based on the results of the inquiry and analytical review when there is a suspicion that the information on which the auditor is reporting is not presented fairly in accordance with the basis of accounting indicated or is otherwise incomplete or unsatisfactory.

(Comment period ending March 31, 1987.)

° ED Proposed Framework of International Auditing Guidelines

The proposed Framework of International Auditing Guidelines:

- ° describes certain services that may be performed by auditors and the levels of assurance resulting from the work performed,
- ° provides a general framework for such services performed by auditors,
- ° describes the conditions for changing the scope of an engagement, and
- ° describes the concept of auditor association with financial information.

The proposed Framework of International Auditing Guidelines describes four types of engagement which may be undertaken by an auditor: audit, review, agreed-upon procedures, and compilation, categorized according to the level of assurance expressed by the auditor. These engagements result in three levels of assurance being expressed: high (audit assurance), moderate (limited assurance), and no assurance, such terms being used to indicate their comparative ranking. The proposed framework notes that high assurance does not indicate absolute assurance. Absolute assurance in auditing is not attainable as a result of such factors as the need to

judgment, the use of testing, the inherent limitations of internal control, and the fact that much of the evidence available to the auditor is persuasive rather than conclusive in nature.

The principal objective of the proposed framework is to put into perspective future pronouncements of IAPC dealing with limited assurance services and no assurance services. The proposed framework notes that in the future International Auditing Guidelines will fall into three categories:

- ° International Auditing Guideline Series (there have been 24 Guidelines issued in this series so far)
- ° International Auditing Guideline/Limited Assurance Engagements Series
- ° International Auditing Guideline/No Assurance Engagement Series

(Comment period ending March 31, 1987.)