



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 13.06.2000
COM(2000) 359 final

**COMMUNICATION FROM THE COMMISSION TO THE COUNCIL AND THE
EUROPEAN PARLIAMENT**

EU Financial Reporting Strategy : the way forward

COMMUNICATION FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN PARLIAMENT

EU Financial Reporting Strategy : the way forward

EXECUTIVE SUMMARY

The Lisbon European Council Conclusions have underlined the importance of an efficient and transparent capital market for fostering growth and employment in the EU. Globalisation and information technology developments have created a unique momentum to realise a single, efficient and competitive EU securities market. In order to accelerate the completion of a single securities market, urgent action in the field of financial reporting is required to enhance comparability of financial statements, as requested by the European Council in Lisbon. The present Communication includes the following key actions

- **Before the end of 2000**, the Commission will present a formal proposal requiring all listed EU companies to prepare their consolidated accounts in accordance with one single set of accounting standards, namely International Accounting Standards (IAS). This requirement will enter into effect, at the latest, from 2005 onwards. Member States will be allowed to extend the application of IAS to unlisted companies and to individual accounts. This proposal will also contain transitional arrangements to encourage the early take-up of IAS together with the rules for the establishment of an EU endorsement mechanism, which will:
 - (i) oversee the integration of IAS in the EU, and
 - (ii) confirm that IAS will represent an appropriate basis for financial reporting by EU listed companies

The endorsement mechanism will consist of a two-tier structure; a political level and a technical level.

- The development of an enforcement infrastructure that will ensure rigorous application by listed EU companies of International Accounting Standards confirmed by the endorsement mechanism. The key focus will be on disseminating implementation guidance, encouraging high quality audit and reinforcing coordinated regulatory oversight.
- **Before the end of 2001**, the Commission will bring forward a proposal to modernise the Accounting Directives so they can remain the basis for financial reporting for all limited liability companies.

The Commission is seeking the urgent agreement of the Council and the European Parliament for its overall approach for this strategy.

INTRODUCTION

1. The Lisbon European Council¹ underlined the key importance of a single financial market in contributing to the Union's central objectives of growth and high employment. The European Council conclusions underlined the need to accelerate the completion of the Internal Market for Financial Services and set deadlines of 2005 and 2003 respectively to implement the Financial Services and Risk Capital Action Plans. The essence of the Lisbon conclusions was derived from the Financial Services Action Plan² and the Commission's Communications on Financial Services³ and Risk Capital⁴ – each of which call for the development of deep and liquid European capital markets to benefit both issuers and investors.
2. Among the priority objectives mentioned in the Lisbon European Council Conclusions is the need to enhance the comparability of companies' financial statements to benefit companies and investors. To achieve this objective, the Union requires common financial reporting standards – standards that are transparent, fully understood, properly audited and effectively enforced. Only with such standards will there be potential to allow the EU securities markets to grow from its present level of around half the size of the US capital markets.
3. Member States' securities markets are in a period of dramatic change and increasing consolidation, driven by new technologies, globalization and the effect of the Euro. The rapid development of information and communication technologies and, in particular, electronic trading platforms, are changing how transactions take place and the way financial information is disseminated. Financial reporting itself is also changing. Internet financial reporting facilitates access to information by investors, enhances analysis and the comparison of information. Increasingly investors want to make decisions on the basis of a continuum of standardised company financial and non-financial information. Similarly, periodic financial reporting also has a crucial role to ensure transparency, provide safeguards for investors and contribute to the overall stability of markets.

INTERNATIONAL ACCOUNTING DEVELOPMENTS

4. There are currently many different financial reporting rules and differing interpretations based on distinct traditions within the European Union. Unless reform is undertaken, inconsistencies – many of them of major importance – will continue. European financial reporting will remain fragmented, thereby hampering the development of a deep liquid single EU capital market.
5. Standard setting itself is evolving rapidly. There is a strong pressure towards the convergence of accounting standards, raising the importance of international standard setting and thereby encouraging national standard setters to cooperate more closely. The Commission's "*New Accounting Strategy*"⁵ focused on the need to

¹ Pts.20, 21 Presidency Conclusions from the Lisbon European Council (23 and 24 March 2000).

² COM (1999) 232, 11.05.99 "*Financial Services: Implementing the Framework for Financial Services Action Plan*".

³ COM (1998) 625, 28.10.98 "*Financial Services: Building a Framework for Action*".

⁴ SEC (1998) 552 final, 31.03.98 "*Risk Capital : A key to job creation in the European Union*".

⁵ COM (1995), 14.11.95 "*Accounting Harmonisation: A new strategy vis-à-vis international harmonisation*".

facilitate the access of European global players to international global capital markets by advocating the use of International Accounting Standards (IAS). The Commission supported the efforts of the International Accounting Standards Committee (IASC) and the International Organization of Securities Commission (IOSCO) to create a single body of financial reporting standards that could be used for listing purposes around the world. The core set of standards contained in the agreement between IASC and IOSCO has now been finalised. IOSCO announced on 17 May 2000 the completion of its assessment of IAS and recommended its members to allow multinational issuers to use IAS for the preparation of their financial statements for cross-border offerings and listings.

6. Recently, major developments have also taken place within the IASC itself. Its new organisational structure should become effective next year driven by a clear determination to make IAS the highest quality, comprehensive accounting standards for use in capital markets throughout the world.

THE EU STRATEGY

7. This Communication sets out the Commission's views on the broad lines of the Union's future approach to financial reporting. The Commission seeks broad political endorsement of this approach so that it can prepare proposals to introduce the strategy by the end of this year. A central objective – and one against which success can be measured – is that the policy should ensure that securities can be traded on EU and international financial markets on the basis of a single set of financial reporting standards. It will also be crucial that the strategy be firmly anchored to best international practice.
8. Sound financial reporting remains at the heart of the Commission's approach. Relevant, timely, reliable and comparable information about the performance and financial position of an enterprise continues to be of central importance in safeguarding the interests of investors, creditors and other stakeholders to ensure a level playing field between competitors. Financial statements underpin the entire system of market information. They are the vital link between issuers and investors and are essential to deliver the high level of comparability the EU needs for a single securities market. Agreed accounting standards must be properly applied and enforced to ensure efficient markets. Accounting standards have to be enforced at an equivalent level throughout the EU and the world. Authoritative guidance must thus be available to assist preparing these financial reports.

FINANCIAL REPORTING IN THE EU

9. Whilst the EU's Accounting Directives remain the basis of the EU's accounting rules for limited liability companies, our existing directives do not meet the needs of companies that wish to raise capital on pan-European or international securities markets. This is because transparency, comparable financial reporting and more demanding disclosure requirements for listed companies are being sought by both investors and supervisors.
10. The present diversity of accounting approaches in the EU results from the many options being available in the Directives and from different levels of enforcement throughout the EU. Adaptation of financial statements to take account of local legal and tax conventions was justifiable when investors and other stakeholders were

generally of the same nationality as the company. But today the securities of any one company tend increasingly to be held by an internationally diverse group of investors. The interests of investors from another Member State are not served by having to interpret, or decipher, financial statements prepared in accordance with the local conventions of the country where the company is incorporated.

11. EU legislation is also silent on many aspects of accounting thereby permitting, by default, differing national specifications. National authorities may also allow companies to prepare their accounts on the basis of internationally accepted financial reporting frameworks (IAS or US-GAAP – Generally Accepted Accounting Principles – in the United States), provided they conform with the Accounting Directives. It is not unusual for different companies to report to different accounting standards within the same Member State and even on the same stock exchange. The co-existence of different reporting frameworks is both confusing and costly. It makes effective supervision and enforcement of financial reporting requirements of publicly traded companies more difficult. Investors are deprived of comparable accounts and therefore essential information. Cross border trade is hampered. In short, the result is market fragmentation that puts EU securities markets globally at a severe competitive disadvantage.
12. With the accelerating pace of business the need for a more dynamic and responsive legislative framework for financial reporting increases. The Union's lengthy legislative processes need close examination to ensure they meet the challenges of the market.⁶ Ways to move from the rigid, sometimes overly-prescriptive nature of EU directives to a more efficient and responsive system for financial reporting best suited to the needs of securities markets have to be considered.

A NEW WAY FORWARD

A single set of financial reporting standards

13. The Lisbon European Council set the goal of a fully integrated financial services market by 2005. The starting point is comparable financial reporting. The accounting standards chosen must meet investors' needs and be compatible with global developments. An internationally recognized financial reporting framework is essential for financial reporting by listed EU companies.
14. There are two financial reporting frameworks, currently in use in the EU⁷ that could provide internationally recognized standards : US GAAP and IAS. Both are investor-oriented financial reporting systems that provide generally equivalent levels of investor protection. There are, however, numerous differences in their practical reporting requirements.

⁶ COM (1999) 232, 11.05.99 "*Financial services: Implementing the Framework for Financial Markets: Action Plan*" Section IV, states that EU solutions must be characterised by a degree of flexibility so that they are not immediately rendered obsolete by the pace of change in the markets. This objective is put at risk by the length of time needed formally to agree legislative solutions.

⁷ In 1998, some 210 EU companies reported in accordance with IAS while 235 reported under US GAAP. Most recent statistics issued by the IASC show that at present 275 EU companies use IAS.

15. Although market forces could be left to determine the preferred set of reporting standards, this would cause delay by prolonging, unnecessarily, the period of competition between competing standards. In the interim, costs would not be reduced, nor transparency be improved. Delay could also undermine the Lisbon European Council's goal of enhancing EU-wide comparability of financial statements by 2005.

In its 1995 Accounting Strategy⁵ the Commission expressed its preference for IAS as the set of standards for EU companies wishing to raise capital on an international and pan-European basis. Since then, the IASC has undertaken a gradual, but in-depth process of revision of its standards. Already IAS provides a comprehensive and conceptually robust set of standards for financial reporting that should serve the needs of the international business community. IAS also has the distinct advantage of being drawn up with an international perspective, rather than being tailored to the US environment. US GAAP, on the other hand, is voluminous and is based on very detailed rules and interpretations. Considerable education and training is necessary in order to use its standards. In the US its effective application stems largely from the strong regulatory and enforcement powers exercised by the US Securities and Exchange Commission. The European Union does not, of course, have influence on the elaboration of US GAAP.

Application of IAS – the Scope

16. The Commission proposes that **all EU companies listed** on a regulated market⁸ (estimated at around 6,700) should be required to prepare consolidated accounts in accordance with IAS. Within two years this requirement should be extended to all companies preparing a public offer prospectus⁹ in accordance with the Listing Particulars Directive.¹⁰ Unlisted companies planning to make an initial public offering of its securities might also wish to use IAS. The Commission therefore proposes that Member States be permitted either to require or to allow **unlisted companies** to publish financial statements in accordance with the same set of standards as those for listed companies. More specifically for **unlisted financial institutions and insurance companies**, Member States may wish to extend the requirement to apply IAS to facilitate sector wide comparability and to ensure efficient and effective supervision.¹¹
17. The requirement to use IAS relates to the consolidated accounts of listed companies. As far as the national statutory individual accounts are concerned, regulatory and tax requirements could make the use of IAS inappropriate or even invalid. Nevertheless, whenever possible, the Member States should encourage even to the point of

⁸ Within the meaning of Article 1(13) of Council Directive of 10 May 1993 (93/22/EEC OJ L 141 11.06.93 P.27) on investment services in the securities field

⁹ Regulated by Council Directive of 17 April 1989 (89/298/EEC OJ L 124 05.05.89 P.8) coordinating the requirements of the drawing-up, scrutiny and distribution of the prospectus to be published when transferable securities are offered to the public.

¹⁰ Council Directive of 17 March 1980 (80/390/EEC OJ L 100 17.04.80 P.1) coordinating the requirements for the drawing up, scrutiny and distribution of the listing particulars to be published for the admission of securities to official stock exchange listing.

¹¹ The Commission proposal does not address supervisory issues and the specific information required by supervisory authorities. The implementation of the proposal should not lead to a lessening of the prudential requirements for regulated entities.

requiring the use of IAS for individual accounts as well. This would facilitate the preparation of consolidated accounts in the future.

Shelf-registration

18. The Commission is examining the importance of linking the approach outlined above with its forthcoming actions to modernize the existing Prospectus Directives¹² which will involve, probably a greater use of “*shelf-registration*” procedures for EU securities issuers. At the heart of shelf-registration is a “*reference document*” (supplemented with a “*securities note*”) which would be filed with the relevant national authorities. The objective of shelf registration is to secure access to other Member State markets by means of a common registration system based on comparable market information, including financial information. Basing shelf-registration on one set of transparent, international accounting standards for financial reports would not only simplify matters for the companies concerned, but would also contribute to enhancing market dynamism throughout European financial markets.

THE NECESSARY INFRASTRUCTURE REQUIRED FOR THE NEW ACCOUNTING STRATEGY

19. This strategy will need to take full account of public policy interests. The European Union cannot delegate responsibility for setting financial reporting requirements for listed EU companies to a non-governmental third party. In national jurisdictions, competent authorities can delegate the drafting of accounting standards to a national standard setting body having defined its governance structure. To achieve legal certainty for users of IAS in the European Union, international standards must be integrated into the EU financial reporting legislative framework. EU authorities must have the means to exercise the necessary regulatory oversight and correct any material deficiencies or concerns in relation to IAS.

Exercising oversight

20. In order to provide for the necessary public oversight, an EU endorsement mechanism is needed. The role of that mechanism is not to reformulate or replace IAS, but to oversee the adoption of new standards and interpretations, intervening only when these contain material deficiencies or have failed to cater for features specific to the EU environment. The IAS used in the EU will be the standards endorsed by this mechanism.
21. The central task of this mechanism should be to confirm that IAS are in full conformity with the Union’s overall approach - more specifically, if there is conformity with the EU’s Accounting Directives and that a suitable basis for financial reporting by listed EU companies is provided. There would, however, be a presumption that IAS meet these needs: the mechanism would confirm that this presumption is right.
22. The endorsement mechanism should have a two-tier structure – one at political level and the other at technical level - to ensure sufficient EU public oversight. The Commission will present a proposal on the structure and institutional aspects of this

¹² See Financial Services Action Plan COM(1999) 232, (11.04.99).

two-tier endorsement mechanism later this year. The proposal will pay particular regard to the mechanism's legal status, powers, detailed composition and possible involvement of securities regulators.

The technical level will need to be under control set at a political level. This control will have to be based on appropriate EU institutional arrangements under established comitology rules. **At the technical level** a group of highly qualified experts should be nominated. They should be selected on the basis of their knowledge of EU and international financial reporting requirements. In addition, specialised ad hoc groups may be necessary to deal with particularly complex issues or where there are standards that could have a particular impact on supervisory and prudential issues (in particular with regard to banks, other financial institutions and insurance companies). Not only should they scrutinise IAS, they should provide input into the IASC standard setting process at all stages, particularly in the early phases.

23. The endorsement mechanism will ensure that IAS, in practice, can be applied in the EU environment. It will, in particular, need to identify whether there is a need for specific implementation guidance to ensure a common and consistent application of the standards. This should not mean revisiting the general interpretations on IAS: the Standing Interpretations Committee (SIC) of the IASC has this function. The objective must be to establish a constructive, dedicated and continuous dialogue with the IASC, in particular with the SIC, when implementation guidance is required. This task will require coordination with national standard setters and, in particular, with securities markets supervisors.
24. The endorsement mechanism will confirm the dates by which new IAS apply within the EU. It may conclude that additional disclosures are necessary or certain options set out in a particular standard do not conform with the EU Accounting Directives. The mechanism would advise the Commission whether or not an amendment to the Directives is recommended in the light of international accounting developments.
25. Objections to IAS – probably infrequent - would have to be substantiated and publicly recorded. Recommendations made at the technical level on a particular IAS standard will need ratification at the political level. To avoid such a situation concerns about emerging IAS will need to be expressed at the earliest stage in the IASC's drafting process. Indeed, the Union will need to develop internal coordination at all stages of the IAS standard setting process not least to influence the debate. The endorsement mechanism can help coordinate the European position within the IASC.

Enforcement infrastructure

26. Clearer internationally-based accounting standards and increased comparability in the financial reporting requirements for listed companies will greatly simplify enforcement particularly in the securities markets.

However, only IAS that are properly and rigorously enforced will improve the functioning of the EU securities market. Enforcement comprises a cascade of different elements including (1) clear accounting standards (2) timely interpretations and implementation guidance, (3) statutory audit, (4) monitoring by supervisors and (5) effective sanctions. Each of these must work efficiently : the system will be as strong as its weakest part in delivering strong investor and creditor protection.

27. If this framework is to provide high quality financial reporting, the statutory audit function, which ensures a proper application of accounting standards, will need to be carried out to uniformly high levels across the EU. This requires giving urgent attention to the establishment of benchmarks for auditing, the development of professional ethics standards and the implementation of effective quality assurance systems for the statutory audit function. The Commission will issue a Recommendation on Quality Assurance for Statutory Audit. Further work of the EU Committee on Auditing will also be undertaken to determine a common approach for auditing standards and professional ethics.
28. Securities supervisors also have a critical role in ensuring that listed companies comply with financial reporting requirements. There is clearly a major interest in ensuring accurate and consistent application of accounting standards in the securities markets they oversee. In the EU securities markets regulators must be actively involved in enforcement issues. In particular, the Commission looks to European securities markets supervisors (through FESCO - the Forum of European Securities Commissions) to develop and implement a common approach to enforcement. Such an approach would establish a level playing field and avoid the danger of regulatory arbitrage. Peer-reviews of securities markets supervisors' practices could be considered as a useful instrument for ensuring a common approach.

IMPLEMENTATION, TIMING AND TRANSITION PERIOD

29. **Before the end of 2000**, the Commission will present proposals to introduce the requirement that all listed EU companies report in accordance with (endorsed) IAS and provide an option for Member States to allow (or require) unlisted companies to report in accordance with IAS. This proposal will also establish the basic rules of the endorsement mechanism, transitional modalities, the timetable for implementation, and a review clause to permit an assessment of the approach.
30. The Commission considers that in order to implement the IAS requirement within the 2005 deadline set by the Lisbon European Council for the completion of the Financial Services Action Plan, a transition period will be needed to allow the transposition of the legislation into national law and the adjustment of listed companies to the new set of rules. The Commission will limit the duration of that transition period, which will begin from the date of implementation of the initial legislative proposal so that, at the latest, from 2005 onwards all listed EU companies will be preparing IAS consolidated accounts. During the transition period, Member States will be entitled to decide what listed companies could (or should) use IAS in advance of the full implementation date. The Commission considers that five years after the adoption of the proposal, the provisions, procedures and mechanisms should be reviewed in the light of national, European and international experience. The Commission will benchmark progress.
31. Within the EU, some large companies apply US GAAP, often because they are listed on the US capital markets or because they operate in industries where the IASC has not yet provided an equivalent industry standard. Member States could permit the use of US GAAP during all or part of the transitional period.
32. The Commission will introduce proposals to modernize the EU Accounting Directives **before the end of 2001** which will continue to be the basis for financial reporting by all limited liability companies in the EU. Modernization of the

Accounting Directives should reduce potential conflicts with IAS and bring the Directives into line with modern accounting developments. This is particularly true where new technological developments call for an adaptation of traditional accounting methods, such as the recognition and measurement of intangible assets. The Commission will seek advice through the relevant advisory committees on whether new communications and information technology, in particular the internet, will affect financial reporting and require legislative action.

CONCLUSION

The Lisbon European Council has requested that steps should be taken to enhance the comparability of companies financial statements. This Commission Communication presents a new orientation to fulfil this objective. The Commission invites the European Parliament, the Council, the Economic and Social Committee and the Committee of the Regions to urgently endorse the approach outlined in this Communication.