

**NOTE FOR THE INFORMAL ECOFIN COUNCIL  
OVIEDO 12 AND 13 APRIL**

**Subject: A first EU response to Enron related policy issues**

The Enron affair – whatever the outcome of the ongoing investigations in the US - has brought to light a number of significant international policy issues. These issues have major significance for the EU in the context of creating its efficient and competitive capital market by 2005. There are five key issues presented in this paper. Each issue is examined in order to show what actions have already been taken and to identify what complementary actions (a summary of the policy actions is included in the back of this paper) now need to be pursued at European level:

- (1) Financial Reporting
- (2) Statutory Audit
- (3) Corporate governance
- (4) Transparency in the international financial system
- (5) Financial analysts' research and the role of rating agencies.

**1. COMPREHENSIVE AND TRANSPARENT FINANCIAL REPORTING**

US GAAP is largely a rules based approach to financial reporting. It comprises tens of thousand pages of accounting rules accumulated over decades (e.g. 600 pages on derivatives, more than 800 pages on special purpose vehicles...). US GAAP contains numerous so-called “bright lines” – in effect they set out demarcation lines between the acceptable and the non-acceptable. In a dynamic business environment with management remuneration increasingly based on financial performance (share based payments) and innovative financial engineering (derivative financial instruments), creative accountants and lawyers have developed products and accounting methods that have little economic purpose other than to fall within the letter, if not the spirit, of these “bright lines”. This has led some financial statements in the US not to reflect properly the true financial position. However, it would be wrong to criticise all aspects of US GAAP and to believe that accounting failures are impossible elsewhere, including in Europe.

The Commission has strongly promoted a strategy based on a principles-based approach to financial reporting, designed to reflect economic reality and so giving a true and fair view of the financial position and performance of a company. This protects the long term interests of investors and other stakeholders and requires company directors to make a careful judgement in selecting and applying the most appropriate accounting policies. At the heart of the Union's strategy is the application, from 2005, of International Accounting Standards (IAS) as the reporting framework for all listed EU companies. IAS are developed at the global level and concentrate on principles rather than on

detailed rules. In IAS the rules which flow logically from the principles have far less complex exceptions and exemptions than US GAAP. Harmonised enforcement will ensure that under IAS the same situations will be accounted for in the same way. In many areas, they are already highly developed and the best available in the world. For instance, the off balance sheet treatment for Special Purpose Entities which are de-facto under the control of the reporting entity, would not be possible under IAS. The US have acknowledged that their standards dealing with off balance sheet financing require revision and the authorities are calling for new IASB-style, principle-based requirements.

After a single reading of the Commission's proposal for a Regulation, IAS will be obligatory for listed EU companies – with few exceptions - from 2005. Efforts must now be made throughout the EU to ensure proper implementation, harmonised interpretation and enforcement of IAS. We must also intensify coordination within the Union and develop best practice at European level.

The EU's commitment to IAS is clearly helping to achieve improved global convergence of financial reporting. Concerted actions are needed at all levels to persuade the US authorities to accept IAS financial statements prepared by EU companies without further reconciliation to US-GAAP. Recent contacts suggest that the US authorities and congressional leaders are less resistant to discuss this issue. The EU must demonstrate its political determination to the US that a solution must be found.

#### **Policy actions on financial reporting:**

-Speedy adoption this year of the Proposed **Regulation requiring the use of IAS** by listed EU companies from 2005, in line with the Barcelona Council conclusions;

- **Preparation of the Commission's endorsement decision of existing IAS** so as to make it possible for listed EU companies to prepare the change-over in time for the 2005 deadline;

- **Further development of EU and national enforcement mechanisms** so as to ensure proper and harmonised application of IAS within the EU in co-ordination with the Committee of European Securities Regulators (CESR);

- **Sustained and co-ordinated upstream pressure within the IAS process** to ensure that new IAS continue to follow the principle-based approach and reflect, as much as possible, European concerns;

- **Continuation of the dialogue with US authorities to encourage their acceptance of IAS financial statements prepared by listed EU companies for listing within the US** without reconciliation to US GAAP from 2005 onwards;

- EU support for **global convergence through the IAS process** on important accounting issues such as the treatment of financial instruments, share based payments and off-balance sheet financing schemes;

- **Urgent modernisation of existing Accounting Directives** in order to apply IAS principles to unlisted companies, when a Member State so chooses;

- Before Summer 2002, publication by the Commission of a second consultative document on **Regular Reporting**. This document will address issues such as the periodicity of financial reporting (quarterly reporting) and on-going disclosure obligations.

## 2. STATUTORY AUDIT

Intense scrutiny on the actions taken by Enron's auditor in the US has prompted much critical comment and led to some loss of public trust in the audit function, although so far it has not greatly affected overall trust in EU capital markets. The Enron case highlighted deficiencies and weaknesses in US auditing and led to criticism notably of **audit firm to audit firm peer reviews** (external quality assurance); the ineffectiveness of the present **public oversight body** funded by the audit profession; the malfunctioning of **audit committees**; and concern about a perceived lack of **independence** of the auditor.

Since 1998, in the EU, the **Committee on Auditing** has been working hard on improving and harmonising the quality of statutory audit, based upon the priorities identified by the Financial Services Action Plan. A three pronged strategy is being developed covering external quality assurance, auditor independence and auditing standards. The Commission has already issued (in November 2000) a Recommendation defining minimum requirements for Member States' systems of **external quality assurance**. That Recommendation set out the basic conditions for a peer review or a monitoring system. It defined proper public oversight procedures; required a majority of non professionals to be on the oversight body; mandated publication of the results of the quality review and linked those results to disciplinary systems.

Based on 2 years of preparatory work by this Committee, the Commission will shortly adopt a Recommendation on **auditor independence**. This will follow a principles-based approach. Its main thrust is that, within a framework of safeguards, the auditor has to demonstrate (and document) that none of his actions or relationships has in fact compromised his independence. The Recommendation will indicate a number of instances where the provision of certain non-audit services to the audit client (such as a general outsourcing of internal audit or the design and implementation of financial information technology systems) is prohibited because these services are perceived as causing an unacceptably high level of risk to an auditor's independence. A rotation of the key audit partners within 7 years of appointment to the engagement team is also proposed. A (well-advanced) draft text was reviewed in the light of the Enron case by the EU Committee on Auditing on 21 and 22 March 2002. There was overwhelming agreement that there was no need for regulation but that the draft Recommendation should be adopted as quickly as possible, with minor changes. These changes include the introduction of a 2 year cooling-off period for partners of audit firms joining their audit client and improved disclosures of audit and non-audit fees. The effectiveness of the Recommendation when adopted will be closely monitored.

**Auditing standards** are crucial to providing high quality audits. There are at present no agreed auditing standards in the EU. Although there is general agreement that any initiative in this field should be based on the International Standards on Auditing (ISA), it is still unclear how all statutory audits in the EU will be carried out on the basis of these standards. There is also no EU mechanism to deal with **supervision of the audit profession**. Oversight in the Member States ranges from public sector oversight to a combination of self-regulation by professional bodies with public oversight boards. There is clearly a need to enhance this supervisory framework, as the 2005 deadline approaches especially by involving people from outside the profession in the public oversight.

**Audit committees** set up within companies also play a crucial role in helping auditors to maintain their independence from the management of the audit client. Nowhere in the EU are such audit committees required by law. In only some of the 39 non binding codes on corporate governance in the EU are such committees dealt with, and even then in a limited way.

**Policy actions on statutory audit:**

- Adoption by the Commission of its **Recommendation on Auditor Independence** by the end of April;
- Adoption by the Commission of a **new Communication** on policy priorities in the field of statutory audit by September. This Communication could address in particular the following issues:
  - The use of **International Standards on Auditing (ISA)** for all EU audits by 2005;
  - Minimum requirements for proper **Public oversight of the auditing profession** at national and possibly at European level, with strong participation from outside the profession;
  - Corporate governance in relation to the statutory audit, in particular the future role of **audit committees** in European listed companies;
  - The possible adoption of a **Code of ethics** to underpin professional integrity within the Union;
  - **Providing a proper legal underpinning for the EU initiatives on statutory audit**, notably by a modernisation of the 8<sup>th</sup> Company Law Directive on statutory audit;
- A review in 2003 of how the **Recommendation on minimum requirements for systems of external quality assurance** for statutory audit in the EU (adopted in November 2000) has been implemented in Member States.

### 3. CORPORATE GOVERNANCE

Enron's collapse has increased awareness that proper Corporate Governance is essential to the efficient functioning of capital markets and high quality financial reporting. The EU has not yet systematically addressed corporate governance issues.

The Financial Services Action Plan indicated effective Corporate Governance as a key condition for the development of European capital markets. A comparative study has recently been finalised, which provides the Commission with a comprehensive picture of all existing codes in the EU, their main provisions and how they are enforced. The study is being considered by the High Level Group of Company Law Experts, chaired by Professor Jaap Winter. The Group is also examining policy priorities on Corporate Governance issues and will report by July 2002. To respond to the Barcelona Council conclusions, the Commission will broaden the mandate of this Group to include additional Corporate Governance issues, including the role of non-executive directors and of supervisory boards; management remuneration; and the responsibility of management for the preparation of financial information.

The Enron case also brought to light the risks of allowing a company's pension fund to invest a large part of its assets in shares of that company. In the Commission's Proposal for a Pension Funds Directive, investment in the sponsoring company is limited to a maximum of 5% of the assets held by the pension fund. Adoption of this proposal remains a high priority of the Financial Services Action Plan.

**Policy actions on corporate governance:**

- **The present mandate of the High Level Group of Company Law Experts will be expanded to cover additional corporate governance issues**, including the role of non-executive directors and of supervisory boards; management remuneration; and the responsibility of management for the preparation of financial information;
- **The High Level Group will examine the Commission's study on codes of corporate governance**;
- The Commission will publish a second consultative document on **Regular Reporting** including ongoing reporting requirements on voting rights and the capital structure of companies;
- There should be speedy adoption of the **Pension Funds Directive**.

#### **4. TRANSPARENCY IN THE INTERNATIONAL FINANCIAL SYSTEM**

Enron's case has demonstrated a lack of transparency in the international financial system as highly sophisticated mechanisms of corporate finance have been developed. Complex derivative instruments also escape proper supervision, in particular when the trading takes place on non-regulated markets.

**Policy action on transparency in the international financial system:**

- **The Committee of European Securities Regulators (CESR) will be invited to report on supervisory issues related to the increased complexity of derivatives and derivative trading** and the implications for the regulation of European financial markets, with particular emphasis on financial engineering techniques and hedge funds, taking into account the work of the Financial Stability Forum. The timing of the report should be agreed with CESR.

#### **5. FINANCIAL ANALYSTS' RESEARCH AND THE ROLE OF RATING AGENCIES**

##### *Financial analysts*

The activity of financial analysis (preparation and publication of general recommendations on investment) is not directly covered under EU legislation. Recent evidence from the US and Europe has underlined concern that general recommendations issued by financial analysts can give rise to false or misleading signals as to the underlying value of an instrument. Systematically skewed recommendations by financial analysts appear to have significantly contributed to the overvaluation of many TMT securities in the late 90s.

Without manipulation of market conditions, bias in financial recommendations may also result from unprofessional conduct/negligence on the part of the firm or inappropriate incentive structures within firms that provide general advice. Recommendations to buy or sell particular instruments may be distorted by conflicts of interest when the investment firm concerned is performing other services for that company. Heavy bias towards buy recommendations may also arise from bonus structures for staff. The EU provisions that impose statutory obligations on investment firms/banks to conduct business in the best interests of clients and to be organised in such a way as to minimise conflicts of interest do not clearly extend to the provision of general financial advice by those firms.

The **proposed Directive on Market Abuse** will introduce a requirement that Member States ensure that persons producing or disseminating financial research concerning financial instruments or issuers of financial instruments recommending investment strategies intended for distribution to the public take reasonable care to ensure that such general recommendations are fairly presented. There must also be disclosure of any conflicts of interest in respect of the instruments that are recommended. (The US SEC's "fair disclosure" Regulation gives effect to similar obligations). Publication of misleading general recommendations that amount to market manipulation within the meaning of the proposed Directive on Market Abuse would be punished in accordance with defined sanctions.

**Policy actions on financial analysts:**

- **There should be speedy adoption of the Market Abuse Directive**, including the changes on financial research;
- In the consultative process now underway on the **Investment Services Directive**, consideration will be given as to whether further requirements are needed for financial analysts. These could clarify that investment firms and banks should be bound by more prescriptive conduct of business rules and organisational arrangements for managing conflicts of interest when undertaking financial research and analysis.

***Credit Rating Agencies:***

Credit rating firms facilitate assessment of the credit-worthiness of potential debtors and valuation of the securities of individual issuers by market participants and supervisory authorities. The ratings provided by specialised agencies overcome information asymmetries and spare market participants the cost of processing large volumes of financial information. In the past, the primary focus of credit rating agencies has been on sovereign debt. Their role is now becoming increasingly broader following the growth of corporate bond issuance and new financial instruments for transfer of credit risk (e.g. securitisation, credit derivatives). Rating techniques are also becoming current in respect of other investment products (unit trusts/UCITs). Such credit ratings are increasingly relied upon for a number of public policy purposes. (in the Basel II discussions, such ratings could help determine the credit risk weightings to apply when calculating capital charges to be applied to credit exposures to a given counter party).

The growing importance of credit ratings as a key support to market participants and as a tool for supervisory authorities means that the effective provision of accurate and reliable ratings is now a matter of broad market importance and public policy concern.

### **Policy actions on credit rating agencies:**

A **cross-sectoral policy assessment** should be undertaken, focussing in particular on:

- The contributions that agencies can and do make in assessing credit ratings;
- Whether consideration may need to be given to regulatory intervention in the area of credit ratings.

## **SUMMARY OF POLICY ACTIONS**

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