

**Regional integration :
European capital markets following the adoption of IAS by the EU
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IFAC – Council Meeting – 14/15 November 2001

Mr. Chairman, Ladies and Gentlemen,

When René Ricol asked me whether I could participate in this IFAC meeting, I accepted without any hesitation and I am very pleased and honored to be with you today.

Your invitation to present my perspective on “the European capital markets following the adoption of the IAS by the European Union (EU)” is very topical, as the draft EU Regulation on International Accounting Standards, which is the legislative act necessary to achieve this adoption, is in its final stage of review and should be adopted by the Council of Ministers and Parliament in the next few weeks.

But it is only one among many current developments which are important both to your profession and to the securities market regulators. And your general theme “Accounting 2005 – a Global Perspective” is well chosen, as I believe we will see important changes in this time frame – and I note that 2005 is precisely the deadline set by our European governments to achieve the integrated financial markets in the EU.

I would first like to provide some facts and figures in order to illustrate, for the benefit of those of you who are less familiar with the European economies, the importance of our financial markets. I will then tell you about the European Action Plan for Financial Services in the field of financial information, and will finally make some remarks about the strategic role of your profession and certain problems which, to my view, need to be addressed.

A - As of the end of year 2000, the market capitalization in the 15 EU member countries totalled 8 300 billion euros, compared to 14 900 bn euros for North American markets (USA and Toronto).

This makes a ratio of 56%, whereas the respective weight of our economies (Gross domestic products) is close to 75% and the comparative ratio of our populations is over 100%. Three years before (end 1997), the respective market cap ratio was 52%.

These figures show that, although our European financial markets have already “taken off”, there is still a potential for further growth and for an improvement in the financing of our business enterprises. My personal forecast is that the economic trends and globalization of policies will fuel further growth in our markets once we have put an end to the economic slowdown, and if we can overcome certain technical barriers and increase our degree of integration.

From the legal and institutional point of view a lot of progress has been achieved on the basis of the Treaty of Rome which provides for the free movement of capital, goods and people within the EU. A set of European directives, with a special mention for the Investment services directive, have organized a system of European passport for products and firms, and a principle of mutual recognition of European authorities of regulation

Nevertheless, a lot remains to be done and we have suffered a slowdown in the process since 1993. A new start was given, end of 1997, with the establishment of a network of securities regulators – called FESCO – followed, partly on their proposal, by the so called Action Plan for Financial Services in 1999, the report of the Lamfalussy group of wise men, and the Stockholm Summit, beginning of last year, which speeded up the process again.

Today, we are working very hard to deliver a new set of directives which will update or complete our legislative and regulatory framework, namely in the field of asset management, market discipline, transparency of information, and last but not least, accounting and auditing principles which I will come to later. FESCO was recognised and re-established as an official body named C.E.S.R. (Committee of European Securities Regulators). We shall never forget this event for it was in Paris on the 11th September. By the way, CESR proved its efficiency on this tragic occasion both in monitoring in cooperation with the F.E.S.E. (Federation of European Stock Exchange) the coordinated reaction of European Exchanges and by expressing, through a coordinated minute of market interruption, our mourning and solidarity with the American people.

From the industrial point of view, integration is on going in many sectors. As for the exchanges themselves, we have to date seen significant undertakings (Euronext : the grouping of Paris, Brussels, Amsterdam and, hopefully within a few weeks, the LIFFE and the Portuguese exchange, Eurex, Virtex...). New forms of markets appear (ATS) with new challenges for regulation. But I feel that we have seen only the first wave of mergers, and many commentators currently predict that further consolidation is to be seen down the road. Euronext is especially noteworthy development, as it represents the first successful attempt to adopt unified market, information and listing rules on a truly multinational basis that will apply to some 1700 companies. I am happy to point to the fact that IAS's have been selected with unlimited support by the securities regulators as the financial reporting language by Euronext, to be used as from 2004 by the companies listed on the main market segments and of course by Euronext itself when it got listed.

I should also mention the evolution of asset management industry which, in the Euro area, does not manage portfolios exclusively on the basis of national markets but on a European approach of the different sectors and with the use of European indexes.

To finish with this rapid overview of European integration, I should mention that within six weeks from now, 12 countries will have one currency, the Euro, somehow abstract a notion since two years, but now a physical reality for nearly 300 million Europeans.

As a result of these evolutions, the European financial market is improving its liquidity and depth and is really becoming paneuropean. Indeed, a lot of progress remains to be made but we are on the way and a lot of new legislation is in process in many fields, with 2005 a deadline for full implementation.

B - I would like now to focus on the accounting and financial information aspects of the Action Plan for Financial Services.

Harmonizing Financial information was deemed a priority in the Action Plan at the Lisbon summit in March 2000: European commission presented in June 2000 a “New strategy for accountancy and financial information – the way forward”. It recognizes that accounting rules, prospectuses and permanent disclosures are key factors for harmonizing the market rules.

Which accounting rules do we need? In theory, 3 choices were possible: develop new European directives, adopt US GAAP, or adopt IAS.

- A time constraint, combined with a lack of resources to establish purely European standards and, even more, a political choice, that of an international and global approach, led to adopt IAS.
- The system decided upon is based on the use of IAS as of, or before, 2005 for the accounts of all listed companies and public offerers of securities (at a minimum in their consolidated accounts) and for certain other entities at member states discretion
- A draft European Regulation is under examination; it should be adopted at the beginning of 2002.
- IAS's will be “endorsed” by a European regulatory committee (CERC) established beneath the European commission, where the states will be represented and which will propose the endorsement or rejection of standards
- Why is an endorsement needed ? Although I recognise Sir David Tweedie's point on the risk of contradictions and possible difficulties if regional standard setters would practice standard shopping, I must also remind you that standard setting is not merely a private activity. It deals with legal environment. IAS/ IFRS will become **accounting law** (in stead of the current directives or national legislations) and there is a need for legal certainty on the standards to be applied ; also, IASB is a private body with strong technical authority and no constitutional or democratic legitimacy, and it was not deemed reasonable to sign a “blank cheque” without retaining the right to oppose future developments which the Europeans would consider irrelevant.
- The European Commission will be advised in this endorsement process by an accounting advisory group (EFRAG) which will, with a proactive role, participate in the work of IASB and, with a reactive role, make recommendations as to the endorsement of standards.
- In parallel, FESCO, today CESR, has created FESCOFIN and two subcommittees to deal with the implementation challenges: a subcommittee on endorsement of IAS, in order to allow securities regulators to participate in the process and express their views to the IASB ; a subcommittee on enforcement in order to achieve a coordinated and high-quality application of accounting standards, to harmonize methods of supervision and exchange information.

We foresee that, with such a mechanism, problems should be solved well ahead of the endorsement decision making with little risk of contradiction between IASB and European views.

Within less than four years, some 6 700 European listed companies will adopt at the same time the whole set of International Financial Reporting Standards.

Companies are used to implementing new accounting standards as they are published by their national standard setters; but a complete change of standards on such a large scale has never happened in the past !

C - Let me now come to the challenges and a key role for the accounting profession in this strategic process.

C.1. The European project will not be easy to implement, because it represents a complete overhaul of the accounting systems, management performance measurements, financing policies, etc... There are possible far reaching consequences. For instance, staff incentives systems will have to be adjusted; loan covenants which include certain financial ratios will have to be renegotiated, off balance sheets and financial management policies will need to be restructured.

In this endeavour, governments, business enterprises and regulators will need the full support and commitment of the accounting profession. You can imagine some of the roles that you will have to play :

- to train of companies' staff
- to educate the public to understand the new accounting model
- to help modify the companies' financial reporting systems
- and moreover, to facilitate the proper and fair application of the new rules. For instance, it will be necessary for the European accounting profession to participate actively in the work of EFRAG and IASB and to reach agreement on how to interpret and apply the IAS in certain specific circumstances.
- It will be of utmost importance, in such a transition period, that the european and foreign investors trust the financial information provided to them. Suspicion on the interpretation and application of standards cannot be accepted. Poor quality audits are always unacceptable, but they are more specially so in the days when a complete overhaul of reporting principles will take place. Therefore, I call on your profession to make it a success. You can foresee a high-risk time ahead, but you have a unique opportunity to increase the confidence of the public.



C.2. Will this be enough? Achieving harmonization and integration at the european level is a necessary step, but it should not stop there. The real challenge is global, as we should attempt to avoid a bipolarisation of "accounting blocks". What the issuers of securities and investors really need is that the standard setters, accountants and regulators agree on a worldwide basis on a common set of accounting standards that will be accepted on all the financial markets.

When I say “accepted”, I mean “can be directly used as primary financial reporting rules without burdensome reconciliations and additional disclosures”. An important first step was achieved in May 2000 by IOSCO, with the endorsement of the 30 IAS core standards, but one of the regulators (and a key one) which approved this IOSCO recommendation is still thinking about and consulting on, the conditions and timing of its implementation. I understand that there are some legal steps to take before it can be implemented, but we would very much like to see some positive signs.

Convergence is probably an intermediate process before full harmonization can happen globally. I commend the new Board of IAS for having decided to put on its priority list of projects, a number of items which can hopefully result in increased convergence. I hope that the FASB will make similar moves, and that, within a few years, US GAAP will be the US version of International Financial Reporting Standards.

- I am reasonably optimistic about it as key opinion leaders in the USA now recognize the role of IASC. Let me quote a few words from a recent speech by Mr Paul A VOLCKER before the US House of Representatives¹:

“I have long been sympathetic to the goal of harmonized standards. What is more important is that that objective has strong support among governments and industry generally, and most important within the United States itself. My understanding has been that both the SEC and FASB, with reason, have considered U.S. GAAP to be the best in the world. In effect, they have long taken the position other countries and companies should conform if they wanted to access U.S. capitalmarkets...”

However, the Asian financial crisis, and growing concerns about the functioning of the international money and capital markets more generally, have led to a different emphasis. They have made clear the importance, beyond the direct U.S. interest, of more rigorous reporting standards, of greater transparency, and of more effective auditing internationally. At the same time, there has been growing sentiment throughout the world that, while perhaps possessing the most developed body of standards, the U.S. did not have all the right answers. Furthermore, developing de facto global standards from Norwalk, Connecticut, has seemed increasingly unrealistic, both politically and economically, in the age of globalization...”

C.3. Similarly, the accounting profession needs to harmonize its technical auditing standards and its ethical behaviour. No real economic progress can be achieved if an international investor has doubts as to the technical quality or objectivity of audits performed in countries other than his home country.

The role of IFAC is extremely important in this respect, and I am aware that profound structural reforms are being discussed with the aim of improving the standard setting process and ultimately the quality of the standards. I also understand that you plan to implement a quality control system on a worldwide basis. As a regulator, I support these initiatives and will do whatever I can to help you.

IOSCO Standing Committee n°1 will examine these proposals and provide comments. The time scale, and the cancellation of the October meeting due to the September 11 events, have not allowed the Committee to meet your scheduled comment deadline but I am aware that a

¹ STATEMENT OF PAUL A. VOLCKER before the CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES SUBCOMMITTEE of the U.S. HOUSE OF REPRESENTATIVES Washington, DC June 7, 2001

meeting with IFAC is under consideration for the first half of December. At this point, I only would like to stress that I find it very important for the credibility of IFAC to be transparent and to establish a Public Oversight Board to represent the interests of the public and investors.

But for this POB to play an effective role, it must be sufficiently independent from the accounting profession as well as from the regulators. Independence can be helped by a selection process that is open and transparent. And this POB should have real powers to oversee, investigate, assess and publicly report about its findings and evaluation of IFAC's actions and processes.

Auditors' independence, both in reality and in appearance, is indeed a critical factor in maintaining public confidence.

May I quote Mr. Graham Ward, former Chairman of the Institute of Chartered Accountants in England and Wales and a member of your Council:

« The days of the public saying « tell me » and of the [accounting] profession saying « trust me » are over. Reputation must now be earned and demonstrated on a daily basis. Now, the public says « show me ».

Until recently, independence and objectivity used to be mainly matters of professional judgment by the auditors and of self-regulation by the professional bodies. The standards, if any, were established at a national level, with very little international harmonization. Furthermore, the ethical and technical standards were enacted by the profession itself, without any practical input from those representing the public interest.

For several well-known reasons, this self-regulation system has been the subject of criticism in many parts of the world and a series of serious audit failures have prompted the attention of the regulators and of the legislators. Everywhere, the subject of auditors independence has been or is debated. And significant changes are in progress. Several noticeable changes have occurred in the recent months in Europe and in the USA – let me mention a few examples :

- A new framework for an independent regulation of the accountancy profession was established in 2000 in the UK and will be fully operational in 2001.;
- In France, following an important study conducted in 1997 under the Chairmanship of my predecessor Mr Yves Le Portz, an Ethics and Independence Committee (CDI) was created in 1999 under a joint agreement between the professional body (the CNCC) and the COB, and has been fully operational for two years. This committee is composed with a strong majority of non accountants, and it has proven its effectiveness and independence by taking courageous decisions on a number of tricky issues ;
- In the USA, the Securities and Exchange Commission has released in February, 2001, its new rules revising the Commission's Auditor Independence Requirements after a very heavy public comment process and a serious debate with the accounting profession ;
- In the European Union, an Experts Committee on Auditing was created in 1998 by the European Commission and, among other accomplishments, is about to release a Recommendation establishing « A set of fundamental principles on Statutory Auditors' Independence in the EU » ;

- At the worldwide level, the Ethics Committee of IFAC is in process of revising its Code of Ethics; the draft document is built around a « threats and safeguards » model rather than based on a more traditional « rules and prescriptions » model. The Standing Committee n°1 of IOSCO has recently sent a comment letter summarizing the views of IOSCO's members on this project and I understand that these comments are under consideration by the Ethics Committee.

A year ago, I personally offered comments to the first IFAC exposure draft. I wrote :

“The COB welcomes in general the new approach developed in the exposure draft. However, we are particularly concerned with what seems to be a fundamental flaw in the basis of the argument : the proposed code is based on the assumption that a very wide range of non-assurance services can be provided by accountants to their clients in addition to the audit of their financial statements, provided that such services do not impair in an excessive manner the independence of the audit opinion. This conveys the impression that the audit of financial statements is just an ordinary business service as any other engagement. We hold a different view. We believe that public accountants should make a clear choice with respect to their role to a given client : they should either elect to be the company's auditor or to be a multi-disciplinary consultant. To intermingle the two roles would only lead to a confusion in the public mind and weaken the confidence placed in the function of the independent auditor, the very foundation of reliable capital markets.”

As you may gather from these comments, the COB views on the matter of independence are similar to those which underlie the SEC revised rules. We acknowledge that the nature of the audit engagements and the circumstances surrounding them have become more complex and that your clients expect more added value from their auditors. We also recognize that the increasing number of events affecting the life of a company, especially a publicly quoted company, could result in the auditor becoming more frequently consulted on the financial aspects of unusual business transactions (such as acquisitions, mergers or divestures) and that his early involvement enhances the quality of financial information and can only be to the advantage of the shareholders.

By the way, it has been said by some defenders of the development of consulting in combination with auditing that the mere activity of audit of accounts and financial statements would not be sufficiently attractive, and that the quality of the profession would suffer if it were limited in its scope. I simply cannot understand this point. I, on the contrary, share the view that audit is a noble and very sophisticated activity which could be enriched by the enlargement of its scope, not in the direction of consulting or delivery of operational services, but in the field of assessment of the coherence and consistency of all the financial aspects of the management of the client companies, assessment of comments on trends, including, why not, financial forecasts. Of course, this would not extend to the commercial and industrial aspects of business plans which are the exclusive responsibility of the management of firms. This is a personal, and for some people in France a rather provocative approach, but I think the profession should consider it and I must say that Alan Anderson's brilliant presentation has confirmed me in my position.

In any case, I believe that when the auditor acts as a commercial supplier of services or when his personal involvement is not clearly justified to accomplish the audit of the financial

statements, and irrespective of his client's desire to benefit from his expertise, the auditor begins to place himself in the same position as any other supplier and loses his unique position of being « the » independent auditor. This also creates the appearance of an association with the client's affairs and self-interest or self-review risks that are clearly unacceptable especially when the audit relates to public entities.

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In conclusion :

- Independent and effective auditing is an essential component of an international financial reporting architecture. Investors and regulators must be able to rely upon this service being carried out with the highest quality, regardless of where it is rendered. All international audit firms should commit very soon to applying as a minimum the International Standards on Auditing published by IAPC, the Auditing Committee of IFAC. Such minimum standards should be applied in all the jurisdictions where they operate, and where the local legislation precludes the application of a particular standard, this fact should be disclosed to the users of the audited financial statements.
- To my mind, the basic independence test which should be used in the decision making process with respect to the provision of non audit services is to ask the following question: is the auditor's proposed engagement (or other specialists involvement) necessary for the auditor to perform an effective audit of the company's results and financial position? or is it a "commercial" service that could be provided by other professionals as well, without a detrimental effect on the quality of the audit ?

In a few words, and to conclude a too long speech, let me express bluntly my very candid belief : the one who delivers consulting is not in a position to deliver independent controls.

Thank you for your attention.