



Fédération des
Experts Comptables
Européens

DISCUSSION PAPER ON A FINANCIAL REPORTING STRATEGY WITHIN EUROPE

FINAL TEXT

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Executive Summary

The stability of the capital and financial markets in Europe is built on three principles: good corporate governance; good financial reporting; and good auditing. FEE has developed this Discussion Paper to stimulate the debate on a financial reporting strategy in Europe. This debate, involving all key players and other interested parties, is not restricted in any way. However in order to stimulate the debate FEE has expressed views on a number of issues based on the internal debate that took place within FEE in the first nine months of 1999.

The financial reporting environment is rapidly changing both at a global and at a European level. Initiatives in Europe need to take into account and form part of the developments at global level. The European Union is moving towards completion of the Single Market, to which the introduction of the euro has given greater impetus. In the new Europe, companies will more and more operate on a global level and want to mirror that in their financial reporting by using global accounting standards - IASs-. The Accounting Directives should not form a barrier to such developments

Accounting diversity is one of the major obstacles to achieving deep and liquid European capital and financial markets and to obtain the full benefits of the Single Market in Europe that within short term hopes to be as important as the US capital market. FEE calls on all stakeholders in financial reporting to debate the rapid changing financial reporting scene in Europe. FEE wishes its Discussion Paper to stimulate and contribute to that debate, focusing in the initial stages on the needs of the capital markets and therefore the consolidated accounts of listed companies.

FEE strongly supports the work of the IASC and believes that IASs currently represent the best opportunity to achieve both global and European harmonisation of financial reporting standards. The prospect of this objective would be undermined by the creation of additional regional standard setting bodies, or by the Accounting Directives not keeping pace with international developments.

The extensive use of IASs by European companies would heighten the credibility of IASs and the prospect of its world wide acceptance, including in the USA. The prospect of harmonisation on IASs as a common set of standards both for Europe and world wide would be increased significantly if European companies were required to use IASs in place of national standards. However, the implementation of such a step would take some time and a measure of caution is understandable whilst the future structure of the IASC is still being determined.

The objective of harmonisation within Europe on one common set of financial reporting standards will be increasingly achievable if all listed companies in the EU are permitted to use IASs. FEE proposes this be facilitated by providing a company option to permit companies to use IASs instead of national GAAP. European listed companies that continue to use their national GAAP in the consolidated accounts should produce a reconciliation statement. FEE would favour giving companies the option to use IASs without requiring compliance with the Accounting Directives. FEE recommends either that listed companies be transferred to a separate capital market regime, or that they be permitted to produce consolidated accounts without the need to comply with the Accounting Directives. Furthermore the Fourth Directive requires modification to enable Member States to permit future developments of IASs without further legislative intervention and thus avoid the possibility that European companies would be unable to apply IASs in full in their individual accounts. FEE recommends enactment of enabling legislation without delay both at European and national level, and calls on national standard setters to narrow the potential differences between listed and non-listed entities by amending or developing national standards to be consistent with IASs.

Given the extent to which US GAAP is already used in Europe, it seems to be necessary to allow also the use of US GAAP. However, it should only be allowed for a limited period of time.

FEE proposes that a new body be established – the European Financial Reporting Coordination and Advisory Council – to promote the understanding and use of IASs, in Europe, including providing a

European forum for the discussion of new standards under development; to advise the European Commission on necessary adjustments to the Accounting Directives; to assist national governments in the implementation of IASs and to coordinate and advise on the enforcement mechanism put in place thought the regulators including providing a mechanism for pursuing complaints about compliance with IASs.

Introduction and background

The introduction of the euro is the logical conclusion of the single market and offers a historic opportunity to draw the full benefits of open and integrated markets. The disappearance of exchange risk and the single monetary policy of the euro area will give impulse to the integration and consolidation of capital and financial markets. With the agreement of 4 May 1999 by the London and Frankfurt Stock Exchanges to open up their bilateral talks to six other stock exchanges: Amsterdam, Brussels, Madrid, Milan, Paris and Zurich, the pan-European exchange has moved closer. The euro will fundamentally change the functioning of Europe's capital and financial markets and the nature of the information they require to operate efficiently and transparently. This integration and consolidation will require the elimination of many barriers which currently partition national markets from each other. The euro will compete with the dollar, and the European capital and financial markets are expected to grow in importance so that European multinationals become less dependent for their financing from the US capital market. Ensuring deep and liquid European capital markets requires the removal of barriers to cross-border provision of financial services.

Not least among these barriers is the accounting diversity which prevents adequate reliance being placed on financial statements across borders, and thus deprives the market of the reliable information it needs to invest across the eurozone as if it were one single economic area. European capital markets are growing in importance rapidly. In 1998 there were 6234 listed companies within the EU, an increase of 17% compared to 1995. The corresponding figures for the US are 6850 listed companies (NYSE and NASDAQ) an increase of only 2% compared to 1995. IASC compiles a list of companies referring to their use of IASs. This list contains 756¹ companies of which 24% is from the EU (43% from the total of Europe). An increasing number of companies is using IASs. This trend is expected to continue. For example, since the introduction of the law in Germany by which companies whose shares are publicly traded, when certain conditions are met, can use internationally accepted accounting standards instead of German law nearly all of the DAX 30 companies have switched to or have announced to switch to US GAAP or IASs. Furthermore, the German Ministry of Justice has published draft legislation, in which it is proposed that companies would also be permitted to use internationally accepted accounting standards if equity or debt securities of the parent undertaking or one of its subsidiaries are publicly traded or if they have filed an application for listing.

In several countries preparers and users of financial statements have expressed a clear wish to use internationally accepted standards, not only for quotation at foreign stock exchanges, but also for competitive reasons and to facilitate the public's understanding of the company's financial performance. Since preparers and users are the main actors on the capital and financial markets, standard setters have to seek to respond by reducing accounting diversity. National standard setters have to operate in a global context and are confronted with the wish of users and preparers to use internationally accepted standards directly. In some countries IASs are incorporated into national law or accounting standards in others the use of internationally accepted accounting standards instead of national GAAP has been made possible by a change of law.

Preparers, users and standard setters in Europe are at present required to operate within the framework set by the Accounting Directives and may be hampered in their use of internationally accepted accounting standards because substantial differences may arise with the Accounting Directives. The

¹ June 1999 figures obtained from IASC website

capital and financial markets are asking for more uniform information and are seeking harmonised and globally accepted accounting frameworks.

This paper discusses how the use of internationally accepted standards can be facilitated. A distinction needs to be drawn between what can be achieved in the short term and what should be the ultimate goal in the medium to long term. There is an urgent need for action and therefore FEE wants to contribute to the debate. The Commission has recognised also this need and has set out its proposed policy orientations for the regulation of Europe's capital and financial markets post-euro in the "Financial Services: Building a Framework for Action" Communication of October 1998, followed by a further communication "Implementing the Framework for Financial Markets: Action Plan" of May 1999. In both communications prominence is given to IASs.

Much attention is given at present as to whether or not IOSCO and especially the SEC will endorse the core set of International Accounting Standards so that foreign companies can be directly quoted at the New York Stock Exchange by using IASs. However, it is possible that IOSCO will not endorse the core set of IASs – or that it will recommend the use of IASs without reconciliation statement to its members but the SEC will not accept or only accept some IASs. In those circumstances, IASs cannot be used without a reconciliation statement by companies listed or wishing to become listed on the New York Stock Exchange. Even so, IASs are likely to play an important role in Europe. Investors in Europe need to have the same level of confidence when investing in another European country as they do in their own country. Europe therefore needs to go beyond the model of mutual recognition and minimum harmonisation currently in place and move, for listed companies, to more uniform and higher quality financial reporting. This would not only apply for cross border listings – as has so far been the case when countries allow for deviations from their national law when allowing companies to use internationally accepted accounting standards – but also for national listings. Moreover, with further integration of the capital and financial markets the distinction between cross border investments and national investments will disappear over time. EU's efforts in the accounting field should no longer be directed at facilitating access to third countries markets, but at assisting the integration of Europe's capital and financial markets post-euro. In some countries there is a tendency by companies to move to US GAAP rather than to IASs since they see US GAAP as having greater long-term acceptability. However this is not the general trend and IASs will play a larger role in the growing European financial and capital markets. In the long run IASs are the only option, if one does not want to have a separate set of European standards and will help to achieve accounting harmonisation in Europe for listed companies and may in addition bring convergence in national standards.

Although the issues of standard setting and financial reporting need to be separated from enforcement of standards, enforcement is of crucial importance to the credibility of standards and requires therefore proper discussion. It is the clear responsibility of the management of the company that the financial statements are prepared in accordance with an agreed set of GAAP and of auditors, regulators and financial and capital markets to monitor the discharge of that responsibility. It is the responsibility of management of the company to apply the accounting standards correctly. The auditor's role is to provide a supporting opinion. Regulators (and/or financial markets) levy sanctions once they are informed about departures from accounting standards.

The debate on a financial reporting strategy cannot be separated from the corporate governance debate, requiring transparency and due process: regulatory safeguards, financial reporting, auditing and compliance mechanisms should go hand in hand. Investors in Europe may experience unnecessary uncertainty due to differences in corporate governance arrangements resulting in legal or administrative barriers.

Developments in Europe cannot be seen separately from global developments. The G7 Group of Finance Ministers of seven industrialised nations, the IMF and the World Bank envisage a "global financial architecture" and the emergence of a truly global standard setter. The larger international

accountancy firms have committed themselves together with other key players to bring financial reporting to a higher level with IASs as minimum benchmark.

The current debate on the future structure of IASC cannot be separated from the financial reporting strategy discussions. It is important to integrate European and international developments. IASC should develop in a way that can be supported by different organisations and fora in Europe, otherwise it is difficult to see why and how Europe can give more prominence to IASs if it cannot exercise proper influence over the standard setting process. The IASC needs to become a truly global standard setter, meeting quality and independence requirements.

Enforcement of standards

Enforcement of internationally accepted standards should ideally take place at global level in form of a partnership between national standard setters, the accountancy profession and enforcement agencies around the world that would subject cross-border listed entities to one set of enforcement arrangements and not to a multitude of arrangements. IFAC (International Federation of Accountants) could consider the establishment of such a mechanism for reducing any significant differences in individual cases and countries. If there is no coherence of application of internationally accepted standards then the standard setter will have to act as moderating agent in ensuring that compliance is addressed consistently around the world.

Whatever financial reporting framework will be decided and whatever standards will result within Europe, the issue of enforcement of the standards is of crucial importance in order to avoid incomplete and inconsistent implementation/application. Enforcement also depends on the legal structure and corporate governance system. There are different degrees of development of enforcement in Europe; in some countries there is no enforcement of standards at all. It is the responsibility of management to apply the standards correctly. The auditor's role is to provide a supporting opinion. Regulators put sanctions once they are informed about departures from accounting standards. The reliability of financial statements needs to be the same and, taking account of differing statutory frameworks, enforcement should be consistent throughout Europe, which is at present not the case.

At present the enforcement mechanisms are quite different within Europe although most countries claim to have an enforcement mechanism. In a number of countries it is the stock exchange that is in charge of the enforcement, in other countries it is the stock exchange supervisor. The UK is the only country that operates in addition a review panel. In the Netherlands there is a special court that can be seen as a form of review panel, but it has not operated during the last few years. The effectiveness and the use of the enforcement mechanisms differs widely. In about half of the cases enforcement applies only to listed companies. The enforcement usually covers interim financial statements, annual financial statements and prospectuses and in some cases also preliminary results. In most cases National GAAP needs to be complied with. In some countries IASs and/or US GAAP could be complied with especially for foreign companies listed in that country. A systematic review of financial information of all listed companies takes place in few countries. In other countries sample basis or complaint basis reviews are taking place. In countries that allow other than national GAAP usually the compliance with the Accounting Directives is assessed. In case of foreign company listings usually for enforcement reliance is placed on the enforcement body of the foreign company in its home country.

Enforcement cannot in practice be done by a standard setter itself, being normally a private organisation but only in partnership with third parties which rely on financial statements or with national enforcement agencies. It is the duty of the auditors in the first instance to draw attention to departures from standards and for regulators and capital and financial markets then to take appropriate action against those companies that abuse compliance with the agreed accounting standards. Capital and financial market regulators have a prudential interest in ensuring accurate and consistent application of accounting standards in the securities markets they regulate. In particular, the differences in enforcement and sanction mechanisms between European countries might hinder an

effective application of decisions of a future European coordination: in some countries the enforcement mechanism for listed companies is highly developed in others it is much less developed.

It can be questioned to what extent a national court is allowed to take decisions on international standards or standards from another jurisdiction. Even where there are possible sanctions, the extent to which they are actually applied in practice varies widely between countries. The issue of enforcement needs to be addressed in the discussion of the screening mechanism, or other form of European coordination.

Financial reporting questions and options faced

The ultimate aim is to improve financial reporting by moving to a higher set of standards. This should be ideally a uniform set of standards in order to achieve maximum comparability and maximum understanding by the user of the financial statements. A distinction may need to be drawn between what is achievable in the short term and what should be the ultimate goal in order to allow for a transitional period. In the financial reporting debate in Europe six issues need to be addressed

- European or global standards
- Consolidated or individual accounts
- Use of US GAAP
- Allowance or requirement to use IASs
- Compliance or not with the EU Accounting Directives
- Scope: listed companies or all companies

These issues are addressed below and result in a large number of theoretical possible combinations and options. In this paper a preference is indicated on each of the issues resulting in an initial FEE view in order to stimulate the debate.

European or global standards

As indicated earlier the world has globalised, Europe cannot operate within fortress Europe. Europe needs to adopt, if it wants to meet the wishes of its preparers and users, standards that can be used at the global level. It will be demanding for companies involved in their national accounting framework to move to another, be it relatively closely related, internationally accepted accounting framework. In practice, however, it is increasingly becoming the case that the country of incorporation is less important than a company's ability to ensure that its shares are traded in highly liquid markets; ultimately companies will find ways to move their headquarters. Movement from a national accounting framework to an accepted global accounting framework will require a transition period.

The Commission has recognised this globalisation development in the 1995 Accounting Strategy and more recently in the Financial Services Framework Communication and the Financial Services Action Plan Communication. If no requirement to use a particular GAAP is introduced the market will decide on which GAAP will be ultimately used: national GAAP, EU Accounting Directives or internationally accepted GAAP - national, versus European versus global environment. It is the general opinion that European companies have no choice but to operate in a global environment and the European Accounting Directives should not be an obstacle to so doing. Therefore, FEE strongly supports the work of the IASC and believes that IASs currently represent the best opportunity to achieve both global and European harmonisation of financial reporting standards. The prospect of this objective would be undermined by the creation of additional regional standard setting bodies, or by the Accounting Directives not keeping pace with international developments.

Transitional measures will be necessary in moving to a common accounting framework based upon IASs to give national standard setters the opportunity to benchmark their existing requirements against IASs and to allow for the introduction of IASs on a phased basis to various categories of companies.

Consolidated or individual accounts

Consolidated financial statements are the most important accounting instruments for information of the users of financial statements. Individual financial statements have limited possibilities to show the performance of economic entities which are legally structured in different single companies. Moreover, individual financial statements are in most Member States linked with national company law and with taxation. A development concentrated on consolidated accounts would not interfere with this existing mechanism. In the long run when the function and purpose of consolidated and individual accounts might move together the differences between both sets of accounts will probably reduce. The Discussion Paper does not exclude developments in the future which would allow some divergence between accounting, tax and company law. The taxation and company law aspects are not further discussed within this Paper which focuses on the consolidated financial statements.

Focusing on the consolidated financial statements would not preclude a Member State's entitlement to impose in national company law additional disclosure requirements, distribution rules, capital maintenance requirements and similar obligations. However, the nature of any further national obligations established in company law should not be such as would inhibit compliance with IASs.

The use of US GAAP

Currently European companies listed at the New York Stock Exchange have two possibilities to meet the SEC requirements: either they draw up their financial statements in compliance with US GAAP or they provide a reconciliation statement from their GAAP to US GAAP. In both cases, the company may have an additional burden were it not possible to prepare a single set of accounts that is in compliance with both the Directives or national law and US GAAP.

It is doubtful whether Europe should or could support a set of standards over which it cannot exercise influence (US GAAP), even though FASB may wish to see itself taking the lead as the worldwide standard setter. Although it may not be necessary that European countries have to be the dominant determinant of GAAP applied in European countries it is important that European countries can exert influence over the standard setting process the standards of which will apply in Europe.

Since the final agreement of IOSCO to endorse IASs remains unclear, the door to US GAAP may need to be kept open for a period of time until the future role of IASC is agreed. It would be unrealistic to prohibit US GAAP given the extent to which it is currently used by US controlled and/or US listed companies in a number of EU Member States, that in some Member States it is currently more widely applied than IASs and the fact that it is an acceptable framework specified by legislation in a number of Member States which have already granted "global players" the possibility of opting out of the national framework for the consolidated accounts, although only for a limited period of time.

If IASs were accepted by IOSCO and especially the SEC, then IASs obviously should be the only internationally accepted standards to be recognised within Europe. During an interim period, the length of which should be as short as possible companies should continue to be allowed to use US GAAP. The ultimate goal would be - provided the market decides so - that IASs can be used at global level under all circumstances.

Allowance or Requirement?

One of the issues to be addressed is whether companies should be required or should be allowed to use IASs. If companies are allowed to follow IASs there will be less comparability – they can continue to apply national GAAP – than if there were to be a requirement to use IASs. An allowance, rather than a

requirement would leave space for companies in countries with a more developed accounting framework to continue to use their own standards.

An allowance (in form of a company option rather than a Member State option) offers companies the possibility to change their accounting policy due to capital market requirements by considering their individual circumstances. The market would determine which set of GAAP would be preferable in the long run. However, as long as such a determination by the capital markets has not taken place, the disadvantage could be that companies will select different sets of GAAP with the resulting lack of comparability between financial statements which could create confusion in the financial markets.

It is suggested that an allowance could be seen as a temporary regime leading to a requirement for certain companies to use IASs. In that case the financial statements drawn up under the Accounting Directives could be seen as accounts which will disappear overtime for these companies.

Another possibility would be the introduction of a requirement for a reconciliation to IASs when under the allowance national GAAP is used. The advantage would be that choice would be allowed, while achieving a degree of comparability across an emerging European single capital market. In addition national standard setters will be pressed to reduce the differences between national GAAP and IASs and to incorporate IASs into national GAAP. It may be argued however that requiring a reconciliation statement to IASs, impairs free choice and constitutes an obligation to use IASs, since it would be burdensome for companies to prepare the reconciliation.

FEE proposes that using IASs be an allowed company option. However, if companies choose to report on the basis of national GAAP they should be required to prepare a reconciliation statement between national GAAP and IASs in order to stimulate the use of IASs and increase comparability between the financial statements of those companies. The market forces will ultimately decide which set of accounting standards will prevail.

Compliance or not with EU Accounting Directives

Another issue to be addressed is whether companies can prepare their financial statements in accordance with IASs in addition to compliance with the Accounting Directives or instead of the Directives. Were compliance with the Accounting Directives no longer required, the Directives would not have to keep pace with international developments. But, if compliance with the Directives is no longer required, two different accounting systems may occur hampering the comparability of financial reporting within the EU.

If compliance with the EU Directives is required, the Directives will need to keep pace with international developments. This is a cumbersome process since it means not only that the Accounting Directives need to be brought in line with IASs to facilitate the use of these standards but also that amending of the Directives should be on a timely basis in order to avoid to the extent possible temporary differences.

There would be several ways of bringing the Accounting Directives in line with IASs: by removing the offending sections of the Directives (or permitting more options) each time a conflict arises; by expanding the Directives to include the relevant provisions. It is not easy to foresee how the European legislative process can keep up with the much faster pace of international standard setting: future standards will give rise to further obstacles. It would require, in cases where there are differences between IASs and the Accounting Directives, companies to draw up at least two different sets of financial statements: one set complying with IASs and one set complying with the Accounting Directives. This will create extra costs for companies and will cause confusion for the public as to which set is the proper set of financial statements. Since there would inevitably be time lags, at both EU and national implementation level, listed companies could find themselves preparing one set of accounts one year, two the next, one the year thereafter, and so on, or at least reconciliation statements.

If compliance with Accounting Directives is required, it seems inevitable that there will be – at least for a period of time – differences between the IASs and the Accounting Directives. It would be helpful if companies were not obliged to draw up two sets of accounts or a fully detailed reconciliation statement in those circumstances. This could be achieved by allowing companies to draw up their financial statements in accordance with IASs and to report in the notes to the accounts on the departures from the Directives by giving an explanation of the main components of the differences with as a minimum the disclosure of the impact on net profit and net assets. Such additional disclosure will put an extra burden on companies and in addition might be confusing to the reader.

Non-compliance with the Accounting Directives could also take the form of scoping-out certain companies from the Accounting Directives and leave it to Member States to decide which financial reporting system could be applied instead of the national GAAP.

It is doubtful whether it is sustainable in the longer run to have different measurement rules for different types of companies. Only differences in disclosure requirements are feasible and any differences in measurement requirements would need to be removed. Therefore in any case a procedure to eliminate inconsistencies between the two systems would be needed. The Accounting Directives have not been amended for over 20 years and even if they have not to keep pace with IASs, some modernisation would be needed – and is planned for in the Action Plan Communication- to result in meaningful financial reporting by non-listed companies. FEE strongly supports changes in the Accounting Directives to permit the adoption for consolidated financial statements of IASs and the effort of the Commission to facilitate the use of IASs for all companies. Timely adaptation of the Accounting Directives is crucial.

FEE recommends permitting companies to use IASs without also having to comply with the Accounting Directives, so avoiding imposing additional financial reporting burdens upon companies which want to operate in the global market.

Since as a first step only consolidated accounts would be addressed, the companies concerned need only be exempted from the Seventh Directive and possibly be transferred to another, capital market, regime. For the individual statutory accounts the Fourth Directive would still need to be respected for company law reasons, including protection of the general interest and creditors' protection. To the extent that the Fourth Directive may not keep pace with the developments in IASs, this will continue to put an extra burden to companies wishing to apply IASs also for their individual accounts.

Listed companies or all companies

The last issue to be addressed is whether all companies should be allowed to use IASs or only listed companies. Listed companies should be broadly defined and should be wider than equity share listings and basically cover any financial instrument listing.

One reason to limit the allowance to listed companies would be that only these companies are subject to the listing requirements of the capital markets. A clear disadvantage of having separate rules for listed and non-listed companies is the reduced comparability of financial statements between listed and non-listed companies since two separate accounting systems will result. There might also be implications for consumer and creditor protection in that in the Directives capital maintenance requirements have a greater influence than in the case of internationally accepted accounting standards.

It could be envisaged that listed companies would be exempted from the Accounting Directives and be transferred to a capital market regime . Listed companies would be allowed to apply IASs (under a Capital Market Directive, for instance the Listing Particulars Directive) instead of the Accounting Directives or national law.

Under the Capital Market Legislation, monitored self-regulation could be imposed. The Commission could state in the capital market legislation that detailed rules could be given by non-legislative coordination between capital and financial market regulators (this could be seen as the non-legislative and self-regulatory solutions between supervisors, involving FESCO, which the Framework Communication and the Action Plan Communication called for). In addition, a competent body needs to be put in place in order to decide on the financial reporting regime to be followed and to provide guidance as to the listing requirements imposed by the coordination of capital and financial market regulators, including a European mechanism of application guidance of IASs for use in Europe. This could involve the creation of a European Financial Reporting Coordination and Advisory Council or another European coordination mechanism.

FEE would at present limit the allowance to use internationally accepted standards to listed (listed in broad sense) companies as a starting point. In the longer term this allowance could be extended to all companies.

European body or mechanism

Introduction

For legal reasons it is complex for the Commission to simply refer in EU legislation to a private organisation or a national organisation such as IASC or FASB. The EU legislation may need to refer to a European body or mechanism.

Some argue that in Europe, internationally accepted standards could simply not be accepted as such, and that a screening device needs to be put in place in order to maintain an influential position towards the standard setter. Although it might not be acceptable to users and preparers to create a possibility to endorse certain IASs and not others, some argue that Europe should be able to influence IASC because it will be the biggest bloc of countries using IASs. Such a mechanism could not deal only with the selection/monitoring of standards but also with enforcement issues. A European SEC would be another possibility to deal with the enforcement issues. However, as stated before enforcement should ideally and ultimately form part of a global mechanism rather than of a European or national mechanism only.

Since Europe would not wish to have European accounting standards there is also not an immediate need for a European SEC, as a mechanism to enforce European standards. Neither will Europe have in the very near future a single stock exchange and a single capital and financial market, requiring a single supervisor. FESCO has already created FESCOPOL being a pan-European regulatory framework to provide the broadest possible mutual assistance between the competent authorities of Member States of the EEA so as to enhance market surveillance and effective enforcement against financial abuse. A European SEC would be responsible for setting a single European regime covering implementation, application and enforcement for all listed companies in Europe. However, given the large differences between the stock exchange supervisors and accounting standard setters at present, it may be too big a step to replace the national systems directly at this stage by a European system. A European SEC might be difficult to get accepted by the national standard setters and stock exchange supervisors because it would remove their freedom of action, if they would need to continue to exist at all. As long as national systems continue to differ within Europe and different stock exchanges and capital and financial markets are in place there is no argument yet for establishing a European SEC.

Various possibilities of a screening mechanism have been discussed in various fora, magazines etc. including a European Financial Reporting Council (EFRC); a European Accounting Standards Board (with the wish of setting separate European standards) and comitology. In the following the roles and functions of a European body or mechanism are discussed. Since such a body or mechanism would be a totally new vehicle thorough thoughts and debates are needed. FEE would like to indicate what kind of issues are seen to be at stake.

Roles and functions of a European body or mechanism

In FEE's opinion such a European body or mechanism is not a standard setting body and should not set (European) accounting standards. Neither should it set interpretations. Interpretations should be determined at world wide level; regional and national interpretations should be avoided. IASs should be applied in full, no options should be closed. Any modifications to IASs involve a departure from truly global standards. There is only one set of IASs to be complied with. It should be ensured that compliance is addressed consistently around the world and that only the SIC gives interpretations. A European body should also not issue sector specific guidance but only adopt IASs. Standard shopping leading to a quasi-European GAAP should be avoided.

The roles and functions of a European mechanism or body that could be considered are:

- coordination of Europe's national standard setters, to promote the implementation of full IASs compliance into national standards: how to work in Europe towards a harmonised system of national accounting standards. Discussion would be needed on the extent to which the European body would have overriding power
- coordination of views of Europe's national standard setters and other interested parties concerning positions within IASC as to enhance influence within the IASC Board and to strengthen individual country voices. A better dialogue would enhance the understanding of the different positions and may bring them closer together
- coordination and advice on the enforcement mechanism put in place through the regulators, be it at European or national level, but ideally forming ultimately part of a global enforcement mechanism including providing a mechanism for dealing with complaints (review panel)
- giving advice to the European Commission on necessary changes to the Accounting Directives in order to facilitate the use of IASs for all companies covered by the Directives

Enforcement will be put in place through capital and financial market regulations. FESCO, as coordinator of capital and financial market regulators, would play a central role. Enforcement is at present lacking for IASs and cannot be exercised by the IASC itself, being a private organisation with no legal power. However IASC could act in partnership with national and regional enforcement agencies around the world. Enforcement of IASs would be a crucial factor in the system. The auditor has to report on compliance with IASs. But in case of departure from IASs and a qualified or an adverse opinion on the financial statements a sanction mechanism might be needed to be put in place. The profession has an important role to play in achieving the situation where financial statements drawn up under IASs are audited in the same way across Europe as part of the enforcement mechanism. Since there is no pan-European organisation of standard setters, the discussion between national standard setters could be facilitated by providing a forum. This forum could also be used to provide input to the European standard setters involved in the IASC Board by those that will not be directly involved in the IASC Board. If a European mechanism were to be drawn exclusively from standard setters, it would not adequately address the enforcement and auditing issues.

One of the tasks of a European body could be dealing with complaints related to European IAS financial statements, being a central source and register of claims whereby investigations will either be carried out at European level or referred to a national review mechanism and acting as an oversight body of a panel. The outcome of the investigations would be published at European level and form soft sanctions (through shaming). Legal sanctions would remain the responsibility of the national enforcement mechanisms. The operation of a European review panel would need further discussion, particularly its relationship with the IASC. It is important that the members of this Panel be independent and not representatives of European standards setters and regulators, any of whom may be indirectly criticised by the findings of such a panel. In a number of European countries the enforcement mechanism is very weak and no review panels exist. A European mechanism would bring economies of scale. A peer review of financial statements may need to be established to assess the effectiveness of national enforcement agencies. Greater consistency of quality of financial statements

is needed to avoid that the whole capital and financial market will be regarded as tainted when non-compliance occurs.

Enforcement would continue to be established at national level with an appropriate coordination at European level in which FESCO could play a role as part of a European body or mechanism. Such a system would be at present more feasible than a European SEC.

The IOSCO endorsement of the core set of IASs comes into the picture, since it would pose some difficulties for FESCO (involving partly the same regulators as IOSCO) to endorse IASs if IOSCO (SEC) would not endorse IASs. The support and involvement of FESCO is a crucial factor.

A possible European body or mechanism could be the European Financial Reporting Coordination and Advisory Council which would carry out the tasks described before.

European Financial Reporting Coordination and Advisory Council

The European Financial Reporting Coordination and Advisory Council (as proposed in this paper) might both be necessary for IASs and US GAAP.

A European Financial Reporting Coordination and Advisory Council could be organised as a private body and involve the key players in the European financial reporting scene:

- national standard setters
- coordination of national capital and financial markets regulators (FESCO)
- preparers (UNICE and European Round Table)
- audit profession (FEE)

Consideration should be given as to how the Commission should participate in the activities of the EFRCAC.

Perhaps further interest groups should be involved, for example, users of accounts. There is a risk that the EFRCAC would become too large and end up as a debating forum without any decisive power. Therefore a proper balance needs to be found between proper representation and workable size. A two tier system could be envisaged. Several models would be possible, each with its advantages and disadvantages which merit further discussion with related proper funding and staffing.

The EFRCAC would replace the existing Accounting Advisory Forum and may also make E 5+2 redundant. The possibility of transferring some tasks of the Contact Committee on the Accounting Directives, particularly those of the Accounting Technical Subcommittee, to the EFRCAC might be discussed.

EFRCAC would involve the standard setters of the 15 EU countries. It should be discussed whether this would require that each country has a national standard setter (or a combined standard setter with another country) which is at present not the case. One might consider including EEA countries, as well as other countries with a link to EU regulatory systems. Other countries, such as those in Central and Eastern Europe and candidates for EU accession, might be granted observer status. It should be noted that the standard setting function has already changed over time in several countries towards incorporation of IASs into national standards.

The EFRCAC would be a private organisation independent of the Commission but the Commission would be involved in its activities. A proper funding structure for the EFRCAC would need to be discussed involving all the key players. However, first the main tasks and functions of the EFRCAC should be decided upon before funding is discussed. The EFRCAC needs to have a critical mass of resources to work efficiently.

The EFRCAC should be seen as a formal organisation. An alternative to the EFRCAC would be a more informal getting together of the same participants in a manner equivalent to an extended version of E5 + 2. The risk would be that it would be difficult to obtain proper resources. Coordination on a voluntary basis would not have the same possibilities for enforcement, coordination, advice and influence, since it would be much easier for a standard setter to opt out.

Appendix 1: Accounting Standard Setting Bodies in Europe

Most of the countries in the EU have some form of standard setting body. However, their structure and method of operation differ between countries. Most of the standard setters are private organisations but in some countries they are public bodies. Few of them issue mandatory standards for listed companies only; about half of them issue standards mandatory for all companies whereas for the remaining standard setters the standards are not mandatory for companies, but are to be used on a voluntary basis. Also only half of them operate a urgent issues task force/interpretation committee type of activity. The apparent differences in structure and in operation between standard setters in Europe (and not having a standard setter at all in some countries) may in itself form a barrier to European coordination of standard setters and be a reason why there is currently not such coordination. It might therefore be the case that some of the standard setters need to change their structure and that countries without a standard setter establish one (or "share" one with another country, as is currently the case for the UK and Ireland) in order to have a voice in a future European coordination of standard setters.

There is no coordination of standard setters at a European level, with the exception of the European Accounting Advisory Forum in which all standard setters (in addition to other parties) are represented. The Forum, however, has so far not been effective in co-ordinating the standard setters, in particular since it, by the 1995 "new accountancy strategy", had been turned into a consultative group. Given the extensive differences it is difficult to see Europe's standard setters combining forces into a real European standard setting body. There is no support for separate European accounting standards, even were these to be a variant of IASs. Another type of coordination may, at this stage, be more successful, being a system whereby national standard setters would operate effectively as a single authority when needed.

In order to achieve a higher level of financial reporting in Europe, it is not sufficient to introduce new accounting standards in Europe. It needs to be ensured that:

- these standards are enforced in the same way throughout Europe,
- financial statements drawn up under these standards are audited in the same way throughout Europe.

An increased coordination of national standard setters may have a negative impact on the influence that European countries will be able to exert in the future if they can be seen to be operating together with ultimately one seat on the future IASC Board.

In the Framework Communication, the Commission calls for a private sector initiative in the form of monitored self-regulation. In the Action Plan Communication, the Commission suggests more specifically a screening mechanism whereby securities markets supervisors could be associated to this task. The auditor should audit the financial statements drawn up under these standards in the same way across Europe and may therefore need to play a role in a coordination or screening mechanism involving standard setters.

If listed companies were allowed to use internationally accepted standards and most companies were doing so national standard setters would continue to be needed in particular for setting rules for non-listed companies and for sector specific issues.

Appendix 2: Recent history

The globalisation of the financial markets and the changed environment, the increasing importance attached to IASs, and the influencing of the technical financial reporting debate by G 4+1 have caused a number of developments within Europe which are listed below and should be taken into account for a proper understanding of the current financial reporting debate and the increasing importance of standard setters in financial reporting.

Commission's "New" Accounting Strategy

The changed environment and the importance of global developments were recognised by the European Commission in its 1995 "New" Accounting Strategy. The strategy gave support to the work of IASC and acknowledged the increasing importance of international capital markets as users of financial information in relation to European global players. In order to prevent European global players from having to prepare different sets of financial statements, the European Commission proposed to allow them to prepare their consolidated financial statements in accordance with IASs under the condition that IASs are in conformity with the EU Directives.

Several countries (Austria, Belgium, France, Germany, Italy, Luxembourg and Spain) have changed or are in the process of changing their national law to enable listed companies to use internationally accepted accounting standards – in practice IASs or US GAAP – in their consolidated financial statements under the condition of compliance with EU Accounting Directives. This means that listed companies can use all options provided by the Accounting Directives and not only those implemented into their national law.

A Task Force of the Contact Committee has investigated the differences between the EU Accounting Directives and IASs as per the end of 1995 and concluded that there are no major conflicts between IASs and the Accounting Directives. Recently, the Contact Committee has updated the conformity examinations and will publish them in two documents. The first one "Examination of the Conformity between IASs, and the European Directives" covers all IASs and SIC interpretations in issue and applicable to accounting periods beginning before 1 July 1998 and concludes there are no significant conflicts, with the previously identified exception of the scope of consolidation. A further conformity examination covering all the new IASs is soon to be published. It identifies a number of minor possible incompatibilities.

In April 1999, FEE published its study on the comparison of the EC Accounting Directives and IASs. With respect to reverse acquisitions, scope of consolidation and fair value accounting, the majority of FEE Member Bodies consider there are incompatibilities between IASs and the Directives – but either the problem is considered of little practical relevance or the process to amend the Directives has already started. However, FEE calls for clarification by the Commission on a number of topics, including substance over form, presentation of construction contracts, employee benefits (future salary increases related to promotion), restructuring provisions, decommissioning costs, preparation of consolidated accounts in reverse acquisitions and netting. In Autumn 1999, the publication of a proposed directive to amend the Fourth Directive to introduce fair value accounting for certain financial instruments is announced as part of the Commission's Action Plan for implementing the framework for financial markets as part of a facilitating exercise.

FEE proposal to scope out listed companies

In December 1997, FEE has written to the Commission on the subject of amending the Accounting Directives. FEE welcomed the preparedness of the Commission to change the Directives in order to allow companies also in the future to comply with both IASs and the Accounting Directives. However, since the amendment process takes considerable time and further differences may occur, FEE recommended that listed companies be allowed to apply internationally accepted accounting

standards even if this would mean being for the moment in contradiction with the Accounting Directives. FEE recommended a rapid – temporary – solution consisting of excluding certain types of companies (companies that have listings abroad or which have significant financial statement users abroad) on a time limited basis from the scope of the Seventh Directive, by introducing a Member State option.

EARF and E5 + 2

In 1996, FEE launched an initiative to establish a European Accounting Research Foundation (EARF) in order to increase Europe's influence within IASC. Due to the lack of financial support, this initiative failed. At the end of 1997, E5 + 2 was established with the objective of undertaking joint research projects as a contribution to the IASC work, promoting the use of IASs in Europe and assisting in resolving inconsistencies with the Accounting Directives. E5 + 2 comprises the five European IASC Board members and the related standard setters for their country, the European Commission and FEE. The other standard setters are not involved. So far, E5 + 2 has not produced any output but is working on a publication on the directors' report. The effect and impact of E 5+2 has so far been limited. The objectives of E 5+2 are very similar to G 4+1 (United States, United Kingdom, Australia, Canada, New Zealand and the IASC) i.e. to seek common solutions to financial reporting issues and to contribute to the development of quality International Accounting Standards through participation in analyses and discussions. It gives the opportunity to learn more about the timing and approach of standard-setting projects in other countries and to exchange new ideas that can be applied in their own countries.

Framework Communication

Towards the end of 1998, the Commission published its "Financial Services: Building a Framework for Action" Communication addressing the European capital and financial markets post-euro. Several elements are of interest, in particular in relation to IASC and FESCO (organisation of European Stock Exchange Commissioners). The Commission wants to stimulate cross-border investments through more transparency and better comparability of accounts. The Commission will review whether listed companies should be required to prepare their financial statements in conformity with a more harmonised framework, such as IASC. One of the points for action mentioned is "The Commission will work towards maintaining consistency between EU financial reporting framework and international accounting standards developed by the IASC". The Commission calls for clear and common interpretation of rules in the form of non-legislative and self-regulatory solutions between supervisors, whereby they see a central role for FESCO. This is formulated as a point of action "Member States should urge their supervisory authorities to enhance their self-regulatory role by deepening and strengthening processes to strengthen regulatory standards and operational practices for an effective single market".

The Commission established a Financial Services Policy Group of personal representatives of Finance Ministers chaired by the Commissioner for Financial Services Mario Monti to follow up on the Framework Communication proposals. Following the meetings with the Financial Services Policy Group, the Commission issued in May 1999 a Communication "Implementing the Framework for Financial Markets: Action Plan". The Action Plan contains a separate section on financial reporting underlining the urgent need for solutions which give companies the option of raising capital throughout the EU, using financial statements prepared on the basis of a single set of financial reporting requirements. "Solutions to enhance comparability within the EU market must mirror developments in internationally accepted best practice. At the present juncture, International Accounting Standards (IASs) seem the most appropriate benchmark for a single set of financial reporting requirements which will enable companies (which wish to do so) to raise capital on international markets. [...] Consideration is currently being given to a possible solution which would provide companies with an option (as the sole alternative to preparing financial statements in

accordance with national laws transposing EU Accounting Directives) to publish financial statements on the basis of IAS standards. The objective of comparability in financial reporting will be secured by excluding national deviations from IASs for companies exercising this option. A screening mechanism will be required in order to ensure that IASs output conforms to EU rules and corresponds fully with EU public policy concerns. Securities markets supervisors could be associated to this task. These issues will be amplified in a Commission Communication to be published by the end of 1999, which will prefigure amendments of the Fourth and Seventh Company Law Directives".

Companies –all companies or only listed companies – will be given an option to publish their financial statements in accordance to IASs. This would be a company option which Member States are required to implement, rather than a Member State option whereby it would be at the discretion of the Member State whether or not to give the company the option. The text is not clear whether companies using such an option can do so instead of the Directives or in addition to the Directives. However, given earlier preferences of the Commission it is possible that compliance with the Accounting Directives could remain a condition for applying IASs. A screening mechanism is referred to although it is not clear how the mechanism would work when IASs deviate from the Accounting Directives.

In the Financial Services Action Plan, three levels of priority are identified: priority 1 actions (actions that call for immediate attention); priority 2 actions (actions important to the functioning of the Single Market for Financial Services); and priority 3 actions (actions concerning important areas where consensus exists that new work should be set in hand). The Communication updating the EU accounting strategy is classified as priority 1 action. Amending the Accounting Directives to allow fair value accounting, and modernisation of the accounting provisions of the Accounting Directives are classified as priority 2 actions.