

Roundtable on financial reporting and auditing

RECENT DEVELOPMENTS AND CHALLENGES REGARDING CONVERGENCE, HARMONIZATION AND RECONCILIATIONS OF ACCOUNTING STANDARDS

**Keynote address
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**THE VIEW POINT OF Michel PRADA, Chairman of the Technical
Committee of IOSCO**

Ladies and Gentlemen,

It is a great honour and pleasure for me to address such a distinguished audience on the occasion of this important roundtable on financial reporting and auditing organised by the Financial Stability Forum together with the IASB and the IFAC.

I shall speak today in my capacity of chairman of the technical Committee of IOSCO, although I might also give some views as the chairman of AMF, the French Securities Regulator and a member of the CESR and even, maybe, some personal comments. I shall not therefore commit my colleagues, nor IOSCO's SC1 experts, who may have not yet expressed their own views on some of the points mentioned hereafter. By the way, a worldwide organisation such as IOSCO is used to diversity, even if it aims to build consensus among its members.

Let me first pay tribute to the major role played by the FSF in the field of the fundamentally needed and most welcome reconciliation of macro-economic analysis, traditionally a main driver for prudential regulators dealing with global financial stability, and microeconomic issues which are the day to day concern of securities regulators, dealing with the good functioning of financial markets.

The need to build a bridge between both sets of issues was identified in the aftermath of the 1997 and 1998 crises which underlined the critical role of good financial reporting, auditing, and corporate governance as the underlying basis for the reliability of macroeconomic analysis and policies.

Although we all worked very hard from the very beginning of the FSF undertakings, it was too late to prevent the kind of earthquake which destabilised financial markets in the first years of this century. The seismic wave which followed did provoke severe and lasting damage to investors's confidence and although the situation seems to have improved, recent events in different parts of the world show that the risk has not melted yet.

While we have to recognise that greed, dishonesty and irrational exuberance were the main causes of these events, they were also a major opportunity for questioning the soundness of our accounting and auditing principles, together with other fundamental pillars of market economy. We also witness that financial innovation, together with globalisation, the I.T. revolution and demographic changes have raised new concerns and require new approaches by the industry and the regulatory community if we wish to preserve future economic growth and financial stability.

After several years of huge work, lively discussions and reforms, today's round table on Financial reporting and auditing comes at a very topical

point and I commend the FSF for having organised this meeting in Paris after having organised such an event a year ago in Basel. I can identify several reasons for the timeliness of our meeting :

- Firstly, some 8000 public companies in the EU are just now in the process of issuing their first annual report under IFRS. **We are now watching the results of many years of effort by IOSCO, IASB and others.** The time is now to face whether this has created an expectation gap, whether the promised benefits will be delivered, and to think about what should be done if it were that results do not sufficiently match the expectations.

This first batch of issuers will soon be followed by the listed companies in Australia and New Zealand, for which the transition date is in average six months behind that of Europe (not because of the time zone differences, but because most of them have a June 30 year end !)

- Secondly, because the adoption by the European Commission and Parliament of the Transparency and Prospectus Directives will require very soon (indeed by the beginning of next year) that non – EU issuers who raise capital or list their shares on an EU market should report their financial results under IFRS or under an **equivalent accounting framework**. Here we find a new concept which is not in the title of this afternoon's session, but which needs to be examined as well: that of **equivalent accounting frameworks**.

- Thirdly, because the approximately 400 EU companies which are listed both in the EU and on a US stock market, and which have borne all the costs and efforts of the transition to IFRS, have good reasons to ask why their accounts, now prepared under IFRS, still need to be reconciled to US GAAP for the purpose of their filing with the US regulator. The same may also be true for many of the 800, or so, non US companies from 50 countries which have a listing on the NYSE or on the NASDAQ.
- Fourthly, because the accounting standard setters of two very large countries, Japan and The People's Republic of China, have recently announced a program of convergence with the IFRS.
- Fifth, and not least, because the FASB and IASB boards have adopted a roadmap to convergence, following their Norwalk Agreement of September 2002, with the aim of making IFRS truly global – a reality that will be achieved only if, and when, they are accepted in the US without additional reconciliations, disclosures or other forms of accounting burden.

We should thus be satisfied to see that today IFRS are accepted in about 75 jurisdictions, the word “accepted” meaning either a required or permitted use. But this absolute number does not mean much in terms of financial markets. It is more meaningful to observe that :

- o Out of a worldwide market capitalization totalling over 36 trillions US Dollars at the end of 2005, 11 trillions \$ correspond to markets where IFRS are either required or permitted and 17 trillions US \$ to markets where US GAAP is

the rule; out of the balance, 4 trillions US \$ correspond to Japan GAAP ;

- o In terms of the largest companies included in the Fortune 500 list, 176 prepare their accounts under US GAAP and 200 under IFRS, 81 under Japanese GAAP.

These data illustrate both the good progress already achieved worldwide by the IFRS, and the strategic importance of achieving a satisfactory arrangement for acceptance of IFRS in the USA and for convergence between Japan GAAP and IFRS.

This leads me to some comments about the different trends that we witness in the field of worldwide accounting and auditing standards, from the point of view of both architecture and process of decision making on the one hand, and substance on the other hand.

- Decision making and due process in the field of international standard setting has always been, and still is, a matter of controversy : indeed, views may differ among countries with regard to the political legitimacy and technical relevance of the bodies which are in charge of delivering the standards.

While, at the national level, it is easier to establish a good balance between the role of practioners, preparers, users, academics, and the role of public authorities, this is clearly more complex at the global level.

What I would like to underline today is that, although the number of acronyms we have to deal with sometime gives the feeling that we are far from rationality and efficiency in that field, we in fact have seen remarkable progress during the past years due to the efforts of those involved, among which IOSCO has played a leading role.

In the field of accounting, may I remind you of the patient work conducted by IOSCO during the nineties, in order to monitor the standard setting by the IASC, provide credibility to this organisation, and finally recommend, in its May 2000 resolution of the IOSCO's Presidents' Committee, that IOSCO members permit incoming cross border issuers to use the IASC core standards ?

IOSCO at that time also played a major role in the reform of the IASC. The establishment of a nominating committee for the new IASC Foundation board of trustees, under Arthur Levitt's leadership, was a first and significant step forward to provide the standard setter with some political legitimacy, as it was monitored by international securities regulators and the resulting board of trustees chaired by an outstanding personality, Paul Volcker. Nonetheless, this progress clearly needed to be confirmed and the basis of legitimacy needed to be enlarged to the global financial community. This was provided by the recent IASB reform, the diversification of the nominating committee and the enlargement of the board of trustees. And I was personally extremely happy when being informed of the nomination of Tommaso Padoa Schioppa as the new chair of the board of trustees. I have not forgotten that, although Tommaso is fundamentally a central banker – nobody is perfect –, he was also the chairman of the Italian CONSOB and the first chairman of the Forum of European Securities Regulators which thrived under its chairmanship and gave birth to the CESR.

I very much hope that these evolutions will improve the quality of the decision making process by the IASB which is fundamental for its credibility and acceptability.

Indeed, we all know that accounting standard setting is not a theoretical exercise and that the views of stakeholders have to be carefully taken into consideration, otherwise the standards may be rejected by the users

and hence by the political authorities. By the way, it is good news that stakeholders take a deeper interest in these issues, at least in continental Europe where accounting was, up to recently, seen as a minor discipline, a tool for taxation, and proof, an exercise for rather narrow-minded technicians. Now we know better that accounting deals with philosophy and metaphysics. It's good news for Sir David Tweedie. But it requires patience, pedagogy and a Socratic capacity to debate.

Dealing with legitimacy and process, I would like to briefly mention that we enjoy a similar evolution in the field of Audit standard setting.

Here again IOSCO has played a leading role. But in that case, due to a beneficial influence of the FSF and the past experience in the field of accounting, it has established, from the very beginning, a close and efficient relationship with its fellow regulatory organisations, through a so called Monitoring group.

Standard setting in the field of audit is probably, besides the thorny issue of independence of auditors, less a matter for multidisciplinary controversies and commitment by stakeholders than accounting standard setting. Control techniques are an art more than a box ticking exercise and professionals are the ones who know better. Legitimacy of standard setting is none the less at stake, at the national as well as the global level.

Hence the important reforms which were decided in the course of 2003 with regard to the role of IFAC, the IAASB and its Ethics Committee (now referred to as IESBA, again an acronym !). As they have been implemented, we can see today an architecture of standard setting which, to my view, should provide relevant answers to the needs at the global level. Standard setting is provided by the IAASB and IESBA. Professionals have been combined with experts from different origins and have undertaken the most important "clarity project". A PIOB has

been set up in order to monitor the due process and provide legitimacy, as its appointment proceeds from the major international public regulatory bodies. Some further progress has to be made, nonetheless, as we have seen recent developments at the national level with the setting of new independent audit supervisory bodies which tend, naturally, to establish links between themselves at the regional or global level. IOSCO is therefore very keen to favor their participation in the global architecture and will take initiatives for this purpose.

Finally, we can appreciate the positive outcome of recent efforts to rationalise standard setting at the global level :

- The work is done by outstanding practitioners who have to follow a clear due process and collect input from a variety of advisory or consultative bodies.
 - Public interest is in the hands of relevant independent bodies established by major regulatory organisations.
 - Technical and political legitimacy is provided by the global monitoring of the international regulatory bodies, among which IOSCO plays a leading role as it appears that accounting and auditing are key for the quality of information by listed companies, which is in the remit of securities regulators.
 - Finally, coordination and coherence is provided by the Financial Stability Forum which did speed up the whole process.
- I would now like to address briefly the issue of substance with regard to accounting standards. As I said, in the field of audit, substance is more an issue for technicians and if we have seen fierce discussions, for instance on IAS 39, involving all kinds of participants, I have never identified similar discussions with regard

to audit standards- besides the issue of independence which is more of an ethical nature-.

The debate on substance is included in a series of concepts which are today commonly used, namely, adoption, equivalence, harmonisation and convergence in relation to IFRS.

The meaning and inter relation of the concepts underlying those four terms may seem very complex to an outsider of the standard setting business, and from time to time the ideas and orientations need to be clarified, so that those who are in charge of the world's financial stability and regulations do not lose sight of where are the real priorities, what the economy really needs, and when is the best timing for each critical step on the bumpy road to global standards.

- “Adoption” is a relatively simple concept :

It means that a jurisdiction, or a region in the case of EU, decides that, from a given point in time, a certain type of companies will have to apply IFRS to prepare their accounts used for financial communication.

The details of implementation are more complex as there is a need to address the issues of interpretation, consistent application, the transition from one system to the new one, monitoring the capacity of issuers to make the necessary changes in due time and the investors education. This is the job of market regulators and we generally describe this under the generic term of “enforcement”. IASB has been helpful in providing IFRS 1 which helps to make the transition less costly. CESR has been doing a wonderful job over the last 3 years in preparing the necessary infrastructures and in doing whatever could be done to smoothen the transition. To date, there has been no “market shock”.

I have to say that regulators have nonetheless some concerns in relation to the multiplicity of options, which may be detrimental to the easiness of comparability of the financial reports by investors.

There is also a need for completing the platform of standards to cover some areas which clearly deserve priority, such as insurance contracts, financial instruments, service concession agreements, and the reporting of financial performance, to mention a few examples.

Finally, due to the huge effort required from those who have to implement the standards, there is also a need for stability. The commitment to create a stable platform established by the IASB in March 2004 and not to be changed before the end of 2006, as mentioned by Sir David Tweedie in its presentation before the EMAC of the European Parliament on the 31th of January is thus both welcome and minimal.

- The concept of equivalence is key for the definition of the requirements by regulators with regard to cross border listings and financial operations. In a way, we have to recognise that achieving equivalence, which is a clear demand by market participants, is somewhat contradictory with stability, although the amount of work to be done depends on the definition of the concept.

I have to say that I like the approach to equivalence proposed by the CESR for the purpose of its advice to the European Union Commission, in June 2005, with regard to the equivalence between IFRS, and US, Canada, and Japan GAAP's.

I quote :“CESR's outcome – based approach to the GAAP equivalence, as a form of direct comparison of standards, has been predicated on the basis that investors decision should be

unaffected by the use of different accounting standards when assessing their buy, hold, sell instrument decision.”

This approach is quite different from purely technical views which may lead to detailed analysis such as the 1999 FASB’s staff publication of similarities and differences between IASC standards and US GAAP, a 500 pages book.

On the basis of a principle based approach, CESR’s advice is that these three third country GAAP under analysis, taken as a whole, are, I quote, “equivalent to IFRS, subject to the following remedies.

- That companies which have subsidiaries such as Special Purpose Entities (SPEs) which are not consolidated for third country GAAP purposes, but are required to be consolidated for the purposes of IFRS, report a pro-forma balance sheet and profit and loss account on their local GAAP basis, but including the unconsolidated subsidiaries .
- That companies reporting under Japanese GAAP which have either accounted for mergers by the pooling of interest method and/or have consolidated subsidiaries on the basis of GAAPs which are not consistent with either IFRS or any of the third country GAAPs, report a pro-forma balance sheet and profit and loss account on the basis of IFRS covering business combinations and consistent accounting policies, respectively.
- That Japan and the US adopt accounting policies for the expensing of stock options on a basis equivalent (i.e. not necessarily identical) to IFRS, for implementation on, or before, 1 January 2007. We understand that both countries are considering proposals to adopt such a standard according to this timetable.

- That in respect of certain specified IFRS and if applicable, in addition to the above mentioned remedies, there be additional disclosures of sometimes a descriptive nature and sometimes a quantitative nature” end of quotation.

Since then, the FASB has adopted a standard on stock options that has taken care of one of the above remarks. Anyway, as you can see, CESR’s view on equivalence is not too demanding and could be a significant step in a long term process of convergence toward harmonisation.

- Let’s precisely talk on Convergence and Harmonisation, finally.

These two concepts have much in common insofar as they address the same objective. **Convergence is a process to achieve harmonisation.** Harmonisation can be total or partial.

Total harmonisation means to me that all accounting transactions, all economic events will be translated into the financial statements according to the same recognition, measurement and presentation standards.

Partial harmonization means that the accounting treatment under two sets of standards, albeit based on the same basic principles, can show some minor technical differences in the measurement, presentation, or in certain unusual circumstances. It could also mean that the two frameworks, when compared, present a limited number of well identified differences which have not been yet eliminated due to external constraints or to firmly anchored beliefs in the respective benefits of two incompatible arguments.

Reaching the status of equivalence is obviously an important objective, as it is probably easier to achieve in the short term than full “harmonization”. Following the equivalence roadmap as a method to eliminate the burden of publishing reconciliations between different sets of GAAP is therefore a route full of promises. I particularly welcome the declaration made by Chairman Chris COX after his meeting with Commissioner Mc Creevy last week, when he reaffirmed his commitment to the road map to eliminate, by 2009 at the latest, the reconciliation requirement. Obviously, I can also understand that some progress in eliminating unnecessary differences between IFRS and US GAAP has to be demonstrated as well and that the process should be an ongoing one. But such progress should not, in my view, lead to aim at a new set of perfect standards. In that matter, as in others, “the best is the enemy of the good” and since we are in Paris, let me remind the standard setters of a French proverb : “Paris was not built in a day”.

Therefore the road map should not be interpreted as a process toward perfection and should take in consideration urgent needs and clear priorities.

Sir David Tweedie, noting that the task of IASB is not yet complete, said recently to the European Parliament’s EMAC that “Convergence v. Stability is a false choice”. He may be right, but it all depends on what is meant by those words, and what is the time frame. I agree that the task of IASB will be complete only if, and when, the IFRS will be accepted on every financial market without local additional requirements. I also recognize that the world will continue to change and that the existing accounting standards are not etched in stone for ever.

But, setting accounting standards is not –let me say it again– an academic exercise. It should take into account the practical aspects and realities of this world.

We should not lose sight that IFRS do not only concern a few hundred of blue chip companies which are equipped with strong accounting teams, large auditing firms, and operate in the most sophisticated financial markets, where users are professional investors helped by the best financial analysts.

IFRS do and will apply to thousands of smaller listed companies. It will concern tens of thousands of auditors and accountants in less developed countries, and will be used by many less sophisticated analysts and investors. Not only is it very important to promote the project “IFRS for SME’s,” but also **to leave sufficient time for the second tier of market participants, the medium size public companies, to digest what they already have now.** To “digest” means to adapt their accounting and reporting systems, to train their staff, to educate the users of their financial statements, to integrate the IFRS concepts in their management culture and in their business plans. And investors may need some time to get used to reading differently the financial statements, to reconstruct an historical series of consistent data.

I do not have the golden key to this balancing act, but I suspect that some stability over the next 3 years may well be needed for the transition to be really completed and digested by the stakeholders. **I note that IASB is aware of these facts but I think that further analysis is needed to determine the best balance between all the conflicting objectives of equivalence, convergence, and standard setting**

pause, and that this reflection should involve particularly those in charge of financial stability.

To conclude, let me express the wish that we all come to a common understanding of the overall objectives, and that we find a reasonable compromise between :

- short term stability in order to facilitate the efficient implementation of what has been already achieved, together with short term completion of standards where needed,
- medium term convergence through a reasonable process aiming to minimise the main significant differences between IFRS and the main third country GAAPs,
- long term further evolutions which require a better understanding by all market participants of the implications and limits of the fair value approach in measuring and presenting companies' performance.

Finally, while I would not pre-empt IOSCO's members and experts detailed views at these issues, I can certainly commit IOSCO to continue its monitoring task and to work hard, together with its counterparts, to the improvement of the standard setting process and to an efficient enforcement of the standards which are key to an efficient functioning of global capital markets.