

## IFRS, shareholder rights: a dialogue with Commissioner McCreevy

### Introduction

The European Audit Committee Leadership Network is a group of audit committee chairs drawn from leading European companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit environment.

The European Audit Committee Leadership Network held its fifth meeting in Brussels on 16-17 February 2006. During dinner, members participated in a dialogue with the EU Commissioner for the Internal Market and Services, Mr Charlie McCreevy and his Deputy Head of Cabinet, Ms Claire Bury. During the discussion, members considered the following issues:

- **Consistent implementation of IFRS across the EU**
- **IFRS and US GAAP: convergence or equivalence?**
- **Shareholder rights: one share, one vote**

Members of the network participating in the dialogue with Mr McCreevy and Ms Bury sit on the boards of 32 large, mid and small cap public companies. Members participating in the meeting were:

- Mr Per-Olof Eriksson, Audit Committee Chair, Volvo
- Dr DeAnne Julius, Audit Committee Chair, Roche Holdings
- Mr Daniel Lebègue, Audit Committee Chair, Alcatel
- Mr Pierre Rodocanachi, Audit Committee Member, Vivendi
- Dr Klaus Schlede, Audit Committee Chair, Lufthansa and Deutsche Telekom
- Mr Gerhard Schulmeyer, Audit Committee Chair, Zurich Financial Services

Other participants in the meeting, included:

- Mr Tom McGrath, Global Managing Partner, Ernst & Young
- Mr Christian Mouillon, Global Vice Chair, Assurance and Advisory Business, Ernst & Young

*ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made during meetings are not attributed to individuals. However, Mr McCreevy and Ms Bury have given permission for their comments to be attributed.

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## Opening remarks by Commissioner McCreevy

### Introduction

Last time we met in June 2005 we had a very topical and lively discussion on the value of audit committees, their composition and functions.<sup>1</sup> The 8th Company Law Directive on Statutory Audit has now been adopted. The final compromise on audit committees is a sound one in my view. It confirms the key principles of the role and importance of audit committees, but leaves flexibility for Member States as to how they translate these principles into national law.

I'd like to kick off our debate this evening by giving you a snapshot of what we are doing on a few topics linked to the way that companies operate in the EU.

Our overall objectives are to enhance shareholder value and bolster investor confidence. At the same time we must ensure that companies are not over-burdened with regulatory requirements and that entrepreneurial spirit is not stifled. This is of course not an easy task in an EU of 25 Member States, with very different traditions. It is a task which requires that we strike a very careful balance.

I want to touch on four issues which are of fundamental importance in getting that balance right:

- Firstly, the role you play in audit committees monitoring effectiveness of internal controls
- Secondly, transparency in corporate governance and internal controls
- Thirdly, globally accepted high quality financial statements; and last but not least
- Effective exercise by shareholders of their rights

### 8th Company Law Directive and Audit Committees

The 8th Directive is clear on your role as chairs of audit committees. You should monitor:

- auditor independence
- the financial reporting process and the audit
- the internal audit function – where such a function exists
- the effectiveness of the company's internal control system

Unlike in the US, monitoring the effectiveness of the company's internal controls for an EU-listed company remains an internal matter. EU law does not contain any requirement for management or auditors to certify the effectiveness of a company's internal control or to provide any disclosure in this regard. This is a very clear example of how in the EU we have sought to strike the right balance in improving compliance with internal controls, but without imposing excessive costs on companies. I was staggered to hear when I was in the US last week that the costs of implementing Section 404 of the Sarbanes-Oxley Act were, in fact, 20 times greater than was originally anticipated. No-one doubts that compliance with internal controls in the US is now a more rigorous process, but the jury is certainly still out on the cost/benefit analysis of Section 404.

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<sup>1</sup> See European Audit Committee Leadership Network, "The 8th Directive, regulation and the Europe Union", *ViewPoints*, 15 July 2005. Available at: [http://www.tapestrynetworks.com/documents/Tapestry\\_EY\\_EuroACLN\\_Jul05\\_View4.pdf](http://www.tapestrynetworks.com/documents/Tapestry_EY_EuroACLN_Jul05_View4.pdf)

### **Corporate governance statement and internal control**

Although monitoring internal controls is an internal matter, investors and shareholders must be kept informed. Recently, the European Parliament and the Council agreed on the Commission's proposal to amend the Accounting Directives (4<sup>th</sup> and 7<sup>th</sup> Company Law Directives). Transparency for off-balance sheet arrangements will be enhanced. Listed EU-companies will be required to make public every year a corporate governance statement following the “comply-or-explain” principle.

Such a statement must also include a description of the main features of the internal control and risk management in relation to financial reporting. This does not amount to introducing Section 404 of the Sarbanes-Oxley Act in the EU by the back door. It is simply a minimum requirement requiring companies to be transparent on what they do on corporate governance and explain when they deviate from best practices. You know better than I do that most companies worth their salt already do this.

### **Equivalence and the road map**

High quality financial reporting is fundamental. Introduction of International Financial Reporting Standards (IFRS) in the EU since 1 January 2005 has been nothing short of a revolution. I am very well aware of the fact that companies need time to bed down the new standards. I have made crystal clear that we won't be accepting any further revolutionary new standards in the near future. We must focus on consistent interpretation across the EU to make sure companies reap the full benefits. Since our standards are now “international”, these benefits should be felt, not just within the EU but also for EU companies when they operate across the globe. A significant number of countries are moving to adopt IFRS. But I have also put my weight behind convincing the US that IFRS are high quality financial statements which should be recognised as equivalent to US Generally Agreed Accounting Principles (GAAP) and that the US requirement to reconcile to US GAAP should be removed. The new Securities and Exchange Commission (SEC) Chairman, Christopher Cox, has confirmed his commitment to work towards IFRS acceptance in the US, without reconciliation, no later than 2009.

But it is not just the US that has to take an equivalence decision. The EU too must address equivalence of US GAAP before 1 January 2007. I favour postponing the European decision on the equivalence of US, Japanese and Canadian GAAP until 2009. This would align the timetables on both sides of the Atlantic, avoid market disruptions in Europe and maintain momentum for getting IFRS accepted in the US.

### **Company law**

In addition to high quality financial statements and audits, investors must also have the tools to exercise controls over the way that companies operate. Day-to-day management is, of course, for the board but the board must be accountable. This brings me to our Proposal for a Directive on Shareholder Rights.

#### **Shareholder rights**

This proposal was adopted at the beginning of January. Its objective is to eliminate obstacles which make it difficult or sometimes even impossible for non-resident shareholders to exercise their voting rights. On average, non-resident shareholders hold about 30% of the capital of listed companies in the EU. Today such shareholders face serious problems when they want to exercise their voting rights. This is due in part to the complexity of the cross-border holding of shares and also to some outdated

national legislation which was crafted in the era when shareholders did not invest across borders. The proposal is limited to making sure that the plumbing of voting across borders works. For example, it would introduce minimum notice periods for meetings, simplify proxy voting and abolish all forms of share-blocking. The proposal is a good example of better regulation, as it is based on the results of two public consultations that showed broad support for the initiative, it is accompanied by a thorough impact assessment and is strictly limited to what is necessary to facilitate cross-border voting.

## Consultation on Company Law Action Plan

Getting regulation right is crucial to competitiveness in Europe. That is why, before addressing future priorities in the area of company law, we are now consulting on what, if anything, needs to be done next. A consultation document has been published on the website of DG Internal Market and Services.<sup>2</sup> Interested parties are invited to reply by 31 March 2006. I very much hope you will give us the benefit of your views. A public hearing will also be organised in early May to allow a full and open debate on these issues.

## Concluding remarks

I am convinced that striking the right balance for companies in Europe and improving competitiveness means keeping regulation flexible and to a minimum. We, in the Commission, must now walk the talk on better regulation. You must ensure that your companies live and breathe good corporate governance. Events such as our dinner together this evening allow us to exchange views on how each of us can best do our jobs. Thank you for providing such pleasant surroundings and convivial company for us to do so.

## Dialogue with Commissioner McCreevy

Following his opening remarks, Commissioner McCreevy engaged members in a dialogue on the following issues:

- Consistent implementation of IFRS across the EU
- IFRS and US GAAP: convergence or equivalence?
- Shareholder rights: one share, one vote

## Consistent implementation of IFRS across the EU

As of 1 January 2005, IFRS became the officially mandated financial reporting standard for public companies in all Member States of the EU. At the close of 2005, compliance varied by Member State. Mr Philippe Danjou, chief accountant of the French Autorité des Marchés and a member of the Committee of European Securities Regulators (CESR), believes that firms in “the UK, Ireland and The Netherlands could be closer [to IFRS] in terms of their way of thinking. Latin countries such as France, Spain, Italy and Portugal will probably have to change a lot more”.<sup>3</sup>

The SEC is actively trying to understand both the particulars of IFRS, and the consistency with which it is accepted by EU Member States. SEC resources and staffing were increased in 2005 to study the

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<sup>2</sup> Available at: [http://europa.eu.int/comm/internal\\_market/company/consultation/index\\_en.htm](http://europa.eu.int/comm/internal_market/company/consultation/index_en.htm)

<sup>3</sup> Quoted by Matthew Gower, “Orchestrated accounting”, *IRontheNet.com*, April 2004. Available at: <http://www.ironthenet.com/leadfeature.asp?articleID=3466&templateID=2>

matter, and a roadmap was laid out to eliminate reconciliation requirements for IFRS users by 2009. Last summer, Mr Donald Nicolaisen, then the SEC's chief accountant, said that the goal of the SEC roadmap was "elimination of the SEC's requirement that foreign issuers reconcile financial statements prepared under IFRS to US GAAP".<sup>4</sup> The SEC will be comparing IFRS and US GAAP sector-by-sector in 2006 in the hope of eliminating the need to reconcile IFRS and US GAAP.

Members discussed with the Commissioner and Ms Bury whether it was possible to achieve consistency in a principles-based accounting environment where individual judgements and interpretations are a requirement of the system. Mr McCreevy said: *"One thing I'm certain about is that problems have arisen due to different [interpretations of the] standards. I have given my views to IASB<sup>5</sup> that until we have this bedded down – and given some time – we will not automatically endorse any revolutionary new standards. The US wants to see consistent implementation across all 25 Member States. We have to make sure our own garden is pretty level before we talk to others. We were in the US last week and met with Chairman Cox, who is personally committed to the agreement [the EU] had with former Chairman Donaldson"*.

The Commissioner asked for feedback from network members on the implementation of IFRS. Network members broadly agreed that conversion, while difficult, had gone well. One member commented: *"A huge amount of work went into conversion. That's water under the bridge now. We anticipated the issues reasonably well and explained it to the analysts. I agree we need to bed down IFRS and work on any problems"*. Another member agreed, saying: *"Moving to IFRS has been painful, difficult and long but we did it"*.

Members also agreed that IFRS was an improvement on the individual country accounting standards it replaced. One member commented: *"I understand the accounts today better under IFRS, than I did under the old system"*. Another audit chair said: *"IFRS is a journey and won't be right on day one but it is a huge positive step forward. How regulators deal with this worldwide is critical"*.

Members also backed the Commissioner's stand on opposing "any further revolutionary new standards". One member commented: *"We are going through the exercise of implementing IFRS and the major issue we need is stability in regulation. If the rules change we are in a mess. Who gains from volatility in our stock? Hedge funds. But we want and need small investors to [provide long-term] support [for] the company. We need a stable environment"*.

## **IFRS and US GAAP: convergence or equivalence?**

Members moved on to a broader discussion of the merits and demerits of achieving long-term convergence of global accounting standards and whether the EU and European companies would be better focused on achieving mutual recognition for IFRS and US GAAP, removing the need for reconciliation between the two systems in either direction.

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<sup>4</sup> Robert Bruce, "The roadmap to global convergence", *FT.com*, 7 July, 2005.

<sup>5</sup> The International Accounting Standards Board is an independent, privately-funded accounting standard-setter based in London. The Board members come from nine countries and have a variety of functional backgrounds. The IASB is committed to developing, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require transparent and comparable information in general purpose financial statements. In addition, the IASB co-operates with national accounting standard-setters to achieve convergence in accounting standards around the world. For more information see <http://www.iasb.org/index.asp>

Ernst & Young, which recently published a book on IFRS/US GAAP comparison, defined the difference between convergence and equivalence: “Convergence should not be confused with equivalence. Convergence is the long-term goal of a single set of globally accepted standards. Equivalence is the short-term imperative that implies broad comparability, not uniformity, and the acceptance by national regulators of different systems without the need for reconciliation”.<sup>6</sup>

In mid-December 2005, the European Parliament encouraged Mr McCreevy to ensure that equivalency of IFRS and US GAAP should only be accepted if it is two-way. In the absence of another decision by the EU, by January 2007, the Prospectus Directive will require US companies seeking to raise capital by listing on European exchanges to file financial statements in accordance with IFRS, if equivalency has not been reached.

Mr McCreevy told network members: *“Europe starts with a big disadvantage. If it was a ‘green field’ we would not be starting where we are now. The US has a central government with a single regulator (SEC) and standard-setter (FASB). We have 25 countries with no central government; no central regulator; and we are trying to do the best we can. We don’t even have a single standard-setter. This is a real problem. We are starting with a structural disadvantage”.*

One network member went further saying: *“Europe’s different regulators don’t trust each other and don’t sing from the same song sheet”.*

However, most members believe that complete convergence between IFRS and US GAAP does not matter. One member said: *“I don’t care about convergence with the US. Why? Who is investing? Large funds and large banks that employ hundreds of analysts to look at my accounts. They have the people and the tools to do this so if there are different interpretations it doesn’t matter. Our shareholder is not the small investor in Albuquerque”.* Another member said: *“We should have two standards: IFRS and US GAAP. Two is fine. It was hundreds that made no sense”.*

There was also broad agreement among network members that cultural issues across Europe, and between Europe and the US, will make convergence difficult to achieve. Mr McCreevy said: *“If people can compare like with like over time that’s all that matters with IFRS. The difficulty will be with rules-based and principles-based [accounting standards]. Are they irreconcilable?”.* One member responded: *“We should be talking about equivalence rather than convergence. Convergence between a principles-based and a rules-based system is difficult to think about how it will work practically”.* Another member agreed: *“The most important thing is not working out all the wrinkles to get convergence. But it is in both sides’ interest to have equivalence. If our standards are equally rigorous – and some say they are better – and we use the same audit firms as they do in the US, why can’t [US and European standards] be equivalent?”*

Members’ main concern was to avoid a situation where the SEC begins to provide its own interpretation of IFRS. One member said: *“The US SEC will interpret IFRS for the largest companies in Europe (and the world)”.* However, Ms Bury responded: *“The Commission is well aware of this risk. We have a commitment from the SEC to confer with relevant parties and give full consideration to the positions of their international counterparts”.*

Members are looking to the European Commission to negotiate on their behalf with the US regulatory authorities on equivalence, as Member States and companies can’t do that for themselves. Mr

<sup>6</sup> For further information see [http://www.ey.com/global/Content.nsf/UK/Media\\_-\\_05\\_06\\_23\\_DC\\_-\\_Convergence\\_of\\_US\\_IFRS\\_shareholder\\_rights\\_a\\_dialogue\\_with\\_Commissioner\\_McCreevy](http://www.ey.com/global/Content.nsf/UK/Media_-_05_06_23_DC_-_Convergence_of_US_IFRS_shareholder_rights_a_dialogue_with_Commissioner_McCreevy)

McCreevy commented: *“The choice should be there on accounting systems. €15 million is the cost of reconciliation for some European companies. Why should European companies be disadvantaged in this way when we have a perfectly good accounting system of our own?”*

Even so, one member felt the whole discussion about equivalence and convergence was unhelpful. *“Is reconciliation between US GAAP and Europe the main priority for the next five years? Investors and analysts are living very well with two sets of rules. There are other priorities. The Commission should go forward on greater convergence of corporate governance practices and rules. IFRS is important for auditors but not for business life”*.

Summarising his views, Mr McCreevy told network members: *“We intend to defer the need for reconciliation with IFRS so as to align the timetables on both sides of the Atlantic. Unless the decision to postpone is made by the end of 2006, US companies will have to reconcile to IFRS. That would cause all sorts of other issues between the US and Europe. This is solvable, so let’s solve it. The trade is that the EU will relax the deadline and the SEC will work towards mutual recognition. This opens doors for co-operation on other issues, for example deregistration”*.

## **Shareholder rights: one share, one vote**

The guiding principle behind the Commission’s shareholder-related proposals is that shareholders need to be active, not passive. The Commission recently adopted a proposal that guarantees a minimum of 30 calendar days’ advance warning of a shareholder meeting, complete with documents. This timeframe permits communications to flow to the shareholder not only directly, but also through the various intermediaries that often intervene, for example securities firms and central securities depositories. Extraordinary general meetings related to takeovers still require only 14 days notice. In addition, the Commission has proposed:

- As many meetings as possible should be accessible electronically, keeping in mind the limits and costs of current technology
- Voting by post, proxy and via email should be allowed, keeping in mind the limits of technology (especially around security). Vote results must be posted on company websites
- Shareholders have the right to ask questions of managers and have them answered
- “Share blocking” should be stopped throughout the EU (a practice that restricts the selling of shares for a period before a company meeting)

Mr McCreevy told members: *“I come from a view that the shareholder is king or queen. It may be inconvenient for the board to go to the annual meeting and answer questions. It is inconvenient for politicians to have general elections but they have to go to the people to elect them. The people who put up the money, own the company. I believe if you empower the shareholder to be the boss, all things flow down from that. That’s why we also launched a debate on ‘one share, one vote’. I know the market factors [into the share price] different voting structures but I want to inspire a debate”*.

Members shared different perspectives on the Commissioner’s view on ‘one share, one vote’:

- **‘One share, one vote’ is essential to a level takeover playing field in the EU.** *“There are different rules on takeovers and voting in each country. We have created a real risk and we need convergence on transaction rules throughout Europe or I am worried that some countries will say no [to a particular deal] under public pressure because there is no reciprocity.”*

- **‘One share, one vote’ does not do enough to protect small shareholders.** *“On principle, there is no way to be against it, but we need to protect the small investor from themselves. There are never more than 40% of the shares represented in the [annual meeting]. We have several thousand small investors but they never represent more than 2% of the company. If I am a raider I am going to buy 22% of the shares – below the 33% [takeover trigger] so I don’t have to acquire the company. In the [annual meeting], I now have 55% of the 40% of those voting and I can take control of the company. We need to protect the small investor. We need a cap or a proportional vote process.”*
- **‘One share, one vote’ discriminates against some forms of majority shareholding.** *“There are natural competitive advantages in some industries from having stable share ownership, particularly where you have to make long-term bets. However, it needs to be transparent: then you can let the market decide. The multiples on different voting structures will determine the differences by industry. I don’t agree with one share, one vote. Let the market decide.”*

Mr McCreevy responded: *“We are not going to have a European-wide corporate governance system or code. However, if the shareholder is king or queen it adds a lot of discipline to business like [democracy does for] politicians”.*

## Appendix: biography of Commissioner McCreevy

Born in 1949, Mr McCreevy worked as a chartered accountant until 1977, when he was first elected to Dáil Eireann (the Irish Parliament) for the constituency where he was born – County Kildare. From 1992 until 2004, he held various cabinet posts in Fianna Fail-led governments including: Minister for Social Welfare, Minister for Tourism and Trade, and Minister for Finance.

Having presided over Ireland’s entry into the European Monetary Union and later the changeover to the euro, Mr McGreevy was selected as Ireland’s European Commissioner in 2004. He was asked to take on the Internal Market and Services portfolio by Commission President, Mr Jose Manuel Barroso.

Mr McCreevy was educated at a Franciscan college before gaining a degree in commerce at University College, Dublin. He is a member of the Institute of Chartered Accountants.

## About this document

*ViewPoints* is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, their advisers and auditors, as they endeavour to fulfil their respective responsibilities to the investing public. *ViewPoints* is a synthesis of key issues arising from discussions among members of the European Audit Committee Leadership Network. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *ViewPoints* may share it with those in their own network. The more board members, management, advisers and auditors who become systematically engaged in this dialogue, the more value will be created for all.

*The views expressed in this document represent those of the European Audit Committee Leadership Network, a group of audit committee chairs drawn from Europe’s leading companies committed to improving the performance of audit committees and enhancing trust in financial markets. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young or Tapestry Networks. Please consult your advisers for specific advice. Ernst & Young refers to all members of the global Ernst & Young organisation.*

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