Part 2 - chap 3 (p93-101) 30/11/05 17:15 Page 93

Conducted by Catherine Distler (PROMETHEE) and Bernard Nivollet (Unisys)

Strategic conversation with

Christian Mouillon

Global Vice Chair, Audit, Ernst & Young

Global markets in search of renewed trust

While globalising their activities, many large European companies in the last twenty years have decided to cross-list in the US to benefit from its lower capital costs, resulting from the quality of US securities and disclosure laws and the liquidity of the American capital market. However, with the adoption of the Sarbanes-Oxley Act in 2002 – a policy applicable to all US-listed companies and one that reinforces corporate governance and internal controls requirements – many companies wonder whether the costs now outweigh the benefits of being listed in the US, not to mention that the new provisos may be incompatible with home-country law or culture. As a consequence, some corporations have decided to de-list in the US, only to discover that it is exceptionally difficult to terminate SEC registration (which predicates Sarbanes-Oxley compliance in the first place). As an auditor, how do you assess Sarbanes-Oxley's extra-territorial implications?

Christian Mouillon: In the case of the Sarbanes-Oxley Act, regulators reacted to corporate scandals in 2001 and 2002 – Enron, Global Crossing, Adelphia, WorldCom, etc. – by establishing a new regulation for the American economy

Part 2 - chap 3 (p93-101) 30/11/05 17:15 Page 94

that aspired to rebuild public confidence in the corporate sector. I will say that European companies will likely adapt. Non-US companies, whether they are still listed in the US or have a significant number of American shareholders, will have to comply because, even if they chose to de-list in the United States, they have no assurance of the regulation that will be applied to them. Moreover, I would add that, in practice, *all* big European companies will have to align with the American regulation. Corporate resistance to an assessment of the effectiveness of internal controls over financial reporting will not last for long: companies listed in the US will ultimately need to comply with the Sarbanes-Oxley Act, and therefore will have to make their assessment available in Europe, too, as local regulation generally requires the disclosure of financial information realised in other markets. The reality is such that all non-US companies will have to align their reporting criteria with the de facto American benchmark.

In Europe, it took the European Commission two additional years to propose a new law to combat corporate fraud versus the US Congress' turnaround in establishing the Sarbanes-Oxley Act. Why has the European reaction been so slow?

CM: The European reaction to corporate scandals has been slow for two reasons: first, many believed that situations such as Enron, WorldCom or Adelphia were unlikely to arise on the continent; second, Europe is a complex entity that is unable to take rapid decisions on the face of unexpected events, as time is required to conduct discussions and coordinate.

After Parmalat and Ahold demonstrated that Europe was not immune from corporate scandal, European regulators started to reassess corporate governance rules in each country, while the Commission advocated a common approach at the EU level with respect to a few primary rules and to the coordination of corporate governance codes. The European approach, though, differs from the US precedent in two distinct manners. First, America's regulatory approach is 'rules-based', whilst the European model is more 'principles-based'. Second, although the US law is designed to have an extra-territorial reach, the European approach does not depart from the traditional territorial paradigm thus making prospective regulations poorly adapted to our contemporary global economic environment. It would have been much more efficient from a European perspective to have discussed potential regulations with the American authorities, as financial security is not a territorial issue. Any attempt to compete with US regulation in financial security matters will be inefficient

because European law takes too long to implement. Just one example: control of financial statements will only be effective in 2007 with the application of the new 8th EU Directive on auditing. Moreover, while some European regulation is being implemented – starting with the adoption of the IFRS accounting norms by European listed companies – no European regulator has oversight on this process.

Will the adoption of the 8th EU Directive have a similar effect as the sweeping US corporate governance rules? Will it mark the European approach to globalisation?

CM: First, let me stress a congenial weakness of any European law: European directives only begin to apply to people and businesses when they have been transposed into national laws. In practice, member states have difficulty resisting 'gold-plating'[1] EU directives and extending them far beyond their original intended scope. At Ernst & Young, we have argued for many years that European Directives should be adopted in the various fields where there are no controversies between member states, and fully transposed into national laws without additional requirements at the national level. One can hope that it will be the case for the 8th EU Directive and for the forthcoming policies under discussion as part of the Corporate Governance and Company Law Action Plan. However, these will not suffice. As long as our national judicial systems remain different and tax harmonisation fails to occur at the European level, Europe will remain defensive *vis-à-vis* the extraterritorial reach of American law – the reverberations of which will be difficult to resist. I am intimately convinced that no national laws on auditing implemented in Europe will have any structural impact at the global level, nor any resonance similar to that of the Sarbanes-Oxley Act on European companies listed in New York. To further complicate matters, any such laws will have to be revisited after the adoption of the 8th EU Directive on auditing, anyhow.

Beyond the extra-territorial reach of American laws, the capacity of the US Government to enact a new regulation only eight months after the Enron collapse contrasts vividly with the time it takes to the European Union to adopt a new directive on a similar subject: three years after the Sarbanes-Oxley Act, and two years after the Parmalat scandal, deliberations at the EU level are still ongoing.

1 'Gold-plating' is when transposition in national law goes beyond the minimum necessary to comply with a directive, by adding substantive requirements.

Part 2 - chap 3 (p93-101) 30/11/05 17:15 Page 96

Lucio Loubet

9ème série de la Métamorphose n° 41
(116 x 81 cm)

Coordination and consensus building among 25 member states is obviously time-consuming, and positions any European regulatory attempt at a disadvantage to American counterparts. 'Gold-plating' is another shortcoming. A third one, as you mention previously, is the fact that the European Union has a territorial view of its regulation, while the US law is conceived, from the beginning, as extra-territorial. Are there other flaws that explain the lack of European influence on global matters in this field?

CM: The emphasis placed by the European Union on principles rather than on rules is another flaw that poses problems in our relationship with Americans. They prefer very detailed rules that can be checked more easily at the implementation stage. This will be the main weakness of the 8th Directive, as the Americans may provide the only rules interpreting principles and the Europeans may neglect to provide any practical interpretation of these principles. If it is the case, transatlantic tension will not diffuse despite the recent agreement that have been reached between European and American authorities.

It could be the same on new international accounting standards: in order to accept the equivalence of IFRS to US GAAP, the US authorities may choose to provide detailed rules interpreting the new international standards, while Europeans may not.

You mentioned earlier that it could have been more productive to establish a transatlantic dialogue on corporate governance. To be sure, such discussions exist in many fields and have led to some convergence of practices in fields like competition policy. Why did the Europeans not attempt this type of approach?

CM: I just mentioned the inadequate level of European coordination. Another difficulty results from the fact that the same sectors do not have the same type of regulatory authorities in different countries. Auditing oversight is exercised in the US by the PCAOB (Public Company Accounting Oversight Board) whose members are nominated by the SEC. There is no such organisation at the European level, and in a country like France, audit supervision is exerted by the Justice Department from a purely juridical point of view; here, the potential influence of listed and non-listed companies is much weaker than in the US, and the rules apply to all companies (whether or not they are listed) while the PCAOB rules are only applicable to *listed* companies.

Many corporations complain about the cost of implementing Sarbanes-Oxley standards. Will these expenses outweigh the benefits of restored

Part 2 - chap 3 (p93-101) 30/11/05 17:15 Page 98

trust in the market? Furthermore, do you think they are affordable for most companies?

CM: This cost may be affordable for large corporations that can expect a benefit in terms of cost of capital by rebuilding trust in American capital markets. The equation is different for smaller corporations that may question the value of remaining public: they may opt for de-listing – like some foreign companies – and turn to private equity. Of course, this may be precisely what the US regulators desire: the SEC's mission is, after all, to protect investors and to maintain the integrity of securities markets. In short, private equity investors are more knowledgeable than those who the SEC seeks to protect.

Another significant consequence of Sarbanes-Oxley is that some companies are no longer so interested in being listed on the US stock exchanges. This may begin to explain the unprecedented growth presently occurring in private equity.

In addition to the increased external costs of auditing, is not Sarbanes-Oxley generating new costs internally as internal reporting standards need to be reinforced?

CM: Yes, indeed. US regulators may have over-reacted to corporate fraud, but this was the price to pay to re-build market trust. As could be expected, US regulators did not wait long to revisit the regulation, to assess which requisites are efficient or not, and to modify the often-criticised section 404.

Two contradictory stories are aired today on the American role within IAS. Some argue that European companies could suffer from on-purpose, ill-designed standards overly influenced by American objectives. Others feel that American participation is necessary to prepare the convergence of IFRS and US GAAP. You seem to adhere to the second vision.

CM: The first story could have been plausible before Enron but isn't so any longer. In addition, Americans demonstrate their willingness to establish standards that could be considered as legitimate equivalents to the IFRS, and could make the reconciliation of companies' accounts unnecessary. In practice, they already changed some of their US GAAP standards, adopting new ones closer to those of IAS. In effect, we no longer discuss the convergence of IFRS and US GAAP that could be considered on one side or the other as an alignment, but the equivalence of accounting standards. This requires considerable effort and time!

Part 2 - chap 3 (p93-101) 30/11/05 17:15 Page 99

Let us move from accounting standards and corporate governance to another subject about which you are very familiar: European banks. Until recently, consolidation within the European banking sector mainly occurred at the national level. What are the obstacles that prevent cross-border consolidation in Europe?

CM: Whatever the obstacles to consolidating Europe's various financial actors, European banks need to become more proactive in this arena. Our American competitors have stronger financial muscle, and will apply their innovative business skills and high margin banking products to the European market. European consolidation will eventually take place but I fear that European actors may not be in the driver's seat.

Is consolidation inevitable in all market segments of the financial industry (both in Europe and globally)? Do big enough economies of scale exist to justify large cross-border operations?

CM: In investment banking – including corporate finance and the securities business – most big banks have reduced their costs, and the remaining issue rests in pinpointing the optimal size for such operations. All investment banks must face, and *answer*, this question. In retail banking, the key dimensions today are cost reduction – as the client base is becoming increasingly cost sensitive – and local presence.

Beyond the obstacles to retail banking consolidation, is there any link between accounting standards and consolidation?

CM: First, let me emphasise that some consolidation in the European banking sector has already occurred or is now taking place! HSBC acquired CCF in France, SCH acquired Abbey National and Unicredito Italiano took-over HBV Group in Germany.

From my point of view, the necessary consolidation of the European banking sectors is delayed by the illusion that it will be the result of mergers of equals rather than clear-cut take-overs. Clearly, outright cross-border takeovers are politically awkward in Europe. However, I think that this perspective is totally misleading and outdated: the agreement may take the form of a merger of equals, however, at the end of the day, one of the companies has acquired the other. Moreover, with the new accounting rules (IFRS 3), the 'pooling of interest' method is no longer authorised: all business combinations have to be accounted for as acquisitions, and acquired assets valued at their fair value.

History is littered with mergers that did not work. However, with new account-

Part 2 - chap 3 (p93-101) 30/11/05 17:15 Page 100

ing standards both in the US and at the international level, mergers will be on the decline and acquisitions on the rise.

In globalisation strategy in general, and with regard to acquisitions in particular, accounting standards play a key role as they permit the assessment of relative performance and lead to a better understanding of risk. Is there anything specific to US GAAP and American corporate governance principles that gives US companies an advantage over European ones as they expand globally?

CM: The main advantage that American companies have is fiscal: US law allows deductibility of goodwill depreciation after an acquisition, an accounting nuance that is neither authorised in France nor in many other European countries. From my perspective, the tax regime is often discarded when discussing competitiveness, but it has a significant impact. In the US, for example, consolidated accounts and worldwide profits are aggregated, and it is then possible to deduct amortised goodwill worldwide. Here, again, their extra-territorial vision provides a sizable advantage to American companies.

We have discussed global regulation, accounting standards convergence and consolidation, but have yet to mention Ernst & Young specifically. Can you explain what these global trends mean for a Big Four audit firm and outline the key challenges such an organisation faces?

CM: Ernst & Young is a network of national partnerships that need to integrate as much as possible to best resolve today's primary global challenges for audit firms: *reputation and risk*. From this point of view, the local dimension is diminishing in importance relative to the heightening benefits of performance at the global level.

We've already extensively discussed Sarbanes-Oxley requirements in terms of internal control, but here is a further interesting case as regards today's disclosure requirements. As a network, we face difficulties when auditing the French entity of a global corporation listed in the US: the PCAOB requests all audit working papers to be transmitted to the US, as the US auditor who will ultimately sign the consolidated account should have access to all those documents. However, this is forbidden under French law and most other national laws in Europe! It is considered to be a betrayal of professional secrecy because the American Ernst & Young entity is legally independent from the French one. However, the solution can't be that the US firm simply conducts audits in France and vice versa. Indeed, none of our French clients would con-

sider it a satisfactory solution for a French team to audit their American subsidiaries; just as none of Ernst & Young's American clients would be content to have an American team audits their French subsidiaries. Ultimately, clients want us to be a *global* organisation with extensive *local* capabilities so that audits can be conducted at the national level with local knowledge informing the context and circumstances of our work.
So, while it is on the one hand necessary for audit firms to integrate and provide the same high quality auditing everywhere, it is equally necessary for countries to revisit laws that have their own logic and interest – protection of privacy for example – but that are antagonistic to globalisation and raise very acute business problems.

You suggest that integration is one way to address those global challenges. In the case of Arthur Andersen, many have argued that integration foretells the disappearance of the whole network?

CM: The counter-example is Parmalat. As soon as the Parmalat scandal exploded, Grant Thornton in the US said he had nothing to do with Grant Thornton in Italy, who was auditing the offshore subsidiaries of Parmalat where most of the fraud took place. As a consequence, the first thing Enrico Bondi, Parmalat's government-appointed administrator, did was to sue Deloitte in the US and not Deloitte in Italy despite the fact that the Parmalat consolidated accounts were audited by Deloitte from Italy. Indeed, he did so to prevent any attempt by the US unit of Deloitte to advocate that Deloitte is a network of legally separate national partnerships, and that each independent organisation should be held accountable for its own actions. Had Bondi attacked Deloitte in Italy, I think this is precisely what they would have done.
I would argue that this time is gone. We need to serve our clients global needs, offer them a global service and implement new internal processes to guarantee the quality of execution. So, we have to find a way to operate as a true global firm, even in front of litigation. This cannot be envisioned unless regulatory agencies rethink the ongoing regime that considers audit firms' responsibility as being without limits and thus out of proportion to the fees they get from their customers for their mandate.