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EDITORIAL

An important aspect of the difficulties now confronting the world economy is the distrust of corporate financial reporting displayed by markets, investors and public opinion at large. Rebuilding confidence in accounts, ensuring more transparent financial information and doing away with conflicts of interest have thus become crucial issues in the wake of the Enron scandal. The two reports issued by the Conseil d'Analyse Economique start with the well-established fact that accounting, like economics, is not an exact science. The aim must nonetheless be to adopt a set of conventions that ensure a reasonable match with underlying business realities and the desired degree of transparency, without adding to already very high volatility on financial markets. Once the diagnosis has been made, the search for appropriate remedies raises a broad range of issues, from re-regulation and self-regulation to the reinforcement of ethical standards in business, as well as future stages in the integration of financial markets and services within the European Union.

Christian de Boissieu
Executive Chairman of the CAE

Accounting Standards and the Regulation of the Financial Information Industry

Reports by Jacques Mistral
and by Christian de Boissieu and Jean-Hervé Lorenzi

The two reports, one by Jacques Mistral and the other by Christian de Boissieu and Jean-Hervé Lorenzi, address the issues raised by financial scandals such as those associated with the names of Enron and WorldCom. Should the blame be put on accounting standards, the financial information industry, standards of corporate governance or regulatory methods? And how can confidence be restored?

The two reports were presented to the plenary session held on March 27th 2003, and in the presence of the French Prime Minister on May 5th 2003. This letter, published under the authority of the permanent staff of the CAE, summarises the main conclusions of the report.

"Providing a Faithful Account of Business Reality"

The report by ***Jacques Mistral*** has three main purposes. First, it tries to understand how financial reporting could have got so seriously off track as it did in the recent scandals, and then how far this should be attributed to accounting procedures. Then, the report reviews the proposed reforms under US GAAP and IAS-IFRS, in particular the full fair value reporting proposed under IFRS. Finally, it explores new horizons in financial communications, non-accounting information and use of the internet.

Four problem areas for accounting standards

Recent financial scandals have cast harsh light on the weaknesses of financial reporting standards in four key areas, which unscrupulous managers were able to exploit to their advantage:

• Reporting of revenue and expense: the WorldCom scandal involved a massive fraud to show profits that did not exist. This was achieved by booking expense for the acquisition of new clients as investment. Yet while this was manifestly intended to mislead in the case of WorldCom, the decision to book spending on intangible assets as investment or operating expense also raises genuine issues;

• Balance sheet revaluation: Enron managers inflated the value of some unproductive assets by arranging sham transactions with hidden subsidiaries, then using these transactions as the basis for the attribution of fair value. While fair value has clear advantages over historic cost, which is often misleading despite its apparent objectivity, it can only be reliably established if there is a market with sufficient depth and without excessive volatility to serve as a basis for assessment;

• Off balance sheet commitments: Enron frauds made extensive use of so-called special purpose entities to hive off loss-making investments. These entities allow a company to take assets off its balance sheet. On this point, there is little doubt that if a company is carrying a debt, it should appear on the balance sheet. But accountants must also be in a position to analyse the financial implications of transactions on a consistent basis. The issues are extremely complex and there cannot be any single rule concerning the consolidation of this type of commitment;

• Material disclosure: Enron has become a byword for opaque reporting, using a few footnotes to meet formal requirements but masking the true nature of the transactions and dressing up its balance sheet. This is manifestly contrary to the principle that management must provide the information needed to interpret the figures it furnishes.

The recent scandals also reflect the legacy of the imaginative accounting used for financial communications in the 1990s, exemplified by the use and misuse of EBITDA numbers and the myths of 15% return on equity. They make for some doubts on a number of common accounting practices, such as not booking stock options as operating expense.

…and the responsibility of directors, analysts, regulators and accountants

Responsibility for the manipulation of data to mislead the market is broadly shared. Directors failed to properly supervise the managers directly responsible, and financial analysts used the information provided without proper checking. Nor did auditors dig deep enough, probably because of the extent of relationships between the audit firms and their clients, as well as relaxation of SEC scrutiny.

The two reforms: rules vs principles

This state of affairs demonstrates the need for accounting reforms, which have been actively pursued over recent years by both the Financial Accounting Standards Board in the US and the International Accounting Standards Board, now the recognised standard-setter for the European Union. Current conditions are favourable for convergence between them, as is clearly desirable, favouring as it would the international mobility of capital. However there is a fundamental difference between the two systems:

• In Europe, including the UK, accounting is based on principles that auditors can invoke to require correction of financial statements. Enron management's manipulation of assets would not have got past a French auditor;

• US GAAP, in contrast, is based on detailed rules expounded over some 140,000 pages and answering most problems of interpretation, but, as experience shows, still allowing loopholes that creative financiers can take advantage of.

Full convergence, technical convergence or mutual recognition?

Jacques Mistral approves Europeans' favour for principles, which provide a sounder ethical basis and allow a closer match with business reality than rule-based accounting. Rules are nonetheless likely to remain fundamental to the system in the US, due in particular to their value in protecting management and auditors from the ever-present threat of litigation, sometimes gratuitous. Which means that Europe would be wrong to seek convergence towards a single system, and should instead aim for agreement on a broad range of substantial technical issues and mutual recognition where possible. This was the approach taken last autumn in the Norwalk Agreement and in the short-term convergence programme adopted by IASB and FASB, aimed at removing a variety of individual differences between US GAAP and International Financial Reporting.

Full fair value accounting: an axiomatic approach

Jacque Mistral reviews in detail the issues relating to fair value, a centrepiece of the IASB system. Nobody can doubt that fair value is both a more useful and more appropriate method of valuing assets and liabilities than historic cost –at least in an ideal world with fully efficient markets ensuring the equivalence of fair value and value marked to market. However, where this is not the case, the only solution is to use valuation models, and thus marked-to-model rather than marked-to-market valuations. This represents a shift from the concept of fair value to that of full fair value, which is criticized for relying on assumptions in ad hoc models. Another criticism is that reference to spot market values, which have recently been highly volatile, could have a pro-cyclical impact with damaging consequences for the economy as whole. The application of full fair value accounting standards, in particular IAS 32 and IAS 39, to banking and insurance is also widely rejected by industry professionals in Europe, who consider it ill-suited to their business. This is particularly true of banks' intermediation activities and would entail significant changes in the supply of credit by favouring floating-rate rather than fixed-rate lending. These standards are also ill-suited to the insurance industry in Europe, where securitization is still on a limited scale. Jacques Mistral thus expresses his concern for the potential dangers of an approach founded on axioms, out of touch with users in general and the practice of industries such as banking and insurance in particular.

And non-accounting information?

The remainder of the report focuses on prospects for the future, in particular as regards non-accounting information the market can use to assess growth potential over the longer term rather than spot prices. An issue of special importance for this purpose is the appraisal of investments in intangible assets such as patents, software, product design and expertise, all of which are increasingly crucial to performances in a modern economy. More broadly, there is growing demand for non-accounting information in the form of fuller business plans and other reports beyond the scope of IASB's mandate. Jacques Mistral thus sees special promise in the use of

Acronyms

ARC	Accounting Regulatory Committee, made up of representatives of EU Member States and presided by the European Commission
CNC	*Conseil national de la comptabilité*, France's advisory body on accounting standards
COB	*Commission des opérations de Bourse*, the French financial market supervisor
EBITDA	Earnings Before Interests, Taxes, Depreciation and Amortisation
EFRAG	European Financial Reporting Advisory Group, advising the European Commission
FASB	Financial Accounting Standards Board, the US standards setter
IAS	International Accounting Standards (henceforth IFRS)
IASB	International Accounting Standards Board, the International setter
IASC	Foundation: International Accounting Standards Committee Foundation, the organisation controlling the IASB
IFRS	International Financial Reporting Standards (produced by IASB, previously IAS)
IOSCO	International Organisation of Government Securities Commissions
ROE	Return on equity
SEC	Securities and Exchange Commission, the US market supervisor
SPE	Special Purpose Entities
US GAAP	US Generally Accepted Accounting Standards, drawn up by the FASB
XBRL	eXtensible Business Reporting Language, a new version of the XML language (eXtensible Markup Language) designed for firms financial information

XBRL (eXtensible Business Reporting Language) for internet-based communications, rationalising the circulation of compulsory disclosures to the market and favouring the development of standards for non-accounting information.

"Accounting Standards and Regulation of the Financial Information Industry"

The report by Christian de Boissieu and Jean-Hervé Lorenzi begins with a review of the various organisations involved in the circulation of accounting and other financial information. Areas concerned range from accounting standard setting and planning of accounting systems to auditors' reports on listed companies, bond ratings, equity research, and origination of equity and fixed-income securities, where an oligopoly of audit firms, rating agencies and investment banks continue to set the running. The report stresses the shortcomings of related regulations, moving on to note that the issues that are the focus of attention following the Enron scandal are closely linked to each other and extend well beyond the question of how the financial information industry is organised. They include in particular accounting standards, transparency, consolidation of corporate governance and the potential for conflict of interest resulting from the close association of businesses such as auditing and consultancy or financial analysis and investment banking. These, in turn, extend well beyond the structure of the financial information industry to raise questions regarding balances to be struck or maintained between regulation, voluntary codes of conduct, self-regulation and consolidation of business ethics, especially as these concern forthcoming stages in European integration.

Regulation, codes of conduct, self-regulation and ethical standards

- Accounting standards: like that of Jacques Mistral, this report favours increased compatibility and a move to mutual recognition of US GAAP and IAS-ISFR rather than convergence towards a unified system.
It argues against wholesale rejection of full fair value accounting, but recommends exemption of retail banking and large sectors of the insurance industry from IAS 32 and IAS 39. It also argues that IASB membership needs to be more broadly based to increase transparency and accountability;
- Organisation of the accounting profession: following adoption of the Sarbanes Oxley Act in the US, many countries in Europe have placed analogous prohibitions on accounting firms providing non-audit services to an audit client, and the report recommends that this principle should be strictly abided by, now and in the future. As regards supervision, in France it recommends a pragmatic approach to build a harmonious relationship between the new *Haut conseil du commissariat aux comptes,* charged with supervising audit firms, and the *Compagnie nationale des commissaires aux comptes* (CNCC), the professional association of auditors;
- Frequency of reporting by listed companies: the report does not favour the quarterly reporting the EU Directive imposes on listed companies, considering that quarterly results are too volatile and individual situations too diverse;
- Rating agencies: the report does not favour regulation of rating agencies, instead recommending rapid adoption of a code of conduct, to be drawn up by the Forum for Financial Stability, as agreed at the recent G8 summit in Evian;
- Financial analysts: self-regulation will not, on its own, suffice to eliminate the most obvious conflicts of interest. The report thus recommends regulatory requirements defining the organisation of the profession and related ethical standards, also suggesting some possible amendments to France's Financial Security Act;

The report suggests that public authorities or members of the profession should take the initiative favouring the establishment of financial analysis firms independent of banks –particularly investment banks– and other financial intermediaries, taking their lead from existing firms such as *Detroyat* and *Associés en Finance*.

- Corporate governance: the report emphasises the importance of the principle of subsidiarity in matters of corporate governance, which are closely associated with the history, culture and preferences of each country. However, the authors would also welcome an EU code, completing the presentation of basic principles in the existing OECD code with more detailed and more demanding standards in line with the Winter group's proposals to the European Commission.

The report argues that the current debate concerning the independence of directors and the need to curb conflicts of interest should not stand in the way of the more fundamental debates concerning the role of shareholders and General Meetings. In this regard, it favours the development of new tools easing the active involvement of shareholders and General Meetings in the life of the business, an example being internet voting allowed under France's new Economic Regulations Act (*loi sur les nouvelles régulations économiques* or NRE).

and European integration?

- Concerning the implications for Europe, the report recommends the establishment of a financial regulator for the European Union as a whole by 2008. In the meantime, the priorities should be continuation of what might be called the "Lamfalussy process", that is, increasing co-operation between national regulators through specialised committees, and the adoption of directives needed to back the ambitions and credibility of a unified European financial area. These include in particular a financial information directive and the take-over directive, the latter having unfortunately become the symbol of obstruction within Europe and confrontation between national perceptions and sensitivities. More positively, it welcomes the agreement reached by the 15 Member States on taxation of savings after years of negotiation.

Comments

Elie Cohen and Dominique Plihon consider the reports offer a useful and illuminating summary, without excessive jargon, of the current debates on accounting standards.

Elie Cohen nonetheless regrets that they do not provide a more structured analysis of the conditions needed to restore confidence in the wake of the Enron scandal and the required rules and regulations. He also considers their discussion of corporate governance and rating agencies too timid. He personally recommends increasing the resources and legal rights of shareholder activists and official regulation of rating agencies rather than a simple code of conduct. He also notes the inconsistency of national and EU authorities in their use of committees. If they delegate regulatory authority for a technical issue to a private professional association, they should go all the way and not seek to take back the initiative.

Dominique Plihon regrets that the authors do not provide an explicit theoretical framework for their analyses. Questions include in particular the nature of a business –should it be considered a financial asset from which to extract the maximum value, or is it instead an economic institution defined by its social role in creating wealth with the participation of all stakeholders, including shareholders, employees, managers, customers, suppliers and the state? And what is the authors' view of the operation of financial markets? Do they consider markets efficient or incomplete and fundamentally unstable? Finally he believes that since the aim of accounting reforms is to preserve the stability of financial markets, which is a matter of international public good, it is up to the concerned public authorities rather than private bodies to take responsibility, for example through an international authority to be set up for this purpose.

Complements

Nicolas Véron assesses the governance of the International Accounting Standards Board.

IASB: a private professional organisation without counterbalance?

Founded by a group of accountants in 1973 to promote international harmonisation of accounting standards, the IASB underwent major reorganisation in 2001 following the US model (FASB). IASB is a private-sector organisation based in London, fully controlled by the IASC Foundation, which provides financing and appoints IASB members. While its constitution provides for a reasonable balance in the representation of accountants, financial officers, investors and academics among both Foundation trustees and Board members, no place is made for national governments and there is no requirement to strike a balance in the representation of countries. The only requirement is a certain balance between major geographical areas, and this is left up to the Foundation.[1] As regards membership of IASB, professional competence is the prime criterion. In practice, English-speaking countries are over-represented on the IASB and Europe does not have a prevailing influence.

Europe: which control on the IASB?

Considering the time being taken for Directives constraining national authorities to achieve harmonisation of European accounting, on July 19, 2002 the EU, responding to the initiatives of the Commission and the International Organization of Government Securities Commissions (IOSCO) in 2000, adopted a regulation requiring the use of IAS-IFRS for the consolidated accounts of listed companies from 2005 on. The procedure[2] for the incorporation of an IAS or IFRS in EU law involves:

- endorsement by the European Financial Reporting Advisory Group (EFRAG), which assists the Commission;
- the decision, following consideration of the EFRAG recommendation, of a committee representing Member States, the Accounting Regulatory Committee, voting by qualified majority.

In principle, this procedure should give the EU significant leverage to influence IASB decisions. The EU is by far the largest economic entity to have adopted IAS-IFRS, and if it refused to adopt a standard, this would deal a severe blow to the credibility of the IASB. However, the EU has tied its own hands in that it has given itself the power to accept or reject a standard, but not to amend a standard or formally propose an amendment.

The IASB's principal partnership is still with investors, the main users of accounting standards, represented at international level by the IOSCO, which brings together national supervisors including the SEC in the US, the FSA in the UK and the COB in France.

Can Europe regain a degree of sovereignty on accounting standards?

Nicolas Véron recommends that Europe set up a powerful authority supervising capital markets, which would naturally operate on a more decentralised basis than the SEC in the US.

In their complement, ***Manuel Plisson*** and ***Côme Segretain*** believe the goal for Europe should be to develop a harmonized European accounting language with sufficient depth to serve all stakeholders, rather than an ideologically based language focused on capital markets.

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