
EN TEMPS RÉEL

Accounting for Globalisation

The Accounting Standards Battle

Philippe Crouzet & Nicolas Véron

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The fall of Enron and the ensuing accounting scandals in the United States and Europe shook investors’ faith and provided a resoundingly stark example of the critical importance of trust to our economic system. Enron showed that accounting malpractice could bring both the seventh-biggest corporation in the United States and one of the Big Five accounting firm to collapse in just a few months. Since then, many major corporate names have been severely hit by suspicions or convictions of flawed financial disclosure, and others may still follow suit.

These events illustrated as never before the interdependence of all participants in the value chain of modern capital markets: savers, employees, analysts, bankers, investors, rating agencies, auditors and company managers. This has triggered a vivid debate in the United States and also, albeit somewhat belatedly, in Europe. The shortcomings of existing accounting standards and, in some cases, of the standard-setting process itself, are a key aspect of this debate.

In their analysis, Philippe Crouzet and Nicolas Véron emphasise the paramount importance of high-quality accounting standards for the survival of the fast-changing fabric of modern capitalism. The contest for dominance between American standards and the international standards recently endorsed by, among others, the European Union, is likely to be a driver of global economic development. With this in mind, Crouzet and Véron raise a number of vital questions. Has Europe made the right choice in opting for the standards set by the International Accounting Standards Board? Are universal accounting standards a welcome prospect, especially if based on volatile assessments of company valuations? Should privately-funded regulatory organisations like the IASB be left to their own devices when making decisions that have far-reaching implications for the business community? What role can Europe play in forthcoming developments?

Those questions were dealt in the “Global Governance” seminar, co-ordinated by Zaki Laïdi, Executive director of EN TEMPS REEL

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The opinions expressed represent the authors’ personal views and are independent of their professional duties.

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INTRODUCTION

At first sight, there are few subjects more uninspiring than accounting. In corporate life, accounting is often perceived as an unavoidable burden, the preserve of faceless experts in comparison with whom even notaries might seem flamboyant. For many observers, the sole window on accounting is companies' annual reports, in which the small-print section comprising the financial statements is barely glanced at, virtually eclipsed by the presentation of corporate strategy and the milestone events of the year. In the dreary world of raw financial information, it is the data that take centre stage, as opposed to the standards underpinning their calculation.

However, accounting standards are a vital component of our capitalist system, and the importance of the process which creates them cannot be overstated. This is one of the many lessons from the astonishing collapse of Enron and from the other corporate scandals that followed it since the end of 2001. How accounting standards are set is an issue that merits the attention of economic observers and of all parties involved in public life. The existing governance system for accounting standard-setting is in many ways a fellowship-based one, where democratically elected governments have little say. Given the economic importance of accounting standards, this system needs discussion.

If left to a handful of ultra-specialised practitioners, the accounting standard-setting process can pose a risk to the market economy. On the contrary, if it is examined and debated widely, this process can gain legitimacy and contribute to a more efficient regulation of the financial system.

ACCOUNTING : THE LINGUA FRANCA OF THE MARKET ECONOMY

Accounting and capitalism

Capitalism is born of the separation between investors and managers, the gap between whose is filled by the financial markets. This separation creates the need for a common language that enables comparisons between companies and the efficient allocation of capital. This common language is accounting¹.

Accounting is, in essence, the quantitative expression of a company's results and financial position in a monetary unit, in accordance with uniform methods that ensure the comparability of information across companies. Accounting standards stem from the need for comparable, transparent and consistent financial data to serve as the basis for efficient capital allocation. As such, they are inextricably linked to the functioning of the capitalist system.

Accounting is, therefore, very different by nature from management controlling or cost accounting systems (sometimes also called "management accounts"), which are not features of capitalism specifically. Management indicators are essential to any complex system: Soviet-era planning, for example, generated myriad quantitative indicators overseen by a ubiquitous bureaucracy. To project an image of corporate operations that is as accurate as possible, the definitions of indicators must be adjusted to each company and necessarily differ

¹ The reference to language is not fortuitous. Accounting terminology has always been closely linked to the written word *per se* and rational thought: the accountant is known as a "bookkeeper" in English, a *Buchhalter* in German, a *ragionere* in Italian, and as an *écrivain* in France before the abolition of guilds in 1791. The association between modern accounting and western rationality was discussed by Werner Sombart in *Der Bourgeois* (1913): "double-entry accounting sprung from the same spirit as the work of Galileo and Newton, and the teachings of modern chemistry and physics."—even though this poetic vision has been largely tempered since, by Fernand Braudel (cf. *Civilisation matérielle, Economie et Capitalisme*, II, p. 510) and other scholars.

from one company to another. Therefore, unlike accounting data, management information as such cannot be used to guide efficient capital allocation across companies of different industries.

Accounting and controlling data thus form two parallel strands that are produced more or less simultaneously from the same source (corporate operations), but are destined for different users - external financiers in the case of accounting data and in-house management in the case of controlling information.

However, the boundary between accounting and management controlling is not rigid and is being reshaped under the influence of investors, managers, and technology. Until recently, in many countries (including France), so-called ‘general’ (public) accounting was often considered to be the production of unessential information used chiefly by the tax authorities. Today, however, capital markets increasingly call for non-financial indicators (for example, production volumes), in addition to precise, reliable financial accounting data, when assessing corporate operations and performance: this was made plain by the restatement of oil reserves by Shell in early 2004, which led to the dismissal of its CEO and to the shakeup of its governance, made plain. This has also heightened the need for consistency between accounting data and management indicators, a task rendered increasingly cumbersome by the growing complexity of corporate operations. As a result, management controlling information is gradually being folded into the accounting process. Such convergence is a source of torment for financial managers and creates daunting problems for auditors, who are required to express an opinion on information extraneous to the accounts themselves. The spectacular development of Enterprise Resource Planning (ERP) software, such as SAP or Oracle, over the past ten years reflects the efforts deployed to rise to this challenge.

The natural link between accounting and capitalism is illustrated by history. So-called “double-entry” bookkeeping, with matching debits and credits summarised in a balance sheet, appeared in Italy at the end of the Middle Ages, at the same time as the first privately-financed merchant-shipping companies, and its scope of application widened with time. The double-entry technique, also referred to as the “Venetian Method”, was thoroughly developed and publicised first by Luca Pacioli (1445-1517), a humanist and friend of Piero della Francesca and Alberti, who taught mathematics and perspective to Leonardo da Vinci. Pacioli wrote the first treaty on modern accounting, which is also a treasure trove of practical advice on sound business management.² This initial framework had considerable influence and is the distant predecessor of all current accounting standards.

Financial information and its users

Accounting information is based on four standard elements: a balance sheet, a profit-and-loss account (or income statement), a cash flow statement, and accompanying disclosure notes. In principle, these elements together provide an overview of a company’s financial position and results.³ The information contained therein is prepared in accordance with accounting standards, which can also shape other aspects of financial reporting for comparison purposes.

The accounting information disclosed by companies is directed first and foremost at external financiers, most notably those active in the public capital markets. In particular, all companies whose shares are listed on a stock exchange are required to publish audited accounting data. Depending on national regulations, this requirement can also apply to unlisted companies beyond a certain size. The accounting information must be certified by one or (in a few

² Chapter entitled “*Particularis de Computis et Scripturis*” in “*Summa de Arithmetica, Geometria, Proportioni et Propornionalita*”, published in Venice in 1494. Incidentally, this book was one of the first to be printed in Italy using the Gutenberg process.

³ In the case of complex groups with numerous subsidiaries that are often not fully controlled, there is a requirement for the preparation of consolidated accounts, in accordance with established rules, to reflect the financial position and results of the entire group, as opposed to those of the parent company alone.

countries) several external auditors, who are independent of the company although remunerated by it.⁴ Shareholders and creditors thus have access to reliable information on a company's financial situation and performance, without being directly involved in the management process.

Investors and creditors, as the main end-users of company accounts, are assisted in their decision-making by a vast body of intermediaries whose activity is centred on the accounting information published by companies. Chief among these are financial analysts at investment banks and credit rating agencies like Moody's, Standard & Poor's and Fitch. The majority of the quantitative information used by such practitioners to assess the value and creditworthiness of companies is accounting data based on the implementation of accounting standards.

In addition, other non-financial stakeholders—for example, customers and suppliers—use accounting information to gauge a company's financial health and adjust their payment terms accordingly. National tax authorities also use some accounting information to assess taxable income; French accounting rules, as in several neighbouring countries, have traditionally been heavily influenced by tax considerations. National statistical offices and central banks also use accounting information to compute macroeconomic data. Company employees, notably through works councils in most continental European countries, are likewise increasingly interested in their employer's financial health. Thus, financial and accounting information is of interest to all of a company's stakeholders.

Standards quality, investor confidence and market stability

Accounting standards are not without their nuances, and conventions perforce influence the posting of accounting entries. Depending on a company's activity, the same expense item may be included, for example, in "cost of goods sold", or "other operating expenses", or capital expenditure. The determination of asset values is likewise rarely straightforward and revenue itself cannot be considered an altogether objective figure. Therefore, although accounting standards are intended to minimise such grey areas, all uncertainty cannot be removed.

Given these assessment-related difficulties, the "quality" of standards of course has no absolute definition, but is usually considered as encompassing relevance, reliability, understandability and comparability of financial information disclosed to investors, creditors and other parties with which a company has dealings⁵. The quality of accounting data is key to foster the confidence that is indispensable in a market economy. Thus, high-quality accounting standards are meant to increase the judiciousness of decision-making by market practitioners, and therefore lessen the risk of unjustified volatility and speculation.

A link can often be traced between speculative runs, which occur when the market ceases to behave rationally, and inappropriate accounting practices. This was the case in those most flagrant examples of speculative behaviour in recent years, the Internet bubble and Enron, although accounting standards were by no means the sole culprit in both cases:

- The rise of the Internet has raised numerous challenges for the accounting profession. The value of Internet companies is based primarily on intangible assets reliant on technology, market position, brands, growth prospects and strategic vision. Such assets are particularly difficult to spot in a traditional balance sheet. Even in the case of revenue, the 'virtual' nature of Internet operations adds a layer of complication. For example, how does one decide the

⁴ Following the collapse of Arthur Andersen, the audit market for international corporations is currently dominated by only four firms: PricewaterhouseCoopers, Deloitte Touche Tohmatsu, KPMG and Ernst & Young.

⁵ This definition of accounting standards' quality is derived from the words used by the International Accounting Standards Board in its "framework", which defines the role of accounting standards is to permit the production of "*decision-useful information for outside investors and creditors*".

origin of advertising revenues generated by an Internet site that is aimed at French users, owned by a Dutch company and whose advertising-banner servers are located in Germany, while the remaining servers of the site are in the United States? What limits should be put on the bartering of online services by two Internet sites on a zero-margin basis? Some start-ups, including AOL as has been revealed by SEC investigations, apparently used this ambiguity to inflate their revenues artificially and thereby increase their market value, contributing to the massive overvaluation of the sector that came to a head in 1999 and early 2000.

- The Enron case demonstrated shortcomings of American accounting standards, which allow the treatment of debts carried by subsidiaries as off-balance commitments in some circumstances. Enron accordingly developed an addiction to large-scale deconsolidation that came to light only when the company collapsed. Furthermore, as a pioneer in the infant energy-trading industry, Enron was well placed to devise questionable accounting practices that greatly overestimated revenues in a manner that long escaped detection by observers of this new industry.

Both examples demonstrate that accounting rules should never be cast in stone. They need to be adapted constantly to the emergence of new activities (like the Internet and energy trading) and to the steady stream of new financial techniques. Maintaining a set of high-quality accounting standards is a moving target; the corresponding framework must be permanently adapted to stay in tune with economic developments.

The unattainable ideal of standards neutrality

The requirements of consistently high quality and adaptability to economic developments in no way limit the diversity of choice with regard to accounting standards. In some fields, standard-setting choices can even strongly influence decisions made by the business community.

Many practitioners assert that accounting standards can and must be perfectly 'neutral', i.e. capable of portraying corporate results without influencing them. In practice, however, no language is perfectly neutral and accounting, as the financial language of corporations, is no exception. To understand how, consider the three following examples.

- Treatment of acquisitions : the acquisition of one company by another generally entails the recognition of "goodwill", defined as the difference between the acquisition price and the book value of the acquired company's assets, which is capitalised by the acquiring company. Goodwill is thus associated with a specific event (an acquisition) and its value in future years is an unknown quantity. During the 1990s, many accounting standards—e.g., in most of continental Europe—called for the steady amortisation of goodwill over a long period, up to 40 years. Others - for example, in the United States - did not ask for yearly amortisation but required that goodwill be entirely recalculated every year, based on a reassessment of the market value of the relevant assets. In a context of volatile stock market valuations, the latter method can have a huge impact on corporate earnings of a given year. In France, this latter method of goodwill depreciation has recently been partially introduced in an effort to converge with U.S. practice, and has had spectacular effects. For example, the 2001 accounts of Vivendi Universal and France Telecom contained asset write-downs amounting to EUR 16 billion and EUR 10 billion respectively, that resulted in losses unprecedented in French corporate history. When Jean-Marie Messier, Vivendi Universal's CEO, declared that these losses were not detrimental to shareholders, he triggered a vigorous debate that eventually led him to retract his earlier statement and played a part in his removal from office in July 2002. The implementation of systematic goodwill evaluation and depreciation will probably encourage companies to be more vigilant than before with regard to the cost of acquisitions.

- Evaluation of bank loans : corporate lending was long recorded in banks' balance sheets on a historical basis, with the original loan amounts and repayments of principal. Today, the "fair value" booking method has gained following both in the United States and in international accounting standards. Under this method, the market value of individual loans is recalculated annually, including in some cases where the bank has no actual intention of selling the loan before the maturity date. The impact of this method on American and continental European banks is very different, because the latter are traditionally more inclined towards fixed-rate lending. Consequently, the application of the fair value method is poised to alter continental European banks' behaviour, possibly triggering a shift towards variable-rate lending and the restructuring or disposal of some outstanding loans. Thus, the accounting standard is likely to influence behaviour in the banking system and practices of the various parties in connection with it.

- Stock options : under accounting standards used until now (both in Europe and the US), stock options have no impact on corporate earnings, even though one may consider they are a form of employee compensation. Options undoubtedly dilute shareholdings and therefore (all other things being equal) reduce earnings per share: therefore, expensing them, as is required since early 2004 under international accounting standards and may soon be also in the US, better reflects the substance of stock-option grants. But it could also limit their usage relative to that seen in recent years. Many believe that the massive use of stock options has run counter to the interests of shareholders.⁶ The ongoing fierce debate cuts across other important issues such as human resources management and the legal framework for the creation of equity capital: under US company law until 2002, stock-option grants did not require a vote at shareholders' meetings, whereas shareholder approval is a prerequisite in France as in most of Europe. It is also clear in this example that the choice of accounting treatment is neither neutral nor independent from other considerations unrelated to accounting theory.

The fact is that accounting can never be an exact science. It is, rather, a body of practices backed by conventions applied by companies, verified by auditors and used by all participants in the market economy. It always involves some degree of human judgment. Accounting conventions should, indeed, aim towards neutrality, but complete neutrality is not possible in practice. At play are significant drivers for the global economy, such as access to equity and debt markets and, to a certain extent, companies' attitude towards risk and innovation. Consequently, the definition of standards and the governance of those charged with the task of setting standards are critical issues.⁷

THE EVOLVING GOVERNANCE OF ACCOUNTING STANDARD-SETTING

The diversity of national standard-setting schemes

Given the myriad users of accounting standards, it is not surprising that governments and market forces have vied for power over standard-setting. The process of defining accounting standards varies from one country to another, mirroring historical tradition. At one end of the spectrum is continental European tradition, with the state in a strong position of

⁶ For example, Warren Buffett, the renowned US investor, has long been a detractor of stock options. In his letter to shareholders of the Berkshire Hathaway Group in 1999, he wrote: "In effect, accounting principles offer management a choice: pay employees in one form and count the cost, or pay them in another form and ignore the cost. Small wonder then that the use of options has mushroomed!"

⁷ Antoine Bracchi, Chairman of the French national accounting standard-setting board, recognized this reality in the presentation of his annual report for 2000: "In France, accounting was far too long seen as a mere bookkeeping technique. While its merits as an indispensable management tool were recognised, it tended to be confined to the recording of data for tax or statistical purposes. Today, corporate imperatives and the associated changes, combined with the growing demand for financial information in tandem with the globalisation of markets and economies and the emergence of internationally recognised solutions, have transformed the financial information produced by the accounting process into an instrument of competitiveness and an essential macroeconomic and political tool."

direct influence; at the other end is the UK/US tradition, which is more accommodative of self-regulation by the business and financial communities.⁸

In France, accounting rules have traditionally been viewed as a subject of public interest and, therefore, the preserve of the state. French accounting standards have long reflected public concerns, mainly in respect of national tax law and statistics, at least as much as the interests of private investors. This explains why the tax accounts are often considered to be equivalent to financial statements in France and are a primary vector of accounting information, especially for SMEs.

The organisation of the standard-setting process also reflects the extent of the state's influence. The *Conseil National de la Comptabilité* (CNC⁹), under the aegis of the Finance Ministry, is mandated to formulate national accounting rules. Composed of 58 members, the body brings together accountants, statutory auditors, companies, associations, employees, various participants in the financial markets and civil servants from the Finance Ministry. Its annual budget is some EUR 2.5 million. Strictly speaking, the CNC's role is purely consultative; formally, accounting regulations need to be approved first by an Accounting Regulatory Board (*Comité de Réglementation Comptable* or CRC), presided over by the Minister of Finance and composed of 15 members (including seven representatives of the state), then by the minister him- or herself.

The German Accounting Standards Board (in German, DSR¹⁰) is part of a privately-funded, not-for-profit association, the German Accounting Standards Committee (in German, DRSC¹¹). The DRSC has been appointed by the Justice Ministry in the late 1990s to establish accounting standards and is funded by listed companies and the accounting profession. The DSR is composed of seven to nine members, currently four accountants (two independents, one at PwC and one at Ernst & Young), two individuals with a background in corporate management, and two with a background in the financial-services industry. These Board members are assisted on an ongoing basis by a roughly ten-strong staff. The DSR's recommendations must be approved on an individual basis by the Justice Ministry prior to application.

The United Kingdom's Accounting Standards Board¹² is a privately-funded body and subsidiary of the Financial Reporting Council (FRC)¹³, itself a private organisation of professional accountants and representatives of the business community and the government. The ASB has up to ten members, of whom two are full-time. The current members are four accountants (including the Chairman), two banking and financial executives, two chief financial officers from non-financial corporations and one "technical director". The FRC is financed by public and private players in the City¹⁴ and has a budget of roughly £ 3 million. The ASB is recognised as official standard-setter by the Department of Trade and Industry and operates independently. It can issue standards on its own authority, without any obligation to secure government approval of individual standards. In addition to the United Kingdom, its standards are also used in the Republic of Ireland, subject to approval by the Irish Institute of Chartered Accountants.

In the United States, the Financial Accounting Standards Board (FASB)¹⁵ prepares accounting standards on an independent basis, under the aegis of the Securities and Exchange

⁸ This analysis leaves aside the main Asian markets, where accounting standards-setting has a shorter history than in Europe and in the United States.

⁹ <http://www.finances.gouv.fr/CNCompta/>

¹⁰ *Deutscher Standardisierungsrat*

¹¹ *Deutsche Rechnungslegungs Standards Committee* (<http://www.drsc.de>)

¹² <http://www.asb.org.uk>

¹³ www.frc.org.uk

¹⁴ Those include, among others, the Department of Trade and Industry (DTI), the National Audit Office, the Financial Services Authority (FSA), and the Bank of England (representing the entire banking sector).

¹⁵ <http://www.fasb.org>

Commission (SEC)¹⁶. The members of the FASB are appointed by a privately-funded foundation, the Financial Accounting Foundation (FAF), which is financed by associations of sector professionals¹⁷. Alongside the FASB, the foundation also appoints a Governmental Accounting Standards Board (GASB), which is charged with formulating accounting rules for American state and local government¹⁸. The FASB has seven full-time members, currently three former accountants (including its Chairman Robert H. Herz, formerly at PricewaterhouseCoopers, who replaced an ex-Andersen partner in July 2002), two former bankers (from Merrill Lynch and JP Morgan), one former financial executive (from Texaco) and one academic. The board also employs a permanent team of some 40 persons and operates with a budget of roughly \$ 17 million.

These few examples show the different institutional and operating approaches applied across countries. In France, the CNC does not have legal autonomy and the state has influence over every aspect of its work. Germany's DRSC is an autonomous body with legal oversight over the DSR standard-setting committee, whose recommendations are nevertheless subject to formal approval by the state. In the United Kingdom, as in the United States, there is no requirement for case-by-case standards approval by the state. Instead, the standard-setting body (respectively the ASB and the FASB) is legally separated from its funding entity (respectively the FRC and the FAF). In the United Kingdom and, even more so, the United States, the funding of standard-setting bodies is much more generous than in Germany and France, where the CNC's financing is part of the state's budget.

The emergence of international standards: a private governance pattern

In 1973, members of the accounting profession, faced with the increasing integration of world markets and the resulting need to move towards global accounting standards which would enable users to effectively compare companies' performances across the world, established the International Accounting Standards Committee (IASC) in London as a privately-funded organisation. The IASC has gradually defined a set of standards and forged collaborative relations with different participants in the financial sector, notably professional accounting organisations and national financial market regulators.

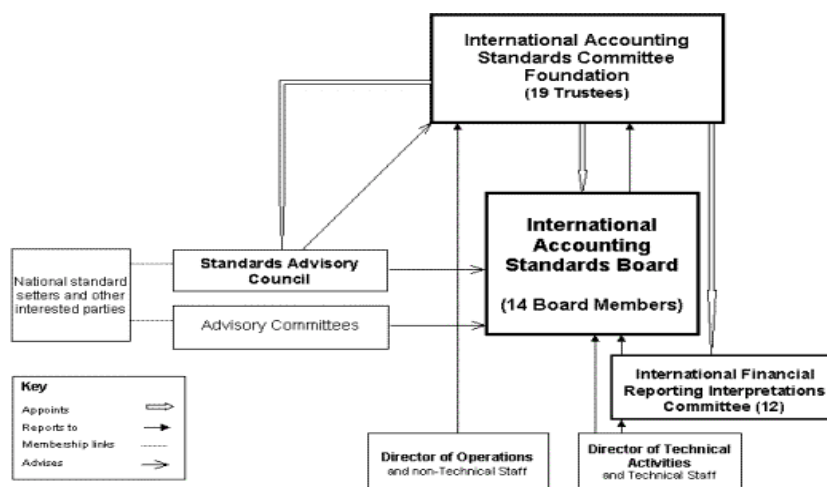
The IASC's legal and operating framework was extensively overhauled in 2001, when the privately-funded IASC Foundation was set up in the United States (Delaware), along with its London-based subsidiary, the International Accounting Standards Board (IASB).

Operating rules are now quite similar to those followed at the FASB, with an advisory council and an interpretations committee in addition to the Board itself and the Trustees of the IASC Foundation. The chart below is taken from the IASB's site (www.iasb.org.uk) :

¹⁶ As stated in the FASB's website, "the Securities and Exchange Commission (SEC) has statutory authority to establish financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934. Throughout its history, however, the Commission's policy has been to rely on the private sector for this function to the extent that the private sector demonstrates ability to fulfil the responsibility in the public interest." In fact, the American system of accounting standards production changed several times during the past decades. The delegation by the SEC to the FASB to decide on standards dates from 1973, the same year in which the International Accounting Standards Committee was created.

¹⁷ The American Accounting Association, American Institute of Certified Public Accountants, Association for Investment Management and Research, Financial Executives International, Government Finance Officers Association, Institute of Management Accountants, National Association of State Auditors, Comptrollers and Treasurers and the Securities Industry Association.

¹⁸ This institutional set-up, where a private-sector body sets the rules for public-sector accounts, would be difficult to imagine in many European countries.



The “Constitution” of the IASC Foundation currently stipulates that of the 19 Trustees, at least six must be from Europe, six from North America and four from the Asia-Pacific region. Eight Trustees are appointed by international professional organisations within a formal, consultative framework (five accountants, one financial executive, one representative of the investment community and one academic) and eleven others are chosen outside that consultation process.

The 14 members of the Board, including 12 on a full-time basis, are chosen by the Trustees by reference to a set of criteria, chief among which is technical expertise (“The foremost qualification for membership of the Board shall be technical expertise”). Nationality is not a criterion, the sole proviso in this respect being that “The Trustees shall ensure that the Board is not dominated by any particular constituency or geographic interest.”¹⁹ Balance is sought between the various professions represented at this level, too (at least five accountants, three financial executives, three representatives of the investment community and one academic). Each full-time Board member is required to cease all dealings with his/her former employer. In addition, seven members have formal liaison responsibilities with the national standard-setters in their respective countries.²⁰

In addition to the contributions of members, the IASB’s work is supported by a permanent team of approximately 40 staff based in London. Annual funding was slightly above £ 12 million in 2002, comparable to that accorded to the FASB. More than half of this funding was provided by corporations, roughly one third by audit and accounting firms, and the rest by governments and international institutions.

The new standards published by the IASB are called IFRS (International Financial Reporting Standards), as opposed to IAS (International Accounting Standards) for those whose first publication predates 2001, even though some of these have been modified since that date.

¹⁹ The Board’s composition as of April 2004 nevertheless reflects the dominance of English-speaking nations: seven nationals from the UK and the US (including the Chairman and Vice-Chairman), one Canadian, one Australian, one South African, one Swiss, one German, one Frenchman and one Japanese.

²⁰ These countries are the United States, Canada, the United Kingdom, France, Germany, Japan, Australia and New Zealand (the last two being represented by the same liaison member).

This change of words is meant to more accurately reflect the standards' application to all forms of financial information and not just traditional accounting statements. Some countries— notably the United Kingdom, Germany and Australia—already allow listed companies to publish their accounts in accordance with IAS/IFRS instead of national accounting standards.

In addition to national standard-setting bodies, the IASB has a close working relationship with national securities regulators such as the SEC in the United States, the FSA in the UK or the AMF in France, which meet together in an international association called IOSCO.²¹ However, in the absence of an integrated global regulation of financial markets, IOSCO cannot aspire to be more than a coordination forum between national regulators which retain autonomous authority.

The relationship between the IASB and the FASB is currently a mixture of imitation and rivalry. The FASB served as the institutional model for the IASB. The current Chairman of the IASB's Board of Trustees, Paul Volcker, who long served as Governor of the Federal Reserve, has an intimate knowledge of the American system of standard-setting. The driving spirit of the IASB is strongly influenced by the experience of capital markets whose main players are in the US and UK. The IASB nevertheless competes with the FASB as regards the recognition of accounting standards for implementation by major multinationals listed on various stock exchanges. For such companies, the cost of simultaneously preparing accounts in accordance with two different sets of standards can be hefty and the co-existence of accounts as per IAS/IFRS, US GAAP²² and, possibly, a third national accounting reference, could not be considered a workable long-term solution.

The European Union's endorsement of international accounting standards

Between 1970 and 1999, the European Commission endeavoured to instigate accounting harmonisation in Europe by means of directives binding upon member states' national standard-setters. However, the process proved slow and the results obtained fell far short of the target. This prompted a change of strategy in 1999-2000. The Commission then came to the conclusion that the emergence of standards suitable for application worldwide would help to put Europe on an equal footing with the United States, especially with regard to companies' access to capital, where Europe is behind the curve. Spurred on by Frits Bolkenstein, the Commissioner for Internal Market and Taxation, the European Council meeting in Lisbon (in March 2000) adopted an action plan for financial services that paved the way for the endorsement of IAS/IFRS as the European Union's common accounting framework.

This issue was more specifically addressed in a communication by the European Commission in June 2000, which proposed that adoption of IFRS be a compulsory requirement for listed companies in Europe by 2005. The corresponding regulation, backed by the Council of Ministers, was approved with an overwhelming majority (492 votes out of 526) by the European Parliament in March 2002 and finally adopted in July of the same year. Under this text, each IAS or IFRS standard is subject to explicit endorsement by the European Union in order to ensure that it (i) is not contrary to existing European accounting directives, (ii) is conducive to the "European public good" and (iii) permits the production of high-quality financial information.

Thus, the Commission has entrusted the preparation of standards to the IASB, therefore giving a very significant boost to its worldwide recognition. However, it reserves the right to approve the standards individually in order to assure regulatory enforcement throughout the European Union. The regulation also provides for examination by a European Accounting Regulatory Committee, composed of member states' representatives voting under qualified-

²¹ International Organisation of Securities Commissions (www.iosco.org).

²² "Generally Accepted Accounting Principles" is the term used for the standards issued by the FASB.

majority rule, prior to endorsement (or non-endorsement). This committee itself is backed by a consultative group of professionals²³, somewhat like the French system with the CRC and the CNC. This organisational structure thus fits well with institutional traditions in most continental European countries, notably Germany and France. However, the scope of the case-by-case standard adoption mechanism is limited to the extent that the Commission cannot amend the standards, but may only accept or reject each of them as a whole. To this date, all IAS standards have been endorsed except the controversial IAS 32 and IAS 39 on financial instruments (the endorsement of the five new IFRS standards published since 2001 is also still under review).

The content of IAS 32 and IAS 39, the latter being the longest and most detailed of the existing IAS, has been subject to a heated controversy against the backdrop of long-established practices of the European banking industry—notably the large size of zero-interest-bearing demand deposits on banks' balance sheets and the fact that a large part of mortgage lending is on fixed-rate terms. In this context, it is feared that the implementation of the standards would lead to increased volatility of the banks' incomes and balance sheets, which may not correctly reflect the underlying level of risks. Intense lobbying by banks and, to a lesser extent, insurance companies, has led the Commission to propose a partial endorsement of the standards, without their most controversial parts.

The shift of listed European companies to IFRS by 2005 is set to be a major test of the IASB's credibility, both in terms of governance and of the practicality of its standards, which have never been tested on such a large scale. A botched transition would do substantial damage and could even be fatal to the very idea of international standard-setting. The spectre is not so much one of an Enron-type accident, but rather a spate of technical difficulties for companies during the switchover process. Not without parallels with the changeover to the euro, the transition to IFRS will be the acid test of the confidence of the financial participants in the new standard-setting system.

This is unprecedented in more than one way. Europe has not retained the option of a set of accounting standards specific to the region: there will be no such thing as "EU GAAP", distinct from IFRS. In addition to the usual scenario of member states relinquishing their sovereignty, the Commission itself has given up its sovereignty – what is more, in favour of a private-sector institution with limited track record. This institution's parent entity is located outside Europe, and only a minority of its members have a European background, whereas the bulk of its influence is currently derived from its endorsement by the European Union. With the controversies on IAS 39 still raging, it is certainly too early to judge the ultimate efficiency of the endorsement mechanism and the strength of its counterbalancing effect. To sum up, a totally new governance model has emerged and it remains to be seen how it stands the test of time.

THREE ISSUES FOR THE PUBLIC DEBATE

IASB v FASB: setting the future global accounting reference

The FASB and the IASB are quickly becoming the only two contenders in a race for global accounting standards. European countries' national standards are bound to disappear gradually, following their adoption of IAS/IFRS. In Asia, resistance to international standards is still broad-based, but is unlikely to spawn a competing set of widely-recognized rules.

²³ As yet, this group (called European Financial Reporting Advisory Group or EFRAG), where major stakeholders in the accounting debate are represented, has had to cope with limited resources and still needs to reinforce its capacity for expertise.

Furthermore, and in spite of China's rise, Asia's influence on these issues is now weaker than in the late 1980s, when Japan's stock markets were at their highest.

Since Europe has already made its choice and Asia's short-term influence is limited, the fate of the two rival systems is likely to be decided in the United States, which dominates the world's financial markets.

In America, a debate has emerged in the aftermath of corporate scandals since late 2001. The collapse of Enron shone a stark light on certain shortcomings of US GAAP, most notably in respect of the treatment of off-balance sheet commitments. Paradoxically, it is US GAAP's overly precise and detailed prescriptions in this respect that enabled Enron to conceal massive debts from investors. Harvey Pitt, then Chairman of the SEC, has enjoined the FASB to conduct an investigation and issue findings rapidly in terms of both standards quality and guarantees of independence with regard to standard-setting decisions. As early as 2001, the SEC had initiated consultative action concerning IAS/IFRS in order to determine their viability as an alternative to US GAAP for listed companies in the United States. Clearly, the mere mention of the possible recognition of IAS/IFRS by the SEC strengthens the latter's hand vis-à-vis the FASB.

Thus, Enron and other US scandals have, in some aspects, played in favour of international standards. These standards are based on general principles that set clear accounting objectives, not least of all concerning transparency, whereas US GAAP are more "rules-based", i.e. more detailed but also more easily circumvented. It is not clear that Enron would have been able to engage in the same accounting malpractice if its accounts had been prepared in accordance with IAS/IFRS. In the future, however, more precise wording and interpretations will be required from the IASB and its accompanying bodies, not least in the aftermath or anticipation of judicial actions. Therefore, it is probably inevitable that IFRS become gradually less "principles-based" and more "rules-based" with time, thus attenuating the currently existing contrast with US GAAP.

A possibly more enduring difference between the IASB and the FASB is the former's greater independence vis-à-vis national corporate lobbying, which, in some observers' view, should result in superior standards quality. This has led to calls for increased recognition of IAS/IFRS in the U.S.²⁴ However, the IASB's independence, which appeals to investors, may be a disadvantage from other points of view. Large U.S. companies, especially, regularly voice reservations against the IASB, fearing that the loss of their existing influence over the FASB would lead to less favourable standards and hamper national competitiveness.

This tension has been especially apparent in the debate over the expensing of stock options, i.e. their treatment as a cost in corporate income statements. In the mid-1990s, intense lobbying in the U.S., especially from the technology sector, succeeded in forcing the FASB to postpone action with regard to the expensing of options. Following the collapse of the technology bubble, the IASB has prepared a new standard, issued in February 2004 (IFRS 2) which would make stock option expensing the general rule. Only after that move by the international standard-setter has the FASB followed suit, by proposing its own standard, largely modelled on IFRS 2, in late March 2004. Whether this standard will go through to implementation will be a key test of the FASB's credibility. Already, the lead taken by the IASB on this matter is seen as a clear indication of its higher degree of independence vis-à-vis some corporate interests.

Furthermore, opposition against international standards in the US is likely to come from others than just influential CEOs, given the current widespread distrust of multilateral rules in that country. A shift to IFRS, or even their mere recognition by the SEC as an option for

²⁴ E.g., "The Enron Failure and the State of Corporate Disclosure / In Enron's Wake, Lessons for Policymakers", a paper published by Robert E. Litan at the Brookings Institution (April 2002): "*perhaps the most important potential advantage of replacing U.S. GAAP [with IFRS] is that it would dilute the political power of narrow interests in this country to influence the outcome of the standard-setting process*".

companies listed in the U.S., may be described by some on Capitol Hill as equal to relinquishing powers granted by the U.S. Constitution. In reality, the IASB is not a multilateral organisation (it is a private body and does not derive its authority from a treaty signed by sovereign states), but it might be presented as such in a political debate and is definitely not subject to congressional authority, as is the FASB.

Therefore, the rivalry between American and international standards is not essentially a clash between the United States and Europe. It is better described as a power struggle between Americans' ingrained wariness of the rest of the world on the one hand and, on the other hand, the financial markets' embracement of globalisation. In this struggle, the unilateralist calls of American corporate leaders are the FASB's best ally, whereas investors, even US-based ones, have more reasons to support the IASB.

Against this backdrop, IAS/IFRS are probably not going to replace US GAAP altogether in the near future. A likelier scenario is more coordination between FASB and IASB (for instance, developing new standards in common) and some degree of convergence between both sets of standards, without the U.S. formally recognizing international standards in the very short term. Such convergence is an aim officially claimed both by the IASB and FASB, which signed a formal document (the "Norwalk Agreement") to this end in the autumn of 2002, and have started to implement it by modifying some technical aspects of their respective standards and aligning their agenda. However, full convergence is still a long way off. For European companies, this means that a "level playing field" with the U.S. as regards accounting rules is likely to remain a distant prospect in the years to come. For the IASB, it means a delicate balancing act between increasing the quality of its standards—an aim which should certainly retain the highest priority—versus making them converge with US GAAP.

Supranational accounting rules: a welcome prospect?

At the heart of the debate surrounding international accounting standards are capital mobility and the opening up of world markets. Participants in the financial markets want to compare companies throughout the world for investment-decision purposes. Companies must be able to produce financial data that comply with the same standards around the globe. The application of disparate accounting standards worldwide generates both costs and uncertainties with regard to the preparation of consolidated accounts, and can create a temptation for companies to tamper with the information given to shareholders.²⁵

Global-scale accounting harmonisation is thus a clear response to the financial market's wish list, offering the prospect of increased transparency, liquidity and stability, and of a lower cost of capital. However, the IASB is a private-sector organisation which does not need to answer to any elected government. Is this compatible with a well-functioning democratic process? To borrow the typical language of anti-globalisation campaigners, it may indeed sound like a death knell for governments, reducing their role to the one of "slavish yes man, the lackey of the true masters of the world, the financial markets"²⁶

This question - whether supranational standards are compatible with accountability in a democratic system - is particularly relevant if one considers that accounting standards have wider implications than mere confidence in corporate accounting data and the efficiency of financial markets. As illustrated earlier in this paper, accounting standards can never be perfectly neutral. They imply choices that influence a broad behaviour spectrum (for example, the granting of stock options), sometimes with macroeconomic consequences. Therefore, it

²⁵ An early European example is the resounding collapse in 2000/2001 of Lernout & Hauspie, a Belgian voice-recognition software-maker whose falsification of its South Korean subsidiary's profit and loss account had a massive impact on the consolidated financial statements. As with Enron, the discovery of this accounting impropriety led swiftly to the entire company's downfall. Of course, Parmalat recently provided an even more spectacular case.

²⁶ Ignacio Ramonet, *Géopolitique du Chaos*, Paris, Gallimard (2000).

seems only logical to require democratic decision-making for accounting standard-setting, in the same manner as for other major economic policy issues.

It is, to be sure, very difficult to quantify the effects of accounting standard-setting on the economy. Furthermore, it may be misleading to oppose democratic control by Parliament to standard-setting by a specialised body such as the IASB. In fact, direct parliamentary control is generally not a feature of current national accounting standard-setting systems. The standard-setting bodies in all major industrialised economies have a fellowship-like organisation, in which financial market practitioners, accountants, financial executives and investment managers are the true authors of standards. In none of these systems is the adoption of accounting standards directly subject to parliamentary approval. Furthermore, as the FASB pointed out in its statements in the wake of the Enron affair, the mere hint of direct political influence over the regulation of financial markets can be detrimental to market efficiency.

Overall, the advantages to be gained from universal accounting rules could well outweigh those associated with full governmental control over the standard-setting process. In any event, direct political control is illusory, as demonstrated by experience in the major industrialised economies.

The institutional solution opted for by the European Union is, in fact, a compromise. The European Union has relinquished direct political control over the accounting standard-setting process, while retaining a veto right through the “endorsement mechanism” of IAS/IFRS and a proactive participation in the due process of the IASB²⁷. It has much to gain from the worldwide recognition of standards not *de facto* imposed by the United States, provided the checks and balances applicable to the IASB’s work function correctly. This, in turn, raises the issue of the quality and efficiency of the governance model of the IASB.

Changes ahead for the IASB’s governance model

The gradual abandonment of national standards do not imply a free rein for the IASB. Given the important implications of the accounting framework, the decision on standards cannot be entrusted exclusively to a small circle of experts. Counterbalances to international standard-setters’ power are thus a highly topical issue.

As noted earlier, the IASB can be considered as more independent from corporate interference than the FASB, and than any other national standard-setter, by virtue of its international dimension. A controversy triggered by the *Financial Times* in early 2002 concerning the funding by Enron of the IASC Foundation proved short-lived. The IASB has instigated consultation at a number of levels in order to secure legitimacy of action. Measures include the formation of a consultative committee composed of standard-users’ representatives and ongoing discussions with financial market regulators within IOSCO.

This dialogue will nevertheless remain largely a matter of form as long as the current imbalance between the IASB and its partners persists. Counterbalances to the IASB’s decisions will be effective only if they match the Board’s technical savvy and global scope. Against this background, any true counterbalancing voice must be representative in a manner surpassing narrow national concerns. Another requirement is the ability to generate alternative proposals in real time concerning state-of-the-art techniques in standard-setting.

The highly technical nature of the work involved partly justifies the IASB’s essentially fellowship-like organisation, with its system of appointments nearly exclusively on the basis of recognised expertise. But a monopoly over technical expertise could throw efforts off course. A deeper commitment of the investment and corporate communities is essential for

²⁷ In particular through the EFRAG (see footnote 23 above).

the discussion of standards and the standard-setting process. Otherwise, the IASB could ultimately succumb to the damaging temptations of exclusive power.

Related to the need to reinforce the IASB's as yet fragile legitimacy is, therefore, the issue of the emergence over time of global intermediary organisations with autonomous technical resources serving worldwide interests in discussions with the IASB. Existing entities like IOSCO in the area of securities regulation are largely confined to a role of coordination and will have to build greater autonomy and action capacity. The practical and political difficulties attendant upon the creation of global institutions to be the able representatives of stock market regulators, companies and investors around the world are easy to consider, but will have to be overcome somehow.

Europe clearly has a key role in this process. Two years ago, there was a clear case for collaborative action: the IASB had an incentive to secure approval by the EU early in the standard-setting process to avoid rejections, given that, under the current circumstances, standards not endorsed by the European Union could lose much of their global influence. This arrangement represented a considerable advantage for the European Union, provided it was used to advance legitimate concerns of general interest and not just narrow interests of some European players. But, with the controversies and delayed decision around IAS 32 and IAS 39, the situation has now become much more confrontational, and is easily portrayed as a battle between the interests of global financial markets and the European Union's struggling political authority.

This is a pity, and one can only hope that the relation between the EU and the IASB becomes more constructive and facts-based. For this, better technical expertise on the EU's side will be key. This expertise, currently largely lacking at the Commission's level, is indispensable for the EU to influence standard-setting choices wherever its interests may differ from those of the worldwide accounting profession and of the companies and markets on the other side of the Atlantic. Therefore, the resources allocated to the endorsement process, both technical and financial, should be increased. The role of the European Financial Reporting Advisory Group (EFRAG) in this process should be emphasized and clarified.

In the medium term, the European Union could also enhance its influence over international standard-setting by further integrating the regulation of its capital markets, thus creating a counterweight to the worldwide dominance of the SEC in that area. This would mean going far beyond the current "Lamfalussy process" of regulatory convergence within the European Union.²⁸ An integrated European regulator, even if it is far less centralized than the SEC, would greatly enhance Europe's influence within IOSCO and would help to achieve more structured exchanges between IOSCO and the IASB. Over the long term, the existence of an EU securities regulator would guarantee more leverage on the IASB's decision-making process than the current endorsement mechanism could ever provide.

Change is ripe also on the IASB's side. To start with, it must gradually achieve a more balanced geographic representation among its own members. The current prevalence of English-speaking members within the Board (10 out of 14) is at odds with the IASB's Constitution and may prove detrimental over the long term²⁹. But the nationality of the IASB's members is only a side issue compared to the importance of a high-quality dialogue and effective "due process" implying all affected parties, most critically at an early stage of consideration of new standards. In this respect, the existing situation leaves room for

²⁸ Within the action plan for financial services that followed the March 2000 Barcelona summit, measures were implemented to speed up the harmonisation of rules set by European financial market regulators, within the Committee of European Securities Regulators (CESR). Common rules can be agreed within a framework that poses fewer constraints than that applicable to European Union directives. The CESR is nevertheless far from being a pan-European regulatory body.

²⁹ A (controversial) proposal was recently made during the review of IASB due process launched by the IASC Foundation, as part of the governance process of the standard setting process: it would consist in tailoring the representation of the various countries or areas of the world according to their commitment to implement the IASB standards. Although technically complex to enforce, such a rule would undoubtedly increase the incentive to adopt IASB standards.

improvement. In the end, if the IASB is to live up to its promise, it has to muster an irreproachable behaviour of transparency, dialogue, and intellectual openness. Such conditions are indispensable for this extraordinary experience of supranational governance to gain acceptance from all affected parties, and thereby to be a lasting success.

CONCLUSION

The production of accounting standards is too momentous an enterprise to be entrusted to accounting specialists alone. The standard-setting process is one of the main tools by which a capitalist system is shaped, nothing less. Accounting principles guide the methods used to assess values, thereby influencing the priorities and choices of the various market participants, from investors to financial intermediaries and corporate managers.

The fact that the financial markets are spearheading globalisation gives special value to the IASB's original institutional framework. The IASB's current strength springs from market practitioners' recognition of the need for global-scale accounting harmonisation. Is this just the temporary capture of a key area of policy by a group of self-appointed, unaccountable individuals? Or is it a new regulatory model for the 21st century? The latter scenario is conceivable, provided that private- and public-sector players alike opt for a more thorough consultation process based on a comprehensive analysis of the issues at play, more commitment and resources, and, last but not least, the enforcement of appropriate checks and balances to secure that this particular variety of globalisation remains acceptable to all.

GLOSSARY OF ACRONYMS

- AMF: *Autorité des Marchés Financiers* (financial market regulator, France).
- ASB: Accounting Standards Board (accounting standard-setter, UK and Ireland).
- CESR: Committee of European Securities Regulators (coordinator of financial market regulators, European Union).
- CNC: *Conseil National de la Comptabilité* (consultative committee, France).
- CRC: *Comité de la Réglementation Comptable* (accounting standard-setter, France).
- DRSC: *Deutsche Rechnungslegungs Standards Committee* (Germany; GASC in English).
- DSR: *Deutscher Standardisierungsrat* (accounting standard-setter, Germany; GASB in English).
- EFRAG: European Financial Reporting Advisory Group (consultative committee, European Union).
- FAF: Financial Accounting Foundation (parent company of the FASB, United States).
- FASB: Federal Accounting Standards Board (accounting standard-setter, United States).
- FRC: Financial Reporting Council (parent company of the ASB, UK).
- GASB: German Accounting Standards Board (DSR in German).
- GASC: German Accounting Standards Committee (DRSC in German).
- IAS: International Accounting Standards (standards issued by the IASC before 2001).
- IASB: International Accounting Standards Board (international accounting standard-setter, private company based in London, UK).
- IASC: International Accounting Standards Committee (private foundation based in Delaware, United States, and the IASB's parent company).
- IFRS: International Financial Reporting Standards (standards issued by the IASB since 2001).
- IOSCO: International Organisation of Securities COMmissions (international coordinator of financial market regulators).
- SEC: Securities & Exchange Commission (equity market regulator in the United States.)
- US GAAP: Generally Accepted Accounting Principles (standards issued by the FASB, United States).