STRENGTHENING THE PROCESS FOR ADOPTING INTERNATIONAL ACCOUNTING STANDARDS: A STRATEGIC CHALLENGE FOR THE EUROPEAN UNION

July 2013

Report prepared by a Committee chaired by Michel Pébereau

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INTRODUCTION

Long regarded as simply a technical matter, a convention of language used by the company to communicate both internally and externally and enable it to present its assets and performance, accounting has over time become a subject of debate, at the highest level of business but also for other stakeholders such as investors, regulators etc.

The significant role that accounting standards play in measuring the company's performance and net assets, but also the fact that they are involved in conditions of competition between companies in the same field of industry give them a real strategic quality. Different accounting standards may significantly alter not only the representation of the company's performance and economic value but also their reality, because of their influence on the behaviour of those involved within the company. They are also likely to affect the stability of financial markets through the volatility they can induce, the sense of confidence or no confidence that this volatility and its consequences inspire to the market players and the reactions they determine. The concepts on which the standards are built determine a level of volatility or procyclicality likely to affect the behaviour of the parties involved and the functioning of the financial markets over time.

While the accounting standards used in the European Union (EU) were a patchwork of national accounting languages, the internationalisation of business and the integration of European markets revealed the need to find a common language in the early twenty-first century. The EU has chosen not to have its own accounting standards by way of the usual legal mechanisms because of the difficulty of achieving this, since accounting is bound up to such a large extent with the legal system, and often the tax system, of each state. This has led to the adoption of international standards for the production and publication of consolidated financial statements for all listed companies, the IFRS, the development of which was already derived from the globalisation of financial markets. In doing so, Europe has largely transferred its expertise in accounting standards to the IASB, the expected result of this being a jump in the quality of financial information published by the companies concerned.

The adoption of the IFRS in 2005 represented a real step forward for companies and all stakeholders in terms of comparability, the existence of a language shared among the entities of the same company as well as between international groups and since it has increased transparency by the scope and reliability of the information required from companies. From the second half of 2007, the financial crisis and the debate that it caused around the excessive use of market value for the accounting of financial instruments sharpened the awareness different stakeholders (governing bodies of companies, investors, regulators etc.) had about the potential impact of accounting standards on the apparent performance of a company and on the economy as a whole, so that the IASB was forced to analyse the role standards played in the crisis by bringing together an ad hoc committee to reflect on the subject.

Beyond the effects of an inappropriate application of market value and other key concepts of the IFRS that have amplified some aspects of the crisis, more general criticism of these standards is emerging, both within European companies and among a number of investors, including long-term ones, in particular regarding the new draft standards. Many companies believe in fact that the IFRS do not allow them, in some respects, to properly account for the economic reality of their activities and their performance and therefore cannot be used to manage their operations. There is now a great danger that the language used for external communication is very different from that used to manage the company: it can alter behaviour and change the nature of its activities. Failing that, it leads companies to base their communication on adjusted indicators, which is ultimately detrimental to comparability, and paradoxical to say the least.

Despite the criticisms levelled against the IFRS after the financial crisis begun, the objective of convergence towards a single set of high quality accounting standards was reaffirmed by the G20 in November 2008, alongside which the major projects that needed to be undertaken in order to address gaps in financial regulation were taking shape. Although real progress has been made in many areas (adoption of the new Basel III prudential rules, reform of OTC derivatives markets etc.), international accounting convergence has only increased slightly, the G20 having repeatedly pushed back the target date while still reaffirming the objective.

To date, the objective of international accounting convergence remains relevant and upheld by the G20 but is being considered on a more long term basis. Given the complexity of the subject of accounting and the pre-existence of national accounting standards, the effective implementation of international accounting convergence unavoidably takes time, especially since it is very difficult to express the performance of businesses and economic fabric that varies greatly from one jurisdiction to another in a single set of accounting standards.

Because of these difficulties and the impact of accounting standards on economic competitiveness, many jurisdictions have chosen to maintain their sovereignty regarding the implementation of the IFRS. For their part, the United States clearly indicated in 2012 that the adoption of the IFRS for U.S. public companies would not be taking place in the near future. Japan has also decided to take some time before making any changes.

In contrast, the European Union has decided to renounce its sovereignty in relation to accounting regulations by entrusting the task of producing the standards to an independent private organisation, the IASB, and since 2002 has made use of a system of adoption of the IFRS[1] which only allows it to apply or reject a standard. For this, it has set up accounting governance, whose organisation has proved too complex and insufficiently coherent to have a role within the IASB compatible with its size and its level of involvement with the IFRS, leading to Europe's position being expressed by many different voices, thus weakening its influence.

While the process of international accounting convergence is losing steam, it seems essential to evaluate these choices in the light of the implementation of the IFRS over the course of 8 years and the crisis. It is essential to adapt the European system of accounting standards in the new international situation and to enable Europe, as the first user of the IFRS, to strengthen its influence and contribution to the development of IFRS that meet their needs. This does not however call into question the original objective that led to their adoption by the EU as companies want to enhance the quality and strength of this framework in order to ensure its sustainability.

[1]Regulation (EC) 1606/2002

SUMMARY OF THE REPORT'S PROPOSALS

The application of IFRS within the EU for the last 8 years has represented a step forward in terms of comparability and the completeness of the information presented by companies in their reporting. It is not a matter of calling their use into question. However, the set of standards has weaknesses, particularly resulting from certain gaps in the conceptual framework. These have been exacerbated by the crisis, generating a growing dissatisfaction among companies, as many of the requirements of the European economy in terms of accounting standards were not covered by the IASB. In particular, all the lessons from the crisis have not been learned.

The structure and governance of the European system used for the adoption of IFRS by the EU are chief among the reasons for this situation: they are far from being efficient enough to enable it to obtain standards that meet its needs even though it plays a major role, by way of its economic weight and its level of involvement, in the implementation of IFRS.

Although the goal of international convergence of accounting standards remains relevant, it has become part of a much more long-term timeframe since the U.S. announcement to postpone *sine die* the adoption of IFRS in the United States and given the absence of any specific timetable having been announced by other major economies such as Japan.

Moreover, while other major economic areas (like USA, China, Japan, India) retain control of this strategic element, the EU has chosen not to give itself the authority to modify or adapt the IFRS to its economic environment, therefore partly abandoning its sovereignty.

Given these facts, it is a matter of urgency to initiate positive action in order to sustain the use and improve the quality of IFRS, to profoundly restructure the mechanism for adoption of the IFRS by the EU so as to align Europe's influence with its economic weight and to enable the EU to regain the share of legitimate sovereignty that other countries have not abandoned. In order to do this, the proposals focus on three complementary pillars:

- Reforming the conceptual framework of the IFRS, so that the standards produced better meet the needs of the European economy (immediate action)
- Reforming the structure and governance of the European system for adopting accounting standards (immediate action, which can be undertaken within the scope of current texts)
- Revising European regulations in order to give the EU the option of modifying a standard if it deems it necessary (European legislative process in co-decision).

First proposal: REFORMING THE CONCEPTUAL FRAMEWORK IN LINE WITH ECONOMIC REQUIREMENTS

The conceptual framework is essential in a set of standards based on principles. It currently contains inconsistencies and does not respond well to the needs of the European economy. It therefore needs to be fixed, drawing lessons from the crisis for the benefit of all areas that apply IFRS.

→ Giving the conceptual framework a prominent place in the hierarchy of the IFRS reference documents.

→ Reopening consultation about the entire conceptual framework since the EU cannot be content with some elements that are now regarded as having been definitively adopted by the IASB.

→ Getting together in order to obtain some major modifications to the conceptual framework, aimed in particular at: broadening the definition of the users of the standards in order to include companies and long-term investors; better reflecting the economic reality by relying more on the concept of the business model; reintroducing the principles of prudence and reliability in order to preserve financial stability by reducing volatility; restoring the essential role of presenting the performance period to the income statement.

Second proposal: Reforming the structure and governance of the European system

The different structures of the current system are poorly coordinated, which greatly weakens Europe. Attempts at organisation based on the only national accounting standard setters (before the adoption of IFRS), on a two-headed system (current system) or involving a conservative reform (attempt to reform the governance of the EFRAG in 2012) have proved to be ineffective. It is therefore now time to initiate an ambitious reform by bringing all relevant stakeholders, public and private, into EFRAG and by expanding its scope to enable it to fulfil its advisory role to the Commission in the context of the adoption of the standards.

→ Opening EFRAG up by creating a general assembly that includes the European state authorities (Commission, ESMA, ECB etc.), the European private sector (the current "owners" of EFRAG) and the national representatives (National Standard Setters), in charge of electing a Board responsible for the consolidation and expression of positions.

→ Creating, under the control of the Board, two committees for analysis of the standards, one technical, the other in charge of analysing the economic impact of the standards in order to effectively link these two aspects.

→ Uniting and strengthening human and financial efforts at European level, both for accounting research and for the analysis of the standards and field studies, by together defining methods for cooperation between the European body and the National Standard Setters.

→ Giving priority to competence through nomination committees and encouraging the identification of high-level European profiles in order to strengthen the presence of Europeans within international standardisation bodies.

Third proposal: Revising European regulations and reasserting European sovereignty

The choice of the EU to only be authorised to adopt or reject the IFRS is unnecessarily reductive. Without jeopardising its commitment to the IFRS, it can legitimately give itself the legal authority to amend or replace a standard that it deems inappropriate to the needs of its own economy. This is what most jurisdictions have chosen to do, either by maintaining their own standards or retaining the right to modify the IFRS. In the latter case, it is important that the mutual recognition agreements concluded by the European Union with third countries allow European companies to use the standards it has adopted, without reconciliation with other standards and without having to draw up a second set of financial statements.

→ Integrating the option to modify or replace an IFRS into European Regulations. In addition, the revision of the regulation would give greater legitimacy to the reform of institutions and governance within the European system.

→ Strengthening the criteria for adoption of the IFRS on a European level by incorporating the criteria of financial stability and the preservation of the European economy into the regulations.

→ Negotiating, at international level, agreements of mutual recognition of accounting standards based on the standards applied by the EU and not on the IFRS as adopted by the IASB.

THE CONTEXT

A. European requirements in relation to accounting standards are not being met

Eight years after the implementation of the IFRS for all listed European companies (a large scale implementation, which is relatively unique among IFRS countries due to the economic size of the companies involved), reactions are mixed.

The adoption of a set of international standards, in a global context of convergence in this area, has been of real interest for the entire business community, promoting market integration. For companies, this has resulted in them sharing a common language and attempting to harmonise methods that have significant impacts on competition (accounting for acquisitions, depreciation etc.) Finally, the IFRS have increased the robustness of financial information thanks to the broad scope of issues covered by the standards and the extensive information they require.

However, over the years, initial imperfections of the conceptual framework, the effects of which have become particularly problematic in recent draft standards, have been compounded by the movement towards convergence with U.S. standards. Furthermore, the IASB has not provided an adequate response to a number of requirements expressed by Europe, largely because of the excessive emphasis placed on the objective of convergence. This convergence has been built on a foundation of principles that are not neutral and consequently encourage certain types of behaviour and business models, very much inspired by American practice, which may be unfamiliar to European companies. Lastly, the financial crisis has highlighted some limitations of the standards, leading to failures to which sufficiently rapid and effective responses have not been found.

1 Inadequacies resulting mainly from the conceptual framework

1.1 An approach that gives precedence to external users to the detriment of companies and long-term investors

Within the IFRS conceptual framework, companies are preparers of financial statements and not users thereof and the analytical perspective of a certain category of investors (analysts, short-term investors) is prioritised. This analytical standpoint offers a universalist approach at the expense of any consideration of the specificities of the business sectors, the organisation of companies and the specificities of different business environments.

1.2 Standards that are not conducive to long-term investment

For all companies, the IFRS implement a strategy that is unfavourable to a long-term analysis of performance: by giving prominence to the balance sheet, valued in part at the market value or the current value of the assets and liabilities, the IFRS give an indication of how value would be realised on disposal, rather than an analysis of its performance. This is extremely detrimental for companies whose business model is designed to be evaluated over a long period: the IFRS neither enables the company to present itself in a way that takes account of its strategy (see next point), nor provides the long-term investor with adequate information about past and future performance, vital for making an investment decision.

1.3 Draft standards that do not allow adequate representation of the economic reality of the company

Financial reporting must explain and reflect the economic activity and performance of the groups in the best way possible. However, the IFRS negate any differences in economic models and fit different economic realities into the same mould. The current draft relating to leases would thus lead to all contracts being analysed according to one principal model and would not reflect the differences in strategies used by the groups as the old standard did. Similarly, the new standard on joint ventures will no longer allow companies to record a large part of their turnover achieved in geographic areas where joint ventures are the preferred tools for growth, such as in China, for example. We have therefore witnessed a gap between the financial statements prepared under the IFRS for legal requirements and the internal accounts used by management and directors, and sometimes used externally for communicating with analysts and investors.[2]

The IASB has gone some way to recognising the merits of this criticism and its work particularly on hedge accounting is placing greater importance on the business model. However, at the level of banking and insurance, although the IASB has recognised the existence of different strategies, it is regrettable that it has not gone far enough in its approach. The IFRS may therefore turn out to be insufficiently adapted to the business model of banks and insurance companies (see below).

1.4 The suppression of qualitative characteristic of prudence and reliability in favour of faithful representation and neutrality has led to questionable valuations methods

These changes in the conceptual framework have justified an ever greater reliance on judgment, the use of unobservable data, market values or current values and multi-scenario weighted averages in cases where it is inappropriate.[3] This trend worries companies who see their financial statements becoming ever more volatile and subject to unobservable and highly variable assumptions; the computation of “spot” market or model values where the market does not exist, or for illiquid instruments, creates a disconnect with reality, a source of great complexity and risk to the reliability of the data.

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[2]For example, the revenue recognition draft may no longer allow companies in the telecommunications sector to communicate their activity and performance as measured and monitored internally.

[3]Market value is the primary measurement basis used for the valuations of financial instruments recorded in financial statements. Although the historical cost measurement basis still remains, the field of application of market value is very broad, either as a requirement or as an option. Theoretically it is intended for trading activities, but also used for biological assets regardless of the model of business activity, real estate investment options, consolidation methods through acquisition accounting and the revaluation of historical investments after successive acquisitions or of assets retained in the case of loss of control. It also covers questionable cases where a fair value, known as Level 3 in the fair value hierarchy, which relies on unobservable data is still considered preferable to a historical cost, for example in the case of unlisted equity assets.

The importance given to the principle of neutrality gives the IASB its justification to prioritise data external to the company even though it does not relate to observable aspects rather than to allow management to rely on its own estimates and judgment. Paradoxically, in other cases, the IASB calls for excessive use of judgment while management does not have the necessary elements for an evaluation. Newly developed drafts[4] have thus required, at least in their initial version, the valuations of many options and the use of multiple scenarios and assumptions. In the context of standards based on principles, the use of judgment is not objectionable in itself and should even be encouraged, but should not lead to unreliable hypotheses being made on the basis of non-observable data.

At the level of banks in particular, the use of market value is criticised: the new IFRS 9 relating to financial instruments (not yet adopted by the EU) sets out that the accounting for financial instruments at amortised cost is only possible if these instruments meet certain criteria, which can be very restrictive. Banks therefore may be required to record a portion of their balance sheets, currently at amortised cost, at fair value. This would introduce volatility to their income statements or their equity which, in some cases, has no economic foundation.

2 The needs of the European economy are not being taken into account, largely sacrificed in the name of convergence

2.1 Major, but unsolicited , reworking of the existing texts

In recent years the IASB has undertaken the reworking of standards, most often justified by the work performed to achieve convergence with the U.S. GAAP, a convergence whose terms are vague and whose deadline for completion is receding more and more (see §B). The revenue recognition project has been subject to major, but unsolicited reworking, justified by U.S. demands. All this work has mobilised a great deal of human resources and energy within companies, for a result that is far from optimal, while other issues should have been given much higher priority (see examples below).

2.2 Missing or very inadequate text

- **A still unresolved "carve out"**

The initial adoption of the IFRS by the European Union was accompanied by an adjustment made to the IAS 39 standard, known as a "carve-out", aimed at allowing the macro-hedging of portfolios made up particularly of on-call deposits. This is a common management practice in the banking sector which is not permitted by the standard as published by the IASB. In 2013, although the IASB has begun work on a draft relating to macro-hedging, this issue has still not been resolved.

- **An accounting-standard vacuum for insurance**

For the insurance industry, the standard currently applicable, IFRS 4 Phase I, is a transitional standard adopted because the work on insurance contracts during the transition in 2005 was not completed. To a large extent, it maintains the use of former accounting practices for the valuation of insurance

[4] Leases, Revenue recognition, Draft revision of IAS 37

liabilities (with varying approaches depending on the nature of commitments and accounting or regulatory standards, ranging from historical cost to the present value of cash flow), whereas for assets, investments are generally valued in accordance with the IFRS at their market value. In its new draft standards currently under discussion, the IASB has identified this asymmetry between the valuation of assets and liabilities as well as the insufficient consideration of the holding period of assets and liabilities but companies are still not convinced, at this stage of the discussions, that the model adopted will respond to these challenges.

2.3 Excessive complexity

- **A standard that sometimes leads to results that do not match the economic reality**

There may therefore be a disconnection between the accounting result and the tangible reality of the cash flows.[5] These counter-intuitive effects are often the result of an approach that is too ideological and too far removed from the business model.

- **Overly complex standards, that can impede a listing**

The IFRS, like any advanced accounting standards, are complex to understand and implement, particularly for small organisations. Applying full IFRS can be a barrier to listing. The IASB recognises this complexity and has edited the IFRS for SMEs with the aim of simplifying and better suiting the standards to small companies. However, that standard, still complex, is not considered relevant by SMEs, who are considered only as companies to be listed in the future.[6] Finally, the specific issue of the notes to the financial statements has now been clearly identified by the IASB but has not yet been resolved: being too voluminous and onerous to produce, they need to be thoroughly reviewed in the context of the review of the conceptual framework of the disclosures.

- **A lack of stability of the standards that is detrimental to all stakeholders**

The IFRS are a constantly changing set of standards, as evidenced by the major projects that are ongoing (revenue recognition, leases, financial instruments, conceptual framework etc.). Supporting these changes is costly and complex, for all the parties involved, especially for small listed companies. These big changes also detrimentally affect the establishment of a climate of confidence in the markets the opposite of that which was sought for during the transition to the IFRS.

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[5]The accounting for changes in equity illustrates the issue: a partial transfer without a loss of control does not lead to recognition of the transfer gain or loss in the income statement, even though the transferor is in receipt of a cash-flow; an acquisition in stages leads, conversely, to the recognition of a revaluation gain in income while cash is paid out. We can also cite examples of own credit risk and the issue of put options on minority interests: in these cases, the application of the IFRS may lead a company to see a deterioration (or improvement) of its net assets even though the economic situation is improving (or deteriorating).

[6]The IFRS for SMEs is not applicable for small listed companies and has not been adopted in France; moreover, small listed companies do not see it as a potential solution to their problems because they fear that using them will be perceived negatively by investors, generating an unfavourable ranking among listed companies.

3 In the face of the financial crisis, responses are coming much too late and falling short of the demands by the European authorities

The succession of crises that began with the subprime crisis in the United States in the second half of 2007 has highlighted the role played by accounting standards in these, IFRS in Europe, or local GAAP in the United States, and the consequences of using certain accounting valuation methods based on market prices.

It is obvious that the crises were not triggered by accounting standards, but there are many who believe that accounting can have a procyclical role according to the system of valuation selected, by encouraging and supporting the formation of financial bubbles that go on to burst and by precipitating the spread of crises when confidence is undermined.[7]

In any event, the magnitude and suddenness of a crisis that the markets had not anticipated resulted in international, regional or national authorities taking or recommending a number of measures to clarify or limit the use of fair value valuations.

The reaction was more appropriate in the United States than in Europe, the rapid implementation of corrective actions by the FASB contrasting with the slowness of the IASB to adapt its regulations under pressure from political authorities. So, in October 2008, the Paulson plan granted the SEC the authority to suspend the application of fair value for "reasons of general interest" and investor protection. In April 2009 the FASB authorised financial intermediaries to record certain financial assets not at market value, which had disappeared or ceased to be relevant, but rather at an estimated value using financial valuation models to correct market excesses and therefore prioritise intrinsic value. For its part, the IASB refuses to follow the same approach, but convinced by European authorities to allow reclassification using historical cost accounting of traded financial instruments that are listed on markets no longer giving them a fair value and therefore managed as an element of the banking book.

Despite these measures, the lessons of the crisis have not been fully learnt. The G20 call to reform the system of funding of debts with an approach shared by standard setters is still being developed by the IASB to date and the possibility of a convergent solution is remote. In addition, the May 2011 publication of IFRS 13[8] on the determination of fair value confirmed the use of market data related to credit risk in order to adjust the model value of derivative financial instruments, whether they represent an asset or a liability, and risks fuelling the procyclicality at the very moment when the crisis greatly increases the credit risk. Lastly, with regard to the own credit risk on issued debt at fair value, although the IASB has proposed a partial solution, the choice not to directly integrate it into the modification of the standard currently applicable in Europe (by directly modifying IAS 39) has unnecessarily delayed its effects for European companies.

[7] Cf. annexe 2

[8] With an effective date on 1st of January 2013

B. A new situation: After an expansion phase of the implementation of the IFRS throughout the world, the U.S. decision represents a slowdown to their expansion

The prospect of the United States adopting the IFRS has justified for a long time the objective of convergence between IFRS and U.S. GAAP being placed at the forefront and this conditioned all decisions and guided all projects.

This ended with the decision by the United States not to adopt the IFRS. The FASB and IASB have indeed publicly announced the end of the jointly-agreed objective on this matter, which had already been announced by the abandonment of convergence in relation to the "impairment" text. The change to the situation is major and is characterised by various elements:

- **The United States will not adopt the IFRS for another 5 or 10 years, if at all.**

Indeed, despite the SEC's historic adherence to the principle of developing a set of accounting standards that can serve as a reference for the accounts of companies listed on several markets, this has fallen sharply away in the light of the many disadvantages cited in the final report of July 2012[9]. The SEC particularly highlights a weighty element in terms of sovereignty: the need to consider and protect the U.S. capital markets. However, only the FASB via an *endorsement* mechanism is able to protect U.S. interests. It is therefore essential to keep it actively involved in the subject. It is notable that the arguments raised by the SEC are those that all countries considering adopting them could put forward as reasons for not adopting the IFRS. But the decision rests on a balance between the benefits that a country draws from them and the disadvantages that their adoption could bring. At this stage, the U.S. seem to think that the benefits do not outweigh the disadvantages. In response to this report, the IFRS Foundation expressed its disappointment last October, taking into account the convergence efforts undertaken to date and the involvement of the SEC.[10] The IASB also stressed the risk that in the absence of a U.S. decision to adopt the IFRS, a decade of convergence could be followed by another period of divergence.

- **In practice, U.S. companies seem disinterested in the IFRS.**

Among the largest U.S. companies, some remain silent while others have come out clearly against the IFRS, or even did an about-turn last year. The view that the U.S. GAAP would be better suited for U.S. companies is widespread. Consequently, they are questioning the relevance of the adoption of the world standard if it does not offer advantages relating in particular to reducing the cost of capital.

[9]Disadvantages cited include: many differences still exist between the IFRS and the U.S. GAAP; the IFRS are not sufficiently developed for certain types of industries; the function of interpretation devolved to IFRIC has only enabled a limited number of subjects to be handled, with limited diligence; the IASB does not sufficiently integrate the expertise of national standard setters into its thinking; there is no uniform practice of the IFRS throughout the world; improving the training of investors in the IFRS would be necessary.

[10]The two documents referred to are the positions of SEC's and IFRS Foundation's staffs, not officially endorsed

- **The funding of the IASB by the United States was halved, making it low in relation to the EU contribution and its presence within institutions.**

It could fall further given the decision to abandon short-term convergence. Out of the 69 countries that contribute to the funding of the IASB today, 27 are members of the European Union. In total, the EU pays 7.7 million pounds against 1.7 million pounds in 2011 for the United States. The U.S. contribution, equivalent to 8.4% of the Foundation's external revenues[11], is small compared to the proportion of seats held by U.S. representatives on the Foundation (20/25%). While the United States were already over-represented in institutions in terms of their contribution, the evolution of their position in relation to the adoption of the IFRS makes this imbalance hardly acceptable.

In this regard, it would be desirable for the objective criteria of minimum contribution to be defined (on a GDP-type aggregate, for example).

C. The assessment: the European system of adopting IFRS - unique compared to the rest of the world - has not allowed the IASB to take sufficient account of European concerns

1 Presentation of the existing system

1.1 A structure supported by two bodies

The mechanism for adopting international accounting standards for application in the EU relies mainly on two bodies; ARC and EFRAG:

EFRAG (European Financial Reporting Advisory Group), based on the model of the IASB, is a technically-oriented private sector organisation, created in 2001 by organisations representing preparers, users and members of the accounting profession at European level and originally funded exclusively by the private sector. EFRAG then signed a *working arrangement* with the European Commission thus broadening its scope and integrating funding from the Commission. This is equal to the contributions made by other stakeholders. In practice EFRAG now has three sources of funding overall: the contribution from the member organisations, that from national financing systems and from the European Commission.

EFRAG is organised as follows:

The General Assembly, made up of representatives from the constituent parts of EFRAG, monitors, with the assistance of a nominating committee, the constitution of the Supervisory Board.

The **Supervisory Board** oversees the governance: it selects the members and oversees the work of the TEG and the PRC, ensures cooperation between EFRAG and the national standard setters and ensures EFRAG's funding.

[11] Revenues excluding publications in 2011: 20.5 million pounds, the EU contribution representing 37.6%

The **Technical Expert Group (TEG)**, made up of independent experts, is responsible for issuing opinions on draft standards, in complete independence.

The **Planning and Resources Committee** (PRC), which includes most notably national accounting standard setters, is responsible for proactive work, making its contribution prior to reflections from the IASB.

The **Consultative Forum of Standard Setters (CFSS)** is also somewhere where national accounting standard-setters can express their opinions; it should be noted that four of them also attend TEG meetings in an advisory capacity.

In practice, decision-making power is held essentially by the TEG.

The ARC (Accounting Regulatory Committee) is an organisation with a political purpose, responsible for assisting the European Commission by providing it with an opinion about the adoption of standards, taking into account, in principle, the general interest of Member States. It is made up of members of the state authorities from the Member States with some of them not being experts in accounting standards while some Member States are represented by their standard setter. The ARC is convened by the Commission and makes its decisions after EFRAG has given its opinion. The Commission then decides whether to approve the standards or not but has, in practice, always followed the advice of the ARC.

1.2 The mechanism for adoption of accounting standards

The Regulation 1606/2002 sets out that in order to be applicable in Europe, international accounting standards must first have been adopted by the European Commission, after seeking the opinion of the ARC and having submitted them to the procedure laid down by the regulation which then allows the European Parliament and the Council to oppose them (which has never happened so far). The international accounting standards can only be adopted if:

- They are not contrary to the principle of true and fair view;

- They meet European public interest;

- They meet the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

They can be refused but there is no mechanism to modify a standard or to substitute it with another standard if it is considered to be inadequate.

2 Weaknesses of the European system

The weaknesses of the European system are a result of its structural organisation and governance, the insufficient consideration of adoption criteria by the various European stakeholders as well as the representativeness of the EU and the relations that it has with the IASB within the current legal framework.

2.1 The inherent weaknesses in the European system

- **A difficult to understand system, with no coordination between the political and technical aspects**

In terms of governance, the European system is relatively difficult to understand. The technical and strategic dimensions of the European position are poorly coordinated: EFRAG is very credible on a technical level but because its mission stops at this technical evaluation, the link-up with the political level does not work. In addition, the ARC, whose technical skills are considered limited, is confined, by the statutory procedure, to a late intervention, taking place once the standard is published and EFRAG's opinion has been formulated, which deprives it of the possibility of giving it prior consideration in order to obtain modifications of the standard.

- **Multiple players without a strong voice for Europe**

In the expression of European positions, a large number of stakeholders with conflicting voices can be seen (EFRAG, ARC, ESMA, EBA, EIOPA, four major national standard setters, other national standard setters, *etc…*). In the absence of somewhere where these different voices could truly come together, the result is a real difficulty in reconciling an expression of different points of view, and consequently in achieving a single European voice that takes into account the European public interest and has powers comparable to those of FASB, supervised by the SEC and Congress.

- **The criteria of European public interest and the preservation and promotion of the European economy are not sufficiently taken into account in the expression of the EU's voice**

The criteria for adoption of a standard are underdeveloped, not allowing the development of a full position at European level that effectively integrates a technical analysis dimension, a critical review of the improvement made and an objective to protect the public and economic interest in the area.

2.2 A lack of resources

In structural terms, the various European institutions do not have the financial or human resources that the United States have. This results in weak and erratic research, which cannot be compared to the research efforts implemented by the FASB. Several reasons may be the cause of this, the first of which is primarily cultural; Anglo-Saxon countries have a strong tradition of accounting. For example, the nominations for staff member positions for the different accounting bodies (EFRAG, ESMA, *etc.*) do not number many from the ranks of continental Europe, in contrast to the Anglo-Saxon countries. This is even more obvious in regard to decision-making positions. In the different bodies of the IASB for example, continental Europe's representation is still insufficient, including within technical teams even though these play an important role in the development of projects. In addition, the research efforts of Member States are insufficiently linked up at European level. This reduced capacity for research has an impact on the credibility of Europe in its dialogue with the IASB, especially regarding the cases where the IASB is not producing the developments claimed by the European Union (see below).

2.3 The EU does not occupy, in IFRS Foundation institutions, a position in line with the economic weight that it represents among IFRS users

Within the IASB, the proportion of EU representatives is not related to its use of the IFRS compared to other countries that have adopted them. In fact, it is represented as well as other countries that have not adopted the IFRS, or which are able to modify the standards. Its economic weight and the strength of its commitment to the IFRS should permit it to occupy a more prominent position within the institutions.

The European Union should obtain greater consideration of the application criteria of the IFRS in the composition of the different IFRS Foundation institutions, since the latter have to be put together by giving a prominent position to representatives of the economic zones that apply the IFRS. Work on the governance of the IFRS Foundation gives a central place to the generally-accepted criteria of transparency and independence but neglects the principles of accountability of the members of the various bodies and the acceptability of the standards by the public, two criteria which are strongly linked to the effective implementation of the standards by the economic zone from which the representative comes. The European Union needs to more effectively promote these views in order that the developed IFRS better meet the needs of those who apply them.

3 The rest of the world: the mechanisms for adoption or integration mostly preserve the states' sovereignty.

Due to the limited flexibility that the EU has in European regulation since it can only approve or reject a standard but not change it, the European Union is in a unique position compared to other countries. Although the IASB emphasises that with regard to the rest of the world the IFRS are diffused in many countries, it is necessary to qualify the analysis:

- **a large majority of countries representing a significant weight in the global economy have not adopted the IFRS**

Among the countries contributing the most to the global economy outside of Europe, the most important countries have not adopted the IFRS. As was mentioned earlier this includes the United States, but also China, India and Japan. Note that although the United States and Japan have not moved to the IFRS, they allow foreign entities listed for the United States and all active companies listed internationally for Japan to present their financial statements in accordance with these standards. In Japan, however, the standards can only be applied after a process of "designation" by the Financial Services Agency. This is different from the United States where foreign listed entities have the option to directly apply the IFRS as issued by the IASB instead of the U.S. GAAP. Finally, China does not intend to adopt the IFRS but since 2006 has been open about the objective of convergence between these standards and local standards (Chinese Accounting Standards). Thus, the most important principles from certain IFRS are rewritten and integrated into the CAS (or should be). However, differences currently persist between the CAS and the IFRS, in particular regarding the use and measurement of fair value.

- **Most countries that have adopted the IFRS have retained their power to amend these standards, although in practice they have made little use of this facility so far.**

Among the countries that have adopted the IFRS, there are differences in the adoption process. In some countries, the adoption of the IFRS is via a certification process (*endorsement*): thus laws or local regulations simply make reference to texts published by the IASB. This is the case of South Africa, Brazil, Canada, Mexico, Russia and the European Union, for example. Other countries are following a process of integrating the IASB texts into local standards, which is the case in, among others, Australia (AAS), Hong Kong (HKFRS), South Korea (K- IFRS), Malaysia (MFRS), New Zealand (NZ IFRS), Singapore (SFRS) and Thailand (TFRS). In all countries, *endorsement* or *incorporation* of an IFRS issued by the IASB is effective only after a process of review and approval by the local accounting (or financial) authorities. Even if we distinguish *endorsement* from *incorporatio*n from a legal point of view, these two mechanisms leave most countries the power to exercise their sovereignty by giving them the ability to reject, modify or replace a standard. So Europe has a special position in that the European legislation only allows the rejection of all or part of a standard, but does not allow modification or drafting of an alternative standard.

Sovereignty in relation to accounting is fundamental to most countries, whether or not they adopt the IFRS. The United States in particular, have demonstrated that they wish to have mechanisms preserving their sovereignty and in preference to convergence, chose a special approach to the IFRS via "condorsement" (a contraction of "convergence" and "endorsement"). Under this approach, (i) the IASB and the FASB, retaining an active role, would continue their current approach to convergence, (ii) the FASB would not embark on new projects, but would gradually converge the U.S. GAAP with the IFRS for stabilised standards. Note also that at present, simply through the review of financial statements of foreign companies listed in the United States, the SEC plays a role in the interpretation and critical analysis of their application even though the United States have not adopted the IFRS.

In conclusion, although the spread of the IFRS worldwide is clear, this quantitative view should not mask the differences in the adoption process and especially the almost systematic existence of mechanisms that preserve sovereignty in the vast majority of states, even though, as it seems, this has been used very little in practice at this stage. The European exception is notable in this regard.

PROPOSALS

The proposals are made up of three complementary ideas, which do not fall into the same timescale:

- Reforming the conceptual framework of the IFRS, so that the standards produced better meet the needs of the European economy. Achieving this goal requires strong and immediate action by the EU.

- Reforming the structure and governance of the European system for adoption of the accounting standards, an action which must be undertaken immediately and can be done within the current regulatory framework.

- Revising European regulations in order to provide the EU with the option of modifying or replacing a standard if it deems it necessary, involving a legislative process in co-decision.

A. Reform the conceptual framework in line with economic requirements

The IASB has announced its intention to revise the IFRS conceptual framework, and is currently actively working on it with a plan to publish a document for discussion early in the second half of 2013, in addition to a first phase adopted in 2010. This step is essential because the conceptual framework lays the foundations for the guidelines of the future standards and the revision of the existing ones. This is a major opportunity to adapt accounting to meet the needs of users in a broad sense, taking into account the general economic interest.

1 Strengthen the place of the conceptual framework in the standard

There is no consensus on the status of the conceptual framework within the IFRS. Indeed, it is currently only one single element of non-binding doctrine which has therefore not been adopted by the EU. Since the IASB has chosen to place it at the bottom of the hierarchy of IFRS sources, the principles laid down therein end up being contradicted by the standard setter itself within the content of the standards; on the contrary, it gives these same principles an almost "constitutional" power to overcome certain criticisms made during the consultation phases of draft standards.

Thus, the position this framework occupies within the system should be set so that the rules are clear and applicable in all situations. The conceptual framework should be given first priority within the IFRS hierarchy since the standards have to be an illustration of the robust fundamental principles that would be detailed therein. This seems all the more legitimate given that it reflects a strong feature of the international standard, because the IFRS are principle-based rather than rule-based, unlike the U.S. GAAP.

Such developments would legitimately raise, at European level, the question of its adoption by the EU, which would only be possible if the principles set out by that framework effectively meet the needs of the European economy.

2 Focus the discussion on the whole conceptual framework

The EU must mobilise its members to demand change in the conceptual framework so that it better meets the needs of economies that apply the IFRS, taking into account the lessons learnt from the financial crisis, the constraints of general economic policy and the reality of company operations. However, some points, which are considered to be major by many stakeholders, would require a further revision of phases of the conceptual framework already brought to a close by the IASB[12] and which are not part of the consultation currently in the preparation stage.

As a major user of the IFRS in the world, the EU must succeed in reopening the consultation process on the whole conceptual framework because certain principles confirmed in 2010 come into too much conflict with the needs of its economy to be accepted. This request is even more justifiable given that the principles discussed during the various phases are closely inter-related.

3 Obtain the modification of the conceptual framework on certain key aspects

The European Union should demand some major developments in the IFRS conceptual framework so that the standards produced better meet the needs of the global economy, profoundly rocked by the financial crisis. The experience of the EU's application of the IFRS should therefore help to overcome some weaknesses in the standards and allow an overall improvement of the framework, of benefit to all the economic areas that apply the IFRS. The main themes, to which the EU's efforts should relate because of the major issues they raise, are outlined below since the purpose of this report is not to go into detailed technical discussions.

3.1 Broaden the definition of users and take into account the needs of long-term investment

The notion of users should be expanded because the financial information produced and the accounting that supports it in its principles and regulations should not be conditioned primarily by the perceived needs of investors in the short term. Companies themselves must be seen as users of the accounts, thereby reducing the discrepancy between published accounts and management accounts, which is detrimental to all stakeholders. The categories of investors other than short term ones should be subject to greater attention, first and foremost, in accordance with the objectives set by the European Commission, in order to promote long-term financing by recognising the needs of long-term investors. This would enable the valuations methods for use in the accounts to be defined in a more relevant way: although the short-term investor may be interested in a presentation focused on instant balance sheet valuations, market values and current values, the long-term investor needs, for its part, to have information that enables it to project forward the operating performance of the company to consolidate its investment decision. It is therefore necessary to reconcile these two objectives. The time horizon has also to be properly reflected in the financial statements in order to correctly describe the various investment strategies that result from this in the accounts.

[12]The phases already closed address the issue of users of financial statements and abandonment of the principles of prudence and reliability in favour of neutrality and faithful representation.

3.2 Greater reliance on the business model in order to reflect the economic reality

The importance of representing performance for companies as for investors calls for setting an objective of correctly representing the economic reality. This can be achieved by taking into account the company's business model and allowing for the use of appropriate valuation methods. This is closely linked with the previous point: different business models should be taken into account, in their rightful place, in order to provide useful information for all users of financial statements and to fulfil the objective of international comparability which is at the heart of the IASB's process.

In particular, the reference to the business model is of vital interest for financial institutions to the extent that the investment policy should be modelled on the structure of liabilities. For the manager of a balance sheet with long-term liabilities, long-term investment is not only possible but constitutes a genuine fiduciary duty and the accounting for its operations should reflect the orientation of its investment policy, regardless of whether the assets to which the investments relate can be traded or not.

3.3 In the light of the financial crisis, reintroduce the concepts of prudence and reliability of financial information.

The qualitative characteristics of financial statements refer to the principles of neutrality and faithful representation, which is insufficient. The concept of prudence should be reintroduced in order to correct the procyclical effects of the accounting standards highlighted by the crisis. These have contributed to excessive profits being made during the growth phase and have had an accelerating effect in decreasing valuations during downturns. The IASB tends to believe that the adverse effects that this can cause to financial stability are primarily prudential issues. In recent years, however, experience has shown that accounting options have strongly influenced prudential approaches, as prudential measures can hardly depart significantly from the accounting data. Although it is indeed desirable to closely link accounting principles and prudential measures, this is not sufficient to resolve the procyclical nature of the IFRS and cannot justify disregarding the principle of prudence in accounting standards.

In addition, these modifications to the conceptual framework have justified increasing recourse to the use of market values or current values and multi-scenario weighted averages in cases where it is inappropriate. Financial statements are therefore subject to non-observable and highly variable assumptions which leave room for accounting volatility that may be devoid of any economic substance. It is therefore a matter of urgency to reintroduce the concept of reliability and to call into question the use of market values or mark to model values when no reliable estimates are available, especially for instruments with market parameters (liquidity, market depth, management, fragmentation etc.) that do not fall into a pattern of pure and perfect markets. The invalidation by the crisis of the efficient market theory which promotes the use of fair value should lead to the restriction of its use to the instruments traded in liquid markets. Undue volatility, which is unfavourable to long-term investment and the interest of investors and, more generally, for financial stability, would therefore be prevented.

3.4 The place of income statements and assessment of the performance of activities must be enhanced.

The conceptual framework should include proper consideration of the business model and criteria of prudence and reliability in the choice of attributes for measurement, both for the balance sheet and the income statement. The latter must provide an adequate representation of the performance period which should not be disregarded or distorted by the incorporation of elements or measures that would only be relevant for the balance sheet. The going concern principle should prevail, market value valuation, responding more to an environment of "exit" accounting should only be applicable in limited circumstances. In the income statement, the measurement of the performance of the activities should enable the cash flows relative to the company's business areas to be reflected and not systematically include all the changes in the values of assets and liabilities on the balance sheet. This would allow investors to find a predictive value, which is fundamental for long-term financing.

In conclusion, the review of the conceptual framework should be an opportunity for the EU to assert the needs of its economy in relation to accounting principles more firmly. All European stakeholders must be involved in this matter accordingly.

B. REFORM THE STRUCTURE AND GOVERNANCE OF THE EUROPEAN SYSTEM

1 The objectives

The proposals aim to ensure that the international set of standards respond to the needs and concerns of the EU in the best way, with the following objectives:

- To strengthen the IFRS for the long-term
- To expand and establish Europe's influence: create the conditions of credibility necessary to effectively take into consideration the specificities of the European economy in the accounting standard setting process;
- To safeguard the fundamental interests of Europe when it considers that these are at stake, by being able to identify and protect them throughout the accounting standard setting process;
- To provide Europe with, as a last resort, the action-levers in the case of a standard being refused and restore its sovereignty in relation to these strategic issues;

2 A partial reform would fail to meet the general objectives

The observation made in the first part involves extensive reform. Different minimal routes for reform were implemented or planned (reform of the EFRAG governance, creation of the Monitoring Board etc.). While these are steps in the right direction, these changes have increased the complexity of the system, without being able to fully respond to the needs. Today, the multiplicity of involved parties and voices speaking on behalf of Europe and the different approaches employed by the different parties require a major reform in order that all stakeholders are ready for action.

During the review work of EFRAG's governance in 2012, solutions that were limited to trying to better integrate national standard setters without revising the overall system were analysed but discarded because the discussions showed that the problem was more general. Some people question the assumption of a minimal reform that sets out to:

- *Strengthen the ARC by adding to it a standing committee*, including therein representation from the Commission, the European supervisory authorities, national standard setters as well as EFRAG and qualified persons from the private sector, who would work in depth, continuously and upstream on the economic impact of the draft standards and would more fully prioritise the identification of the needs and interests of the EU in relation to accounting standards.

- *Retain EFRAG in its current technical role*, by strengthening the legitimacy of its position through increased integration of national standard setters without losing the contribution and integration of representatives of the European "founding fathers" (companies, auditors, investors), by redefining decision-making processes and the structural organisation.

Despite some benefits (preservation of balance between Member States and EFRAG's current capacities), this limited modification of the system has major drawbacks:

- The ARC is an organisation that includes the 27 member states, characteristic which creates difficulties related to the lack of appropriate skills / time dedicated by small countries, difficulties in mediating between the small and large countries, the cumbersome nature of the process, which would not be solved by the addition of the committee. That committee would be complex to set up because all the Member States might wish to be represented.

- Coordination with EFRAG would be a weak point, as is currently the case; we would maintain two areas of major discussions relating to the IFRS, forcing all stakeholders to increase their efforts in order to contribute to it.

- The EFRAG governance's review undertaken has shown that, in order to be effective, the integration of national standard setters within EFRAG should be undertaken within the scope of a more comprehensive reform.

- This solution could weaken the political voice which would not be sufficiently connected to technical analysis, a criterion that we know is essential for getting the IASB to listen.

Hence this solution has been discarded in favour of an extensive reform of the structure and governance of the European system, in other words, transforming EFRAG by:

- ➢ Building on its existing capacities,

- ➢ Increasing the resources that Europe devotes to these issues, in particular by optimising existing resources,

- ➢ Involving all stakeholders in the development of the EU position in order to prevent the break-up of messages and increase its credibility and legitimacy,

- Closely and coherently linking the EU's political and technical voices for a proper consideration of its economic interests.

3 Reorganisation proposal and founding principles

The ARC cannot (and should probably not) be reviewed in depth; the formal system of adoption under the terms of the regulations can remain, adapted to the procedure laid down by the Treaty of Lisbon in relation to implementation measures, just as it could be reviewed if the regulations are reformed. However, it is essential to quickly engage into a profound transformation of EFRAG, in order to create a more powerful body, including within it representation from the Member States via the national standard setters without abandoning the representation of European private interests, justified both by their technical input but also by the fact that they uphold the interests of the large European market economy. The new body must be able to fulfil the current technical role, conduct a strategic analysis of the economic impact of the standards under discussion, by having conceptual and technical capacities more in line with the economic power of the European Union.

The main principles on which to base this transformation are:

3.1 Unite and coordinate European representation and national representations

The diversity of the composition between representation of private and state interests at European level which makes the uniqueness of EFRAG and provides it with a truly European nature should be leveraged on and strengthened. The objective is to make EFRAG into a shared working tool for issues relating to accounting standards. To this end, the Founding Fathers, the current owners of the organisation, and the European Commission as main client and founder of the organisation, should take the initiative to open up the control *(the ownership)* of EFRAG, in order that it accommodates both the relevant European authorities (ESMA, EBA, EIOPA, the ECB) alongside the Commission itself and the relevant national bodies (national standard setters and national funding mechanisms). A breakdown of this *ownership* into thirds could represent a good balance between European and national interests, with public and private components, respective contributions of preparers, auditors and users, including supervisors.

This new shared constitution would express itself through a general assembly responsible for appointing the body's Board, allocating funding and receiving the mandate report.

3.2 Structure the body by expanding its field of intervention

The objective is that Europe's voice, thanks to its strength in research, proposals, guidance and forecasting, is able to integrate both the assessment of the quality of the standards, the critical review of the improvements they make and the analytical elements able to preserve its economic interests. The EU should establish a more explicit framework for analysing the standards, which is not inconsistent with the fact that it retains a certain margin of discretion - desirable - in its final decision-making about the adoption of the standards.

In order to construct this channel, the new body should have two divisions, in charge of separate missions: firstly, a technical committee, whose composition would be similar to that of the current TEG, in other words, including persons with accounting competence but also representatives from the national standard setters, all with a voting right; and secondly, a committee to assess the economic impact of the standards, both under the responsibility of the board.

The field of intervention of the technical committee would be broader than it is at present: it would analyse not only the effects of the standard, but also the improvement or lack thereof, in the quality of financial reporting, analysis of alternative routes to those adopted by the IASB.

By taking into account the general European interest, the Economic Analysis Committee would be responsible for studying, beforehand, the potential impact of the draft standards, as well as the possible need for modified or new standards, on an economic basis. This should allow the European Commission to express its vision to the IASB, throughout the process of developing the standard, in order to obtain, if necessary, a change in direction.

3.3 Strengthen the institution's resources

This is achieved by optimising the powers through more intensive cooperation with national standard setters but also strengthening financial resources. Given the amount of work in the new institution, it would be desirable to plan to pay at least some of the members on a part-time basis. This would better ensure the quality of work but also preserve the ability of small countries to integrate operational and decision-making structures into the institution.

A significant increase in human and financial resources dedicated to the system is required, including the optimisation of existing facilities and ensuring that the whole standardisation chain is covered. This would also require accounting research to be united at European level, in close collaboration with the Commission (development of a genuine shared policy, networking of projects etc.). It should also establish a process aimed at identifying the "right people" for generating European candidates in all international accounting bodies.

3.4 Set clear missions and specifications

In addition to the link-up with the political dimension, the four main tasks of the new structure must be better established in order to cover the entire spectrum of standard setting:

- Definition, direction and coordination of accounting research in Europe
- Proactive work[13]
- Analysis of draft standards through to their *endorsement*
- The organisation of analytical work: trials on the ground *(field tests)*, in conjunction with the IASB *(outreach)*, post-implementation review and other impact assessments *etc.*

Specifications defined in consultation with the European structure and the national standard setters, should specify the terms of their cooperation for the organisation of proactive work as well as

[13] The EFRAG currently coordinates the more applied section of the research part, work which it would be worth continuing.

analytical and field works *(field tests, outreach* and *post-implementation review)* with the objectives being an optimised use of European and national resources and the ability to exploit the data collected as well as possible and in a standardised way in order to facilitate consolidation. The standardisation of working methods across the whole of the EU would also better prepare the European work.

3.5 Ensure a high level of cohesion within the system

A coherent, legitimate European voice that will be heard should be established, which means including all the stakeholders within the organisation and having strong decision making and analysis skills.

The two committees, technical and economic, should work in close collaboration, to help to ensure proper coordination of the positions expressed: avoid reducing the quality of the technical analysis in order to protect economic interests but on the contrary, seek to improve the technical proposals while preserving the economic interests of the EU.

The distribution of the work between the two committees and the monitoring of their work should be the responsibility of the Council, the coordination of which can be entrusted to a General Executive Director, under the leadership of a Chairperson responsible for ensuring the sound governance of the whole body. The board would endorse the report of the work undertaken by the Committees and the Chairperson would be responsible for expressing the positions externally.

3.6 Establish the credibility of this organisation

This requires high-level representatives and a high quality technical foundation. The hearings conducted to develop these proposals have in fact made it clear that the ability to influence a region in relation to the conceptual framework and the content of international standards is closely linked to the strength and quality of its accounting research and its technical teams.

To ensure the quality of its advice, it is necessary:

- to think carefully about the recruitment of members of the institution, with the help of nomination committees who focus their work on a search for competence, while ensuring a balance of power (representation of the various stakeholders but also a geographical balance)

- to prioritise the independence of members, placing them under the authority of the institution’s board, in order to promote credible positions while making synthesis possible,

- to make the board responsible for regularly assessing the quality of its governance so that it may be accountable for its actions to the General Assembly.

C. Revise the European regulation and reassert European sovereignty

1 Acquire the power to adapt the standard

- **Reform of the institutions and the governance of the European system would gain in legitimacy if it was supported by a review of the regulation**

It is possible to initiate the reform of the European system's institutions and governance described above with the current regulation: the criteria for adopting the standards and the modes of organisation of the technical work are described broadly enough in the current regulations to allow the European Commission to change the system without prior revision of the regulation.

However, the legitimacy of this reform would be enhanced by a revision of the regulation. This would enable broad guidelines to be set at the highest level of the texts, in order to allow the new structure to expand its activity, to review its criteria for adoption and add to them, to adapt, if necessary, the regulation as a result of changes introduced by the Lisbon Treaty, and to return to any other element deemed useful in addition to the ability to modify the standard.

- **Europe must have the ability to replace or modify an IFRS.**

The description of the systems for adopting and integrating the IFRS by other countries that have decided to apply international standards (see Context, part C.3), shows that few major jurisdictions have divested their accounting sovereignty. Most have retained the legal capacity to adapt a standard if they feel the need. In addition, major economic areas (USA, China, Japan) have maintained their accounting autonomy. Consequently, giving the EU the ability to modify or replace a standard, by revising the regulation, would only place it in the same position as other comparable jurisdictions.

Such an addition is fully complementary to the reform of the European system's institutions described above. Indeed, improving the system will increase European influence in the development of the IFRS, which should reduce the risk of being confronted with the IASB's publication of a standard that does not meet the needs of Europe. At the same time, the legal capacity to adapt the standard to cope with such a situation should it occur, would enable Europe to effectively protect its interests and to restore its sovereignty in accounting standards with all the cards in its hand to develop an alternative quality standard if necessary. With these two aspects of the reform, the EU would reduce its dependency vis-à-vis the IASB, while providing more resources for obtaining IFRS that meet its needs.

2 Strengthen the criteria for adopting the IFRS at European level

It is necessary that the EU develops its analysis of the criteria for adopting a standard, both by adding, if necessary, to the criteria currently identified in the regulations, but also by clarifying its position by giving some guidance in order to facilitate analytical work on the draft standards.

It would be appropriate to add two criteria to those set by the regulations, firstly, to ensure that the accounting standards adopted are not detrimental to financial stability and secondly, that they do not interfere with the economic development of the area. Indeed, any standard that would be detrimental to one of these two objectives should not pass the scrutiny of the criteria for adoption. Although we can consider that the public interest criteria covers these two points, it would be preferable, however, that financial stability, essential for the sound functioning of markets and economies, and ensuring therein the protection of investors, should be recognised as a criteria for evaluating the appropriateness of the accounting standards, like the objective of economic development. It should amend the regulation accordingly.

In addition, the EU would benefit from clarifying, in its theory, the purposes, principles and conditions to be met by the IFRS in order to be adopted with regard to these criteria, without trying to create a too rigid framework. It would facilitate the consideration of the major objectives that it also sets itself (e.g. white papers) and would provide a robust framework for the work of EFRAG.

3 Get the EU to negotiate bilateral agreements on mutual recognition of accounting standards based on the standards applied in Europe

Concurrently with the reform of the process of adopting standards, the EU must change its approach in relation to the mutual recognition of accounting standards and ensure that the agreements on equivalence between EU and third-party countries relate to the standards applied in that country and with the standards adopted by the EU and not with the IFRS as adopted by the IASB. Indeed, Regulation 1569/2007 of December 21, 2007, which establishes a mechanism for the determination of the equivalence of accounting standards under the requirements of the Prospectus Directive, provides for a foreign issuer being able to disclose data in a standard deemed equivalent to the IFRS.

The European Commission should take up the issue of the determination of equivalence. In this context, conversely this determination of equivalence should focus on the standards as adopted by the European Union. Reciprocally, the third-party country should recognise equivalence for the IFRS as adopted by the EU. This is both more coherent, because the EU must judge the equivalence of standards in third-party countries with regard to what it considers adequate to its own legislation, and fairer because otherwise European private stakeholders, especially companies, would be in difficulty if the EU decided to reject a standard. Indeed, in case of rejection of a standard by the EU, European companies listed abroad - including in the United States - would be required to make reconciliations or to establish a second set of financial statements, which must be avoided. The mutual recognition agreements should enable European companies to use standards that the EU has adopted, without reconciliations with other standards and without drawing up a second set of financial statements.

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Annex 1 - Interviewees

- Bernard Colasse (Paris Dauphine University)
- Vitor Constancio , Werner Studener, Jürgen Kirchhof (ECB)
- Philippe Danjou (IASB)
- Ramon Fernandez , Charles Sarrazin (French Ministry for the Economy &Finance)
- Françoise Flores (EFRAG)
- Olivier Guersent (European Commission)
- Laurent Guillot (Saint Gobain), Gervais Pellissier (Orange) (CFOs' Club des 30)
- Jérôme Haas (ANC)
- Hans Hoogervorst (IASB)
- Pascal Imbert (Middlenext)
- Guido Kerkhoff (ThyssenKrupp)
- Steven Maijoor, Laurent Degabriel, Roxana Damianov (ESMA)
- Didier Marteau (ESCP EAP)
- Philippe Maystadt (Advisor for European Commission)
- Didier Millerot, Anne-Françoise Melot (European Commission)
- Yves Nicolas, Christian Libéros, Mireille Berthelot (CNCC)
- Michel Prada (IFRS Foundation)
- Gérard Rameix, Patrick Parent (AMF)
- Philippe Richard, Jean-Jacques Dussutour, Philippe Bui, Frank Malek, Ludovic Lebrun (ACP)
- Yves Thibault de Silguy (Former Trustee IFRS Foundation)

Annex 2 – Accounting standards and the crisis

The succession of crises that began with the subprime crisis in the United States in the second half of 2007 has cast harsh light on the role played in these crises by accounting standards, international standards or local ones in the United States, and on the use of certain accounting methods and valuation based on market prices.

No one is claiming that the crises were triggered by accounting standards, but there are many who believe accounting can have a procyclical role according to the system of valuation selected, by encouraging and supporting the formation of financial bubbles that go on to burst and by precipitating the spread of crises when confidence is undermined.

The mechanism

The mechanism is now well known and analysed by many observers. The mass distribution of risky mortgage loans to borrowers with limited repayment capacity, combined with the securitization of these loans, formed the basis for the crisis. The valuation at market or model prices of loan portfolio models or structured securities held by securitization vehicles has, in the pre-crisis period, allowed much more significant profits to be posted, especially given that the demand for these products loosened the conditions for new issues, the market no longer perceiving the attached risks.

The appearance of losses, larger than those envisaged by the rating agencies, and the difficulties of major issuers of subprime loans changed investors' feelings about these products in August 2007: their abrupt withdrawal from these markets led to the collapse of market prices thus creating a serious problem of accounting valuation of instruments whose values given by the market did not reflect the intrinsic value, creating difficulties for managers of savings, securities, banks and insurance companies, and prompting investors to withdraw the fund assets where they had placed their cash.

This movement, amplified by the mimetic behaviour of investors, led to these funds, banks and insurers selling the assets required to repay depositors in markets that were already dry and unbalanced by supply hugely outstripping demand. Losses from these forced transfers accentuated the seller behaviour of investors and further exacerbated the imbalance in the markets.

Despite these virtues, the exclusive use of market value as a "fair value" undoubtedly contributed initially to encouraging the accumulation of unrealised profit, feeding bonuses and dividends, then to accelerating and amplifying the crisis in the markets where an assumed efficiency failed to deliver.

Measures taken in haste

The scale and suddenness of a crisis that the markets had not expected suggest a number of measures to the authorities:

- The report from the "Financial Stability Forum" (FSB) given to the G7 in April 2008, which was based on hearings in front of United States parliament committees in October 2007 recommends, among other measures, clarifying and limiting the use of fair value.

- In October 2008, the Paulson plan granted the SEC the authority to suspend the application of fair value for "reasons of general interest" and "investor protection"[14]. It advocated the study of the economic consequences that this method of accounting for companies has on the balance sheet and on the economic system as a whole.

- Meanwhile in Europe, the IASB is forced to return to the accounting of financial instruments at fair value by allowing their reclassification in accordance with historical cost accounting.

- As far as the FASB is concerned, in April 2009, it authorised financial intermediaries to record certain financial assets not at market value, but rather at an estimated value using financial valuation models to correct market excesses and therefore prioritise intrinsic value. This will help alleviate the criticisms relating to the responsibility of accounting standards in the deepening crisis[15].

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[14] Emergency Economic Stabilization Act of 2008, 3 October 2008, Sec. 132. Authority to suspend mark-to-market accounting: “(a) AUTHORITY. – The Securities and Exchange Commission shall have the authority under the securities laws (as such term is defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47)) to suspend, by rule, regulation, or order, the application of Statement Number 157 of the Financial Accounting Standards Board [concerned with fair value measurements, NdA] for any issuer (as such term is defined in section 3(a)(8) of such Act) or with respect to any class or category of transaction if the Commission determines that is necessary or appropriate in the public interest and is consistent with the protection of investors.”

[15] See « Banks get leeway in valuing their assets », the New York Times, 3 April 2009. Cited by the authors (V. Bignou, Y. Biondi, X. Ragot) in "An economic analysis of "fair value". Accounting as a crisis medium"

Annex 3 - IFRS's use around the world

Country / Theme	Type of process Endorsement vs. Incorporation [1]	IFRS compliance status to date	Can the endorsement / incorporation process result in divergence from IFRS? (theoretically)	Are there actual divergences from IFRS as published by the IASB?		Scope of applicability	Timing of endorsement / incorporation
Australia	Incorporation AAS	Compliance (IAS 26 not adopted)	Rejection Modification Replacement	Minimal	Removal of some options Additional guidance Domestic issues	All companies	Same as IASB
Brazil	Endorsement	Compliance	Modification	Minimal	Removal of some options (e.g.: revaluation of PP&E not permitted)	Listed companies Most financial institutions	Same as IASB No early application
Canada	Endorsement	Compliance	Rejection Modification Replacement	None	-	Listed companies (mandatory) Private enterprises and not-for-profit organisations (voluntary application)	On a timely basis
China	Incorporation (of main principles) CAS	Convergence	Rejection Modification Replacement	Major	Main principals rewritten Additional guidance No reversing of impairment Related-party disclosure	Listed companies	During the year a standard becomes effective
European Union	Endorsement	Compliance	Rejection Modification (only deletions)	Minimal	IAS 39 Carve-Out	Listed companies	Around 10 months (timing can vary, depending on how complex/controversial the standard is)
Hong-Kong	Incorporation HKFRS	Compliance (IFRS 1 not adopted)	Rejection Modification Replacement	Minimal	Additional guidance Removal of some options	Publicly quoted companies (mandatory) Other private companies (voluntary application)	Same as IASB
India	Incorporation Ind AS	Convergence	-	-	-	-	-
Japan	Endorsement	Compliance (IFRS not mandatory yet)	Rejection Modification Replacement	None	-	Listed companies (voluntary application)	Within 1 year from standard's release date
Korea	Incorporation K-IFRS	Compliance	Rejection Modification (only additions)	Minimal	Further disclosures Presentation clarifications	Listed companies, financial institutions, state-owned companies (mandatory) Unlisted companies (voluntary application)	Same as IASB
Malaysia	Incorporation MFRS	Compliance	Rejection	None	-	Non-private companies (mandatory) Private entities (voluntary application) Financial institutions apply the central bank's guidelines which can be different from MFRS	Same as IASB

Annex 3 - IFRS's use around the world

Country / Theme	Type of process Endorsement vs. Incorporation (1)	IFRS compliance status to date	Can the endorsement / incorporation process result in divergence from IFRS? (theoretically)	Are there actual divergences from IFRS as published by the IASB?		Scope of applicability	Timing of endorsement / incorporation
Mexico	Endorsement	Compliance	Rejection Modification Replacement	None	-	Listed companies (mandatory) Private companies (voluntary application) Companies belonging to the financial and insurance sectors use Mexican Financial Reporting Standards which can be different from IFRS	Same as IASB
New-Zealand	Incorporation NZ IFRS	Compliance	Rejection Modification	Minimal	Reduced measurement and disclosure regime for unlisted companies and small for-profit public sector companies Additional or amended accounting recognition and measurement requirements for unlisted small companies Removal of some options	Listed and large companies Large for-profit public sector companies (mandatory) Unlisted small companies (voluntary application)	Same as IASB
Russia	Endorsement	Compliance	Rejection Modification	Minimal	Reporting period restricted to calendar year	Credit institutions Insurance companies Listed companies Companies required to publish consolidated financial statements (mandatory)	Same as IASB
Singapore	Incorporation SFRS	Compliance (IFRIC 2 not adopted yet)	Rejection Modification	Minimal	Transitional provisions Effective dates (IFRS 10/11/12) Local adaptations (IFRIC 15, IAS 12)	All companies apply SFRS Listed companies can apply IFRS if they are traded on a foreign stock exchange that requires IFRS Other companies can apply IFRS by exemption	Close to that of the IASB
South Africa	Endorsement	Compliance	Rejection	None	-	Listed companies (mandatory)	Same as IASB
Thailand	Incorporation TFRS	Compliance (IFRS as published in 2009 for the moment)	No	None	-	Listed companies (mandatory)	1 to 2 years from publication by IASB
USA	-	-	-	-	-	Foreign private issuers Unlisted private companies (voluntary application)	-

(1) Endorsement: standards published by the IASB are referred to in the local law/regulation
Incorporation: standards published by the IASB are integrated in a local GAAP

Document prepared based on a survey conducted by PwC in February 2013 and the IFRS's Foundation survey (http://www.ifrs.org/Use-around-the-world/Pages/Jurisdiction-profiles.aspx)