

Accounting in Crisis
Remarks by Paul A. Volcker,
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There are a number of reasons why I welcome this chance to visit with the European Commission. I've followed your progress from a common market to a broader economic community to the European Union for decades. The crowning economic achievement of a common currency is both historic, and in my view healthy and constructive, whatever its recent performance in the exchange markets.

Today, I have rather more prosaic things on my mind - at least they used to be thought prosaic. Accounting has never been high on the scale of excitement, at least until recently. But here we are, front-page news right around the world, with both human drama and profound implications for capital markets and the efficiency and effectiveness of global finance.

The fact is the collapse of Enron and the new sense of crisis only exemplify problems that have increasingly plagued the accounting profession for years. Those problems are plainly not limited to one company, one auditing firm, or one country. Nor are they matters for accounting and accountants alone. Long before Enron hit the headlines, one could read on almost a daily basis, in both the United States and in Europe, of restatements of earnings, of sudden and massive write downs of intangibles, the growing use of "pro forma" earnings that seemed to come uncannily close to analysts estimates while departing sharply from the U.S. GAAP or IAS bottom line.

As policymakers, we have endlessly lectured emerging economies about the importance of transparency, good accounting, and ending cronyism. Confidence in the financial reporting system is, we rightly point out, an essential element in ensuring that markets are allocating capital effectively, internationally as well as domestically. In a well-functioning, disciplined financial system, we shouldn't be surprised by shoddy bookkeeping.

And, now we discover, those lectures apply at home - even in the United States where we have taken such pride in our accounting standards and practices and in our open and active securities markets.

Specifically, the United States has long hailed its own accounting standards, US GAAP, as the model for the rest of the world to follow. The managers of the major auditing firms are headquartered in New York. Our markets have indeed thrived - in the midst of the greatest boom in all of history. Our critical faculties were dulled.

With the shock of the Enron failure- with the barrage of news about that and other failures day-by-day for months - all of that has changed.

Don't misunderstand. Virtually every auditor and every audit firm still feels that the U.S. has the best and most comprehensive set of accounting standards worldwide and a history of sensitivity to investor protection. But obviously what may be relatively best is not good enough. Everything is on the table - the structure of the auditing profession, the accounting standards, our enforcement mechanisms, and even the style which accounting standards are set out - whether the emphasis is on matters of principle or detail.

The silver lining in the Enron crisis in the U.S. is that we have an opportunity for real reform.

In that respect, I would offer a word of caution. If you are tempted to think that the crisis facing accounting is limited to the United States, you are misled. The occasional suggestion that wholesale adoption of existing international accounting standards would be a "cure all" has no foundation. I make that point as one who has a certain responsibility for overseeing those standards and working toward their improvement.

Our aim is to work toward fully credible international standards -- with the end product something that all countries can accept as "best of breed."

Clearly, I would not be here if I did not believe that to be a practical and worthwhile objective. Well-developed global standards would be a major step forward. These standards would help discipline auditing practices, ease

their enforcement, and assist analysts and investors in allocating capital to where it can do the most good. That is the main impetus behind the restructuring of the IASC. I am delighted that the EU has so clearly recognized the potential benefits.

You have recognized both the essential need for a common approach within the Union - and the desirability of conforming to broader international practice.

Inevitably, it will take time to reach the goal. But we are making progress. The new International Accounting Standards Board (IASB), whose oversight Trustees I chair, is very much aware of the 2005 deadline being set by the European Union for your adoption of the International Standards. The present turmoil in the United States provides further powerful impetus, incentive, and relevance to our work.

In my roles as a treasury official, central banker, director of companies in the U.S. and Europe -- most recently in my roles in the accounting world -- I have seen first hand the pressures and the challenges facing the accounting profession. The problems are systemic. They grow in part out of the enormous complications of new financial instruments and techniques. A whole new profession of financial engineering has been spawned, dedicated to the proposition of finding exotic ways around accounting or tax conventions. They are not specific to the United States and therefore make the idea of "can't happen here" attitudes seem a little shortsighted, to be blunt.

The fact is that the accounting profession has been hard-pressed to keep up with the growing complexity of business and finance -- with its mind-bending complications of abstruse derivatives, seemingly endless varieties of securitizations, and multiplying off-balance sheet entities -- and it has been subject to strong political and financial pressures as well.

The Three Pillars

I think of good financial reporting as resting on three pillars:

- Accounting standards setting out with clarity logically consistent and comprehensive "rules of the game" that reasonably reflect underlying economic reality.
- Accounting and auditing practices and policies able to translate those standards into accurate, understandable, and timely reports by individual public companies.
- A legislative and regulatory framework capable of providing and maintaining needed discipline.

Standard Setting

It is the first of those pillars that I have been directly involved with over the past 20 months.

The general case for international accounting standards has been clear for a long time. In a world of global finance, we have a strong interest in encouraging high quality standards every place our companies do business. We want to avoid distortions in the international flow of capital because of mis-information or lack of information. Not least, a single set of standards would minimize compliance costs for companies and, I believe, assist enforcement. In Europe, the case is particularly strong, because of the desire to build a common market where capital moves freely over national borders.

The European Union has provided leadership in the move to international standards with its pending proposal to make these standards mandatory for publicly listed companies. This has made a real impression in Washington. Members of Congress and regulators are now reevaluating U.S. attitudes to accounting standards. The easy assumption for years is past -- that "made in the USA" is somehow automatically best, and that the mere size of our markets and our economy will force others to fall in line. The fact that the unified European economy is comparable in size is beginning to dawn, and with it the potential as an equally large and active source of capital.

In light of the evident crisis much has been made of the time that standard setters have taken in adapting their standards to current business developments and needs. Conversely, there are claims of inadequate consultation, and concern that those perceiving harm to their interests might withdraw financial support or lobby their legislators for preemptive action. In the United States, as well as

elsewhere, we can now appreciate that change has been too slow and suspicions of political compromise damage confidence in the process.

In this context, there is a real opportunity for a reinvigorated international effort. A new highly professional organization is in place. It has strong backing from industry and governments around the world. Given its strong staffing and organizational safeguards, the IASC framework should be able to maintain high credibility. In its key components - the oversight committee I chair, the standard setting board chaired by Sir David Tweedie, its advisory council and interpretations committee - it can command the best professional advice, international representation, and appropriate independence.

I want to assure you that our intent is to move beyond compromise among existing standards or convergence for convergence's sake. To be sure we will work to ensure proper consultation with all interested parties, most especially existing national standard setters, including those within the European Union. Specifically the IASB has established three official relationships with national standard setters in Europe -- France, Germany, and the United Kingdom -- and board members who have fluency in the appropriate languages have been assigned to liase with both standard setters and industry in the other 12 countries of the European Union and in other European countries. In addition, the IASB receives input from European members of the Standards Advisory Council -- 14 of the total of 49. The SAC includes members from Belgium, Estonia, Finland, France, Germany, Italy, the Netherlands, Russia, Spain, and Sweden. The Trustees of the IASC Foundation have recently selected four (of twelve) members from the European Union to serve on the International Financial Reporting Interpretations Committee.

I have read with interest Commissioner Bolkestein's call for the U.S. to accept international accounting standards for listing purposes. That in fact is one of my own wishes - I would not otherwise be chairing the International Trustees. Realistically, that will take time. We have to build the credibility of the International Standards. We have to overcome residual suspicions that the object is somehow to weaken U.S. GAAP. But I am convinced that time and events are with us. I do not know whether we will meet your timetable. What I do

know is that the U.S. Securities and Exchange Commission is taking a hard look at the progress at the IASB.

Furthermore, the SEC and those interested in good corporate governance will be looking to see that the IASB will have the freedom to operate without the threat of political pressures compromising the judgments of the Board. I recognize that it will be difficult at times to accept some of the decisions of the IASB on some of the most controversial issues facing accounting. However, if professional and independent standard setting is to work, we must accept and respect the outcome of a process that incorporates adequate consultation, follows established decision-making procedures, and, most importantly, is well reasoned.

Restoring Confidence in the Auditing Profession

Broadly accepted, up-to-date international standards will help discipline the auditing process and encourage effective and consistent enforcement by national and international authorities.

Yet there is no escaping the fact, in the end, the accuracy and reliance of financial reporting lies in the hands of the auditors themselves. They are the ones who must interpret and apply the standards and protect their integrity. They are the ones to which the investing public must look to ask the tough questions, to demand the answers and to faithfully certify that at the end of the day -- or the quarter or year -- the financial results of a company are fully and clearly reported.

As you may be aware, I have recently agreed with Andersen International to chair an Independent Oversight Board, with broad responsibilities to work with the company in reviewing and reforming its auditing practices and policies. I don't minimize the challenge for Andersen or for other firms. Auditors individually and the auditing profession generally have been subject to strong and conflicting pressures. Company management urgently wants to present results in the most favorable light to meet market expectations. The temptation to stretch to demonstrate a consistent pattern of earnings is real. Too often the

emphasis is on finding ways to meet the letter of the technical accounting requirements at the risk of violating the spirit. Large and profitable consulting assignments may, even subconsciously, affect auditor judgment. Companies want to minimize accounting costs. Directors and auditing committees may not be sufficiently knowledgeable or attentive - that is until it's too late.

All this raises questions of the internal management and policies of auditing firms, matters with which I am only beginning to grapple. How can the auditing functions and "technical" accounting decisions be protected from extraneous influence? Can strong safeguards be put in place against other business interests intruding on the auditing process? What are the appropriate limits on non-auditing services performed by an auditing firm to avoid the perception or reality of an unacceptable conflict?

These are questions relevant to all auditing firms, to all businesses, to all countries.

The Enforcement Challenge

High quality standards and improved audit practices should go a long way toward enforcement. However, there are areas where it may be difficult or impossible for any one firm to proceed alone. Hence, there is a need for official regulation. We Americans have long seen our SEC as the example of effective regulation of securities markets. But we can no longer blind ourselves to our own weaknesses. Crises are the antidote to complacency, and I feel certain that recent events will stimulate more effective supervision of auditing firms and practices, including a new regulatory body with independent commissioners, adequate funding and a meaningful disciplinary process. In parallel fashion, it seems to me particularly important for the European Union to develop a regulatory and enforcement mechanism with adequate resources that can span the whole of the member states.

In sum, I emphasize again that the crisis in the accounting and auditing professions is not a matter of the failure of a single company or perceived problems in a single audit. It demands attention to serious problems endemic to a world of global capitalism. The enormous and growing complexities of capital markets, the strong and insidious pressures on individuals and their companies to

stretch behavior to meet financial expectations, and weaknesses in accounting standards and enforcement demand attention.

To fail to respond to that challenge would indeed have serious implications for maintaining confidence in markets, for the cost of capital and for the global economy.

The development of truly international accounting standards - building on the best that now exists and responsive to new needs - can be and should be one key element in the needed reforms.

The restructured IASC is in large part a result of initiatives taken by the European Commission and the U.S. SEC.

I trust that support will not weaken. Rather, as you examine the implications of the current crisis and the range of appropriate remedies, I hope you will help reinforce the effort to reach international convergence, recognizing its potential for improving accounting and auditing practices.