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# Accounting for Stakeholders or Shareholders? The Case of R&D Reporting

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# Accounting for Stakeholders or Shareholders? The Case of R&D Reporting

## Abstract

Accounting numbers (and especially net income, equity or total assets) are based on conventions that are shaped by accounting standard setters. Elected choices result from a trade-off between the information needs of various stakeholders. This paper investigates how accounting choices meet the information needs of various stakeholders. Analyzing the R&D policy of Renault, one of the largest carmakers in Europe, over ten years (from 2002 to 2011), the paper illustrates how Renault modifies its R&D accounting policy from total expensing (a static convention) to capitalization (a dynamic convention), coping with the shift from State capitalism dominance to professional shareholder emphasis. Our findings are based on a content analysis of analysts' reactions to Renault accounting choices as well an extensive analysis of the documentation related to Renault (annual reports, presentations to analysts, conference call transcripts). Interestingly, while the R&D capitalization, promoted by the international accounting standard setter (the International Accounting Standards Board - IASB) in line with its advocacy of investors' interest as the principal recipient of accounting information, is supposed to help investors better understand the firm future cash flow, Renault's choice has been constantly challenged, even doubted by analysts. Our findings contradict the conventional wisdom in which shareholders should prefer *dynamic* conventions of accounting over *static* conventions while from its inception, the IASB purposely decided to favor investors over other stakeholders and promoted dynamic options of accounting choices.

Key words. Stakeholder, R&D capitalization, Renault, accounting

# 1. INTRODUCTION

Accounting systems are designed to provide useful information to a large set of stakeholders ranging from shareholders, creditors, customers, suppliers, debt holders, government or the general public. Meeting the information needs of these various stakeholders has long been recognized as impossible as information needs of these stakeholders are not necessarily compatible. For instance, banks may prefer to know the liquidation value of the firm's assets (to assess the value of their collateral for instance) whereas shareholders might be more interested in knowing the future value of the assets (Ding et al., 2008, p. 724-25).

Even if the investor primacy principle has been advocated by the international accounting standard setter, the IASB (International Accounting Standards Board), over many years, it has also been extensively criticized. According to Gaa (1986), this primacy principle can be *rationaly* justified “with a set of fairly plausible assumptions about the securities market” (Gaa, 1986, p. 452). However, Gaa (1986) points that this conclusion depends on the acceptability of its premises. As noted by Young (2006), standard setters assume that users are rational economic beings. These “calculative” users are also supposed to request disclosures that will assist them in making their own judgments in order to calculate values and risks as well as to form predictions about the future cash flows.

However, the information needs of users (investors) of financial information are assumed rather than empirically explored: “More frequently, [the standard setter] speaks for users and expresses its beliefs about the information that [users] should require and the accountings that should best serve their interests. Statements about these beliefs act as a partial justification for different accounting and disclosure requirements” (Young, 2006, p. 593). To some extent, this conclusion is confirmed by Cascino et al. (2013) who surveyed the literature on how information is used by capital providers. Their overall conclusion is that there is much to be investigated on how various classes of investors (bank, shareholders, creditors, and analysts) actually used information.

In this paper we inquire how accounting choices satisfy (or not) the information needs of various stakeholders. From a normative perspective, assets can be recognized in a balance sheet under a continuum of approaches from a pure static theory to a dynamic approach. Under the *pure static theory*, for the sake of creditor protection, a balance sheet shows the liquidation values of assets. This implies that an intangible asset is a fictitious asset (because it can't be easily sold) and should be expensed (recognized in the income statement). By contrast, a dynamic theory puts the emphasis on the going concern. Under this approach, the main purpose of the financial statements is no longer to record liquidation value but rather to

present a net income that is informative of future cash flows. A practical implication of this dynamic theory is that intangible assets should be recorded as long as they are expected to generate future cash flows. Consistent with the assumption that investors are calculative and rational, the IASB decided to adopt a dynamic approach as it requires that all development outlays for which future cash flows can be reasonably expected must be recognized as assets and not as expenses.

We test this conjecture by analyzing the R&D policy of Renault, one of the largest carmakers in Europe, over ten years (from 2002 to 2011). Since its IPO in 1994, Renault has experienced a rise in the investors' importance after the progressive withdrawal of the State as a major shareholder of the firm. Consistent with what found in the previous studies (Mitchell et al., 1997, p. 873; Agle et al., 1999; Brammer and Millington, 2004; Clement, 2005, p. 259; Su et al., 2007, p. 307), we document that investors can be perceived as a "salient" shareholder, on other words one of the "stakeholder groups [that] matter most" (e.g., Mitchell et al., 1997; Mitchell et al., 2011).

Renault decided to adapt its R&D accounting policies to the rise of the investor pressure. As predicted by the accounting literature, Renault switched its reporting policy for R&D activities to a convention where successful R&D outlays are considered as assets rather than expenses. Renault decided to capitalize R&D as early as 2002, when such treatment was optional. According to the literature in accounting (Lev and Sougiannis, 1996; Aboody and Lev, 1998), this accounting treatment is supposed to satisfy information needs from shareholders as it indicates that Renault expects future revenues from its R&D activities. Vis-à-vis full expensing, capitalization immediately boosts earnings (as no expense is recorded) but, in the long run, the R&D asset will be amortized (which will therefore lower earnings).

From a normative point of view, such a change is supposed to be beneficial to shareholders as it represents a move towards a dynamic model of recording transactions. We gauge shareholders attitude towards this accounting change by studying analyst's reactions. Financial analysts are supposed to be financially literate and to proxy the knowledgeable investor. During CEO – Analysts meetings (conference calls), many analysts questioned this new accounting policy all the more that the effect of R&D capitalization on Renault's operating margin is much more pronounced than for its competitors (e.g., Peugeot). Net income increased and the successive CEOs of Renault were able to meet their operating margin objectives by capitalizing an important portion of their R&D outlays. However, from 2007, the net effect of R&D capitalization began to reverse and was negative. As a consequence, after a questioning phase, analysts started to accuse Renault's management of manipulating earnings. Especially, analysts began to realize that firm objectives were met

because Renault's policy in terms of R&D capitalization was more aggressive than its competitors.

The study makes three contributions to existing stakeholder literature. First, we add to the literature on the information needs of shareholders. As shown by Young (2006), information needs of shareholders are "constructed" by standard setters with little or no reference to the actual information needs of investors. If the empirical literature on how markets react to the disclosure of information, little is known on which information is actually useful to the various stakeholders (Cascino et al., 2013). If investors are assumed to be rational and to prefer information that eases their assessment of future cash flows (i.e., dynamic model conventions). We show that these assumptions are probably too strong, at least as far as R&D reporting is concerned.

Second, our study is a first step towards a better understanding of the relationships between accounting information and the various stakeholders. According to Parmar et al. (2010, p. 422-25), most of the development of the stakeholder theory in accounting relates to the development of corporate social reporting, which extends the traditional boundaries of accounting to address the information needs of stakeholders. Our article contributes to this literature in showing that even within the traditional boundaries of financial reporting (the production of financial statements), there is room for a better understanding of the various stakeholder interests. In a way, our paper extends Gaa (1986) who shows that accounting choice reflects a social choice.

Last, we also contribute to what Agle and Mitchell (2008) call the literature on the "basic debate (stakeholder vs. stockholder)" (p. 154) or "normative stakeholder vs. stockholder theory" (p. 155). Our case sheds light on the fact that the opposition between shareholder and stakeholder is not always clear-cut. As far as R&D reporting is concerned, information needs expressed by financial analysts (proxy of investors) are not inconsistent with other stakeholders.

The remainder of this paper is organized as follows. We first link the literature on stakeholder importance to that on accounting models (static versus dynamic); in the third section, we lay out our methodology before presenting how shareholders became the dominant stakeholder in Renault during the nineties in the fourth section. In the fifth section, we study the new R&D rules of Renault as well as how analysts reacted to it. The sixth section discusses our results and concludes the paper.

## 2. STAKEHOLDER AND SHAREHOLDER MODELS AND THE BALANCE SHEET THEORIES

### 2.1 Stakeholder and Shareholder Models

The “stakeholder theory” has extensively developed since the seminal work of Freeman (1984), despite some debate or criticism (Jensen, 2001; Friedman and Miles, 2002). In his “stakeholder view of firm”, Freeman (1984, p. 25) defines a stakeholder as “any group or individual who can affect or is affected by the achievement of the firm’s objectives”. He provides in figure 1.5 a list of 11 examples of categories of stakeholders (e.g., owners, employees, customers, suppliers...). Mitchell et al. (1997, p. 853-54) refine this list by adding several distinctions (e.g., owners and nonowners of the firm; owners of capital or owners of less tangible assets; resource providers to or dependents of the firm, etc.). They provided (p. 858) a chronology of the definitions of stakeholders. Among the stakeholders identified by the literature<sup>1</sup>, one category, the owners, is of particular interest for our research. The owners, which can be also called “investors”, “stockholders” (terminology used by Freeman (1984)) or “shareholders” (the terminology that we will use in this paper as in Parmar et al. (2010, p. 419)), represent a particular category of stakeholders because they are at the origin of the firm. However, the role, not to say the prominence, of the shareholders among the different stakeholders has been highly debated as an opposition between the shareholder and the stakeholder models.

Freeman (1984, p. 101-04) defines five generic strategies for the firm as being tradeoffs “about the relative importance of the stakeholder concerns, values and social issues”. Among these, the “utilitarian strategy” aims at maximizing benefits to all stakeholders, as well as the average welfare level of all stakeholders and benefits to society. We will call this strategy, for the sake of simplification, the “stakeholder model”. Another strategy identified by Freeman (1984, p. 103) is the “stockholder strategy”. The essence of this strategy is “to maximize returns to stockholders”, or if interpreted more broadly, “to maximize the value of the firm”. We will call this strategy “shareholder strategy” in the rest of this article. This includes namely the increase in the distribution of dividends and the specific attention paid to short – term performance measures (Freeman, 1984, p. 104).

As recalled by Agle and Mitchell (2008), the opposition between the stakeholder and shareholder models (or strategies) have long been subject to debate and the primary objective

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<sup>1</sup> For a review on the stakeholder theory, see Clement (2005), Parmar et al. (2010) and Freeman et al. (2010).

of the “debate” strand of stakeholder-theory research has been to address assertions about the relative contributions or privileges of stakeholders and stockholders (Freeman and Reed, 1983; Phillips et al., 2003; Smith, 2003; Freeman et al., 2004).

Freeman et al. (2010, p. 138) recall that “accounting researchers have also examined the influence of different international contexts in terms of whether they support a pure stakeholder or multi-stakeholder orientation” (e.g., Ball et al., 2000). This research stream tends to show “that the US financial system is oriented almost exclusively towards shareholders, so that its accounting regulations and requirements are focused on providing shareholders with the information they require. In contrast, other countries support a culture in which the needs of a broader group of stakeholders are taken into consideration”. However, Ding et al. (2008) show that this difference between the US (representing common law countries) and other countries( mostly code countries) is not so clear-cut.

## **2.2 Balance Sheet Theories**

Ding et al. (2008, p. 724-25) present several conceptions of the balance sheet inspired by continental European balance sheet theories (see also Richard, 2005) and suggest the following typology, that we adapted to our research question:

- (1) “Pure static balance sheet”: the balance sheet, for the sake of creditor protection, shows liquidation values. This implies, if R&D outlays are capitalized and considered as an intangible asset, that this asset is a fictitious asset and should be expensed in the income statement of the year or amortized rapidly (over 5 years).
- (2) “Weakened static balance sheet”: this is a variation on the previous theory and an adjusted form of non-recognition of intangible assets. The R&D outlays, instead of being expensed in the income statement, are written-off against equity. The impact is the same in terms on non-recognition in the assets but different with regard to the impact on the income statement: in the pure static balance sheet theory, the R&D outlays are expensed in the income statement and the income of the period is decreased by that amount whereas with the “weakened static balance sheet” theory, these outlays are deducted from equity, having consequently no impact on the income of the period. However, it should be noted this solution is not accepted by any accounting standard for R&D outlays.<sup>2</sup>

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<sup>2</sup> It had been accepted in the past for goodwill but most of the current accounting standards, including the IFRS (IAS 38, IASB, 2004) do not allow it.



- (3) “Dynamic balance sheet”: the emphasis is placed on the going concern (dynamic) approach, although an intangible asset is still assumed to have a finite life. This implies the recognition of R&D outlays of an asset (capitalization of R&D outlays), with application of an amortization over a long period.
- (4) “Actuarial balance sheet”: the going concern assumption is applied but without the idea that an intangible asset can “die”, leading to the recognition of an asset with no amortization at all, but with an impairment testing, i.e., the recognition of an expense in case of a sudden loss in value of the recognized intangible “capitalized R&D asset”.

### **2.3 Stakeholder/Shareholder Models Applied to R&D Capitalization**

Whereas Ding et al. (2008) apply the stakeholder/shareholder models and balance sheet theories to goodwill, we relate the two models and these theories to R&D capitalization which, although being related to intangible assets, as is goodwill, present several differences with the case of goodwill.

Stakeholders, mainly blockholders such as families, state, banks or employees, often represent a long-term commitment to the firm, and favor the absence of “fictitious assets” from the balance sheet. Hence their preference for the static balance sheet, i.e., for the non-recognition of R&D outlays as capitalized R&D in the balance sheet. Conversely, shareholders, and more specifically “professional shareholders” (as opposed to family shareholders) are generally short-term oriented and expect immediate, maximum profits. In this context, they should, in theory, favor capitalization and the non-amortization of R&D (actuarial balance sheet). However, given that no accounting standard in the world ever accepted this solution, shareholders accept the capitalization and amortization of R&D (dynamic balance sheet).

Therefore, meeting the information needs of these various stakeholders with one R&D accounting policy is impossible as information needs of these stakeholders are not compatible. For instance, Benjamin and Stanga (1977) compared the information needs of financial analysts with those of loan officers in banks for 79 kinds of information that might be disclosed in financial reports. They find that that the needs of financial analysts and bankers differed in 51 of 79 of the disclosure items (64.6%).

The international accounting standard setter has recognized the inconsistency of the various information needs since its creation in 1973. In other words, accounting standard setters must make the trade-off between various information needs and chose conventions that

will determine accounting numbers (and especially net income, equity or total assets). The IASB purposely decided to favor information needs from investors over other stakeholders.

*“While all the information needs of the users of financial statements (present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public) cannot conceivably be met by only one set of financial statements, there are needs that are common to all users,”* The IASB, one of the two main accounting regulators in the world,<sup>3</sup> explained, during the period under study in this research, that, *“as investors are providers of risk capital to the enterprise, the provision of financial statements that meet their needs and expectations will also likely meet many or most of the needs of other users who are interested in estimating risks and potential rewards attached to the operations of a given enterprise”* (see IASC, 1989, § 10). In other words, investors alone were considered to be the primary users of financial information (see Stolowy et al., 2013).<sup>4</sup>

As a result, instead of allowing firms expensing totally the current-year R&D expenses, the IASB opts to dynamic convention: According to IAS 38 (IASB, 2004, § 57), *“an intangible asset arising from development (or from the development phase of an internal project) shall be recognized if, and only if”* six criteria are met. Although one may argue the achievement of these six criteria relies on the subjective judgment by the firm, the wording ‘shall’ is important here as it implies that capitalization of R&D is required if the six above-mentioned criteria are met.

Meanwhile, to the best of our knowledge, the preference for dynamic/actuarial conventions by investors is largely assumed rather than empirically validated in the extant literature. According to Young (2006, p. 589), the “user” referred to by standard setter is “an idea or a type rather than a physical being”. Physical beings (referred to as “readers”) remain enigmas and the way they use accounting information in reaching their decisions is essentially a “black box”.

Moreover, these accounting choices should not only reflect the importance given to the dominance of shareholders, but also offer the means in order to correct the excess of their dominance, by imposing both the legal check done by auditors and the scrutiny operated by financial analysts. The R&D capitalization signals that the related firm expects future revenues from its R&D activities and therefore offers a better informativeness to the

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<sup>3</sup> The other one is the U.S. Financial Accounting Standards Board (FASB).

<sup>4</sup> The position taken on this issue in 2010 differs from that the IASC (predecessor to the IASB) held in its 1989 Conceptual Framework. The revised framework explains that many existing and potential investors, lenders and other creditors cannot require reporting entities to provide information directly to them and must rely on general purpose financial reports for much of the financial information they need. Consequently, they are the primary users to whom general purpose financial reports are directed (see IASB, 2010, § OB5).

shareholders in their assessment on firm's future cash flow. Nevertheless, the subjectivity in the assessment of the capitalization criteria might make external (professional) shareholders skeptical because of the information asymmetry. Therefore, it remains an empirical issue if shareholders truly prefer the dynamic convention adopted by the standard setters in R&D accounting.

### **3. RESEARCH METHODS**

#### **3.1 Value of a Case Study**

As explained by Yin (2009, p. 4), “as a research method, the case study is used in many situations to contribute to [the] knowledge of individual, group organization, social, political, and related phenomena. [...] The distinctive need for case studies arises out of the desire to understand complex social phenomena. [...] the case study method allows investigators to retain the holistic and meaningful characteristics of real-life events - such as [...] organizational and managerial processes”. Case studies allow to address the “task of understanding and theorizing the content, processes and context of the practice of accounting” (Berry and Otley, 2004, p. 231).

Case studies can also help researchers respond to the challenges made about the practical relevance and the progressive scientific achievements of accounting research and can contribute to relevant knowledge. (Cooper and Morgan, 2008, p. 159).

#### **3.2 Research Material**

Beginning with the year 2001 (one year before the triggering event of R&D capitalization), we analyzed 11 years of annual reports<sup>5</sup>, from 2001 to 2011. From the annual reports, we extracted R&D levels, the accounting treatment of R&D and some accounting measures of performance. From the Renault website, we extracted all presentations to analysts from 2002 to 2012. This set of documents provided the salient facts put forward by Renault to inform financial analysts.

From Thomson research we also downloaded the 30 available transcripts of conference calls held between October 2004 and June 2012, and identified all occurrences of the terms “R&D” and “capitalization”. For each occurrence, we read the related question and answer to identify “significant occurrences”. Conference calls usually consist of a presentation of results

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<sup>5</sup> The annual report is sometimes included in a broader document called the “Registration document”, which is filed with the AMF (French Financial Markets Authority).

by the firm, and a Q&A session with analysts. Analysts are free to ask any questions they believe relevant.

In our paper, we consider that financial analysts are a good “proxy” for the calculative agent that investors are supposed to be for the accounting standard setters (Young, 2006). This approximation is based on the fact that financial analysts perform an important monitoring role. According to Jensen and Meckling (1976): “One of the groups who seem to play a large role in these [monitoring] activities is composed of the security analysts employed by institutional investors, brokers, and investment advisory services [...]” (Jensen and Meckling, 1976, p. 354). Dyck, Morse, and Zingales (2010) document that, in the U.S., financial analysts are among the quickest detectors of fraud. Degeorge et al. (2013) document that analyst coverage is associated with lower earnings management, at least in financially developed countries.

Despite their role, there is little direct evidence on how analysts go about generating forecasts or making stock recommendations (Bradshaw, 2011). A notable exception into this inquiry of what financial analysts actually do is a research by Block (1999), who surveyed members of the Association for Investment Management and Research (AIMR). Block (1999) queried analysts on their uses of valuation models, importance of financial inputs, bases for recommendations, various opinions regarding market efficiency and dynamics. It appears that analysts do not emphasize present value models to value firms and focus more on the long-term prospects than near-term quarterly results.

Another stream of literature note that financial analysts are not always rational in the sense that they do not fully reflect available information in their forecasts (Keane and Runkle, 1998). However, they have a superior ability to predict future performance (Brown et al., 1987) and their approach relies on multiple methods to value firms that extensively rely on accounting numbers. (Demirakos et al., 2004).

Another advantage of financial analysts is that they are vocal about their appreciation of the firm’s choices (Bowen et al., 2002). Conference calls are a common method that senior management uses to communicate with financial analysts. The fact that analysts participate in conference calls suggests that calls provide material information that is potentially useful for forecasting future earnings and making stock recommendations. However, it is possible that conference calls simply expand on previously released news or partially replace other mechanisms for disclosure (e.g., one-on-one conversations with analysts). It is also a way for analysts to communicate information to managers.

## 4. RENAULT AND THE RISE OF SHAREHOLDER SALIENCE

### 4.1 The Renault Group

Renault's primary business is the manufacture of automobiles and the provision of related services. The group is structured in two segments: the Automobile division, which handles the design, manufacture and marketing of passenger cars and light commercial vehicles under the Renault, Renault Samsung Motors and Dacia brands, and the Sales Financing division, which provides financial and commercial services related to the group's sales activities, and is comprised of RCI Banque and its subsidiaries. As of December 31, 2011, the group operated worldwide via its subsidiaries and dependent companies, including Renault SAS, Dacia and Nissan Motor Co Ltd, plus others. The group operates in Europe, Asia, the United States and Africa<sup>6</sup>.

Renault has a long history: it was originally formed as *Société Renault Frères* in 1898 to manufacture motor vehicles, taking advantage of patents such as the first direct-drive transmission. Based in the Paris suburb of Billancourt, the group achieved international renown through its success in motor sports, and initially specialized in the construction of passenger cars and taxis<sup>7</sup>. Renault was nationalized in 1945 to punish its owner Louis Renault for allegedly collaborating with the Nazi Occupation (Freyssenet, 2009). The company became the symbol of "State capitalism" in which state-owned firms operate in the private sector. In this system, business practices, from inter-firm relations, medium-term corporate strategies and labor relations to long-term industrial policy were all State-led. The State's medium-term goals were given priority and the State was prepared to sacrifice the financial return on State-owned firms to preserve employment or increase production in strategic areas (Schmidt, 2003). CEOs of large French firms are often former top civil servants who worked for ministerial cabinets. Most of them graduated either from ENA (*Ecole Nationale d'Administration*), the French elite school for top civil servants, or the *Ecole polytechnique* (also called X), the top French engineering school.

In the mid 1980s, Renault went through a severe crisis involving quasi-bankruptcy in 1984-1986. Confrontation between trade unions and the management became more frequent and more serious. As part of the transformation of French State capitalism in the 1980s, the State decided to withdraw progressively from direct intervention in the decision-making

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<sup>6</sup> Sources of this paragraph: Renault Registration document 2011, Reuters business summary ([www.infinancials.com](http://www.infinancials.com)).

<sup>7</sup> Source: <http://www.renault.co.uk/about/historyofrenault.aspx>

process (Schmidt, 2003), and Renault was finally privatized and listed in Paris Stock Exchange in 1994.

### **Insert Table 1 About Here**

As a consequence of this privatization process, Renault's ownership structure changed radically between 2001 and 2011, as shown in Table 1 (source: Thomson Ownership). The change in ownership during this decade has three striking features. First, as a result of the privatization in 1994, the French State's stake declined from 51.53 percent<sup>8</sup> in 2001 to 15 percent in 2006. There were two reasons for this. First, the French State decided to sell most of its shares<sup>9</sup> and second, Renault and Nissan decided to enter into a cross-continental alliance in 1999<sup>10</sup>. As part of the strategic alliance, Nissan acquired a 15 percent stake in Renault in 2002. A rise was thus observed in "strategic partners" in Renault's ownership, mainly Nissan (15 percent), Renault employees (around 3 percent) and Daimler AG (around 3 percent from 2010).

The second distinctive feature is the progressive rise of institutional investors. In contrast to the French State and "Strategic partners", these investors are volatile and short-term oriented. Their proportion in Renault's ownership structure varies with time, Renault's performance and the attractiveness of the automobile industry. Between 2001 and 2008, institutional investor shareholdings increased from less than 13% to more than 29%. When the crisis hit European carmakers, the institutional investors' collective stake fell back to 24.51 percent in 2009 and further to 16.37 percent in 2011.

The third key feature of Renault's ownership is that it is relatively diffuse, with individual investors representing one third at the beginning of the 2000s and more than 50 percent by the mid-2000s. This is partly the result of the privatization in France, when the State sold shares to institutional investors (making a voluntarily commitment to hold the shares for four to five years) and individual investors (in order to extend private share ownership to a wider segment of the population) (Jenkinson and Mayer, 1988).

## **4.2 The Louis Schweitzer/Carlos Ghosn Transition**

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<sup>8</sup> This figure is not consistent with Renault's website, <http://www.renault.com/fr/finance/action/pages/repartition-du-capital.aspx>

<sup>9</sup> Source: <http://www.renault.com/fr/finance/action/pages/repartition-du-capital.aspx>

<sup>10</sup> Although Renault and Nissan have cross-shareholdings and a deep alliance, their relationship deliberately stops well short of an outright merger.

Louis Schweitzer had a typical career path for a top manager under the “State capitalism” regime: after graduating from ENA, he worked for the French Treasury, and was then chief of Staff for French Prime Minister Laurent Fabius. In 1986, he joined Renault’s senior management and then successively held the positions of director of planning and management control, chief financial officer and Executive Vice-President. He was appointed Chief Executive Officer of Renault in December 1990, then Chairman and Chief Executive Officer in May 1992. Louis Schweitzer was Renault’s CEO from 1992 to 2005. He took over the position from Raymond Levy, who supervised the company’s restructuring “during the mid-1980s crisis. During Schweitzer’s tenure, Renault decided to form an alliance with Nissan. In 1999 Renault bought 36.8 percent of Nissan’s outstanding stock, and Nissan made a commitment to buy into Renault once it was financially able. In 2001, after a turnaround from near-bankruptcy, Nissan bought a 15 percent stake in Renault, which in turn increased its stake in Nissan to 44.4 percent.

Carlos Ghosn has a much more multicultural background. Born in Brazil, he moved to Lebanon when he was six. After his secondary education in Beirut, he graduated from *École Polytechnique* and the *École des Mines de Paris*<sup>11</sup>. Ghosn spent 18 years at Michelin & Cie., Europe’s largest tiremaker, working in France, South America and North America. In 1990, he was appointed chairman and chief executive officer of Michelin North America, where he supervised restructuring of the company. In 1996, Renault hired him as executive vice president responsible for advanced research, car engineering and development, car manufacturing, powertrain operations, purchasing and supervision of Renault business in South America. After the Renault-Nissan alliance was launched, in addition to his roles at Renault, Ghosn was appointed chief operating officer of Nissan in June 1999, Chairman in June 2000 and CEO in June 2001. He led a complete company reorganization and lifted Nissan out of near-bankruptcy: twelve months into his three-year turnaround plan, Ghosn had Nissan back in the black, and within three years it was one of the most profitable carmakers, with operating margins consistently above 9 percent - much more than the industry average (Shirouzu and Boudette, 2006). This earned him a reputation as a brutal but charismatic manager, with the nicknames of “Cost Killer” and “Mr. Fix it”, epitomizing the perfect “global manager” (Fonda, 2003). In 2005, Louis Schweitzer handed over the CEO position to Carlos Ghosn, making him the first person to head two Fortune 500 firms simultaneously on

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<sup>11</sup> All graduates of *Ecole Polytechnique* must enter a second (“application”) school after graduation to complement their training. As the *Ecole des Mines de Paris* is also a top engineering school, the graduates of *Ecole Polytechnique* + *Ecole des Mines* (called “X/Mines”) are considered as the best among *Polytechnique* students.

two continents. In 2009, Schweitzer stepped down completely and Carlos Ghosn became Chairman and CEO of Renault, while keeping his position in Nissan.

Figure 1 shows a comparative timeline of the careers of Louis Schweitzer and Carlos Ghosn at Renault.

### **Insert Figure 1 About Here**

This change in CEO is also accompanied by a change in the compensation package of CEO. An analysis of annual reports brings out a number of distinct features of Renault's compensation policy. The two chief executive officers during the period investigated (Louis Schweitzer and Carlos Ghosn) (see Table 2) received a fixed salary and a performance-related bonus ranging from between 0 and 150 percent of the fixed salary. The actual bonus paid to Renault's CEO is usually around 100 percent of the fixed salary, except in 2008 and 2009 when Carlos Ghosn voluntarily forewent his bonus. Given the increase in the fixed salary when Carlos Ghosn took over as CEO of Renault, the CEO's bonus also rose significantly.

### **Insert Table 2 About Here**

The bonus criteria, specifically the financial criteria, have been disclosed since 2002 and are relatively stable over time (see Panel A, Table 2): achieving the target operating margin and ROE are key considerations in setting the yearly bonus over the period of investigation. Other criteria changed in 2004, when the economic performance and warranty cost-cutting objectives were replaced by a qualitative criterion related to strategy and management. In 2010, the bonus was also related to cash flow.

Taken together, these criteria incentivize the CEO on beating the expected earnings level, especially because the bonus is related to the difference between the budgeted and actual operating margin. This aligns the top management team's interests with those of the shareholders and is consistent with a rise the shareholder's salience in Renault SA.

## **4.3 Changes in the Business Model of Renault and the Rise of the Shareholder Importance**

In 1984, despite decent sales figures, Renault was losing a billion francs (€150 million) a month and reported a deficit of FRF 12.5 billion in 1984 (€1.8 billion). Renault was practically bankrupt and the situation was not sustainable (Freyssenet, 2009). George Besse,



the CEO at that time, decided to cut costs dramatically, selling off many of Renault's non-core assets, withdrawing almost entirely from motorsports, and laying off many employees. Criteria were then introduced to evaluate projects: (1) positive NPV for the investment, applying a 14 percent discount rate; (2) gross operating margin of 4 percent; ROE of 11 percent. These criteria grew increasingly stringent over time with the privatization of Renault in 1994.

Louis Schweitzer hired Carlos Ghosn, who had already demonstrated his cost-cutting abilities at Michelin. Having become Renault's second in command by autumn 1996, Ghosn stressed the importance of profitability as a "guide for action" (Jurgens et al., 2002). In 1998, he proclaimed that Renault must "generate profits to meet shareholders' expectations and finance our development" and the firm began to view shareholder interest as an integral part of its strategic objectives (Jurgens et al., 2002). The importance of "shareholder values" was introduced in the 2002 annual report ("Renault Group Strategy" section, p. 31).

Taken together, the changes in Renault are consistent with an increased emphasis on shareholders versus stakeholders. The privatization in 1994 is just the final outcome of this process. The abandonment of the "State capitalism" principles and the hiring of a new type of CEO (more international, oriented towards performance achievement) are both in favor of the choices of accounting policy with dynamic conventions.

## **5. CAPITALIZATION OF R&D AND REACTIONS FROM ANALYSTS**

### **5.1 R&D Importance and Reporting at Renault**

It has long been recognized that investment in Research and Development (R&D) is a key success factor in the automobile activity. As early as 1979, Rockhart (1979) suggested that style, efficient dealership organization, unit cost, and the ability to meet energy standards are key success factors. At least the last two items relate to R&D investment. Not surprisingly, out of 37 industrial sectors, the "Automobiles & Parts" industrial sector is ranked number three, after "Pharmaceuticals & Biotechnology" and "Technology Hardware & Equipment" in terms of level of R&D investment<sup>12</sup>. Based on R&D intensity (R&D investment/net sales),

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<sup>12</sup> Source: The 2011 "EU Industrial R&D Investment Scoreboard" (hereafter the *Scoreboard*), European Commission, Joint Research Centre/Directorate General Research and Innovation, available at: <http://iri.jrc.ec.europa.eu/reports.htm> (last retrieved: August 4, 2012). The *Scoreboard* contains economic and financial data from the world's top 1400 companies, ranked by their investments in research and development (R&D). Each of these companies invested more than €30 million in R&D in 2010; 400 were headquartered in the EU and 1000 were located elsewhere. The data are drawn from the companies' latest available accounts, i.e. financial statements for fiscal year 2010.

Automobiles & Parts belong to the “Medium-high R&D intensity sectors”<sup>13</sup> (sectors with an intensity of between 2 and 5 percent). More precisely, in terms of overall R&D intensity, the Automobiles & Parts sector is ranked number 7 out of the 37 sectors analyzed, with an average worldwide R&D intensity of 4.1 percent in 2010<sup>14</sup>.

Given the importance of R&D activity for Renault it is no surprise that R&D reporting is of interest for financial analysts and Renault’s management. From January 1, 2002, as announced in 2001, Renault started to apply International Accounting Standard (IAS) 38 on intangible assets and decided to capitalize development expenses with no retroactive effect to 2001. More precisely, the 2002 annual report discloses the following information on R&D capitalization:

“As of January 1, 2002, development expenses incurred between the approval of the decision to begin development and implement production facilities for a new vehicle or part (e.g. engine or gearbox) and the subsequent approval of the design for mass production, are capitalized as intangible assets (previously they were recorded as costs in the year incurred). They are amortized from the date of approval for production over the expected market life of the vehicle or part, up to a maximum of five years (note 2-A).”

This change means that successful R&D outlays will no longer be expensed but capitalized and then amortized. In other words, Renault moved from a static to a dynamic model for its R&D reporting. This change is presented as an effort to adapt to IFRS. However, French Local GAAP already allowed for R&D capitalization well before 2005, under certain conditions very similar to the requirements of IAS 38, (e.g., clearly identifiable projects, serious chances of commercial success, etc).

In addition, IAS 1 (Presentation of financial statements) was revised in 1997 to require application of all International Accounting Standards/International Financial Reporting Standards (IAS/IFRS) – if reference is made to this set of standards. The objective was to prevent companies from stating that they applied IAS/IFRS while playing a “cherry picking” game, choosing the most favorable standards for their accounting strategy. Even though Renault does not claim to apply IAS/IFRS in 2002 (see quote above and the reference to French accounting standards), the fact of applying two international accounting standards (IAS 38 and IAS 40) early (i.e., before they become mandatory) is not consistent with the

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<sup>13</sup> Source: the *Scoreboard*, p. 37. High R&D intensity sectors (intensity above 5%) are, e.g. Pharmaceuticals & Biotechnology; Health Care Equipment & Services; Technology Hardware & Equipment; Software & Computer Services.

<sup>14</sup> Source: the *Scoreboard*, p. 42.

substance of IAS 1, which promotes a simple rule: “all or nothing”. In other words, we interpret this change as a symptom of the rise of the shareholder importance in Renault.

In 2004, Renault even decided to extend the amortization period from 5 to 7 years:

“(…) Revised amortization periods apply for development expenses since January 1, 2004: some have been reduced and some extended. The extensions concern expenses for development of parts and commercial vehicles, whose maximum amortization period has been raised from 5 to 7 years. This has no significant impact on the consolidated financial statements” (Annual report 2004, Notes to the consolidated financial statements, 1. Accounting policies, F. Research and development expenses, p. 238).

Table 3 presents the main figures for R&D capitalization over the period 2001-2011 and Table 4 discloses the main operating margin figures for the same period. All figures except percentages are expressed in millions of euros. These tables are analyzed below, focusing first on R&D capitalization *per se*, then on the link between this capitalization and the operating margin.

#### **Insert Tables 3 and 4 About Here**

Table 3, column 5, and Figure 2 show the net impact of R&D capitalization over the period.

#### **Insert Figure 2 About Here**

The net impact of capitalization is positive from 2002 to 2008 and in 2011, but negative in 2009 and 2010. The negative impact can be explained by the well-known “scissor effect”, when the amount of amortization of current and past capitalized R&D becomes higher than the current capitalized R&D. For example, in 2009, capitalized R&D amounts to 587 M€ while amortization of capitalized R&D is equal to 739 M€, hence a negative impact of 152 M€.

Some explanations for R&D capitalization may lie “behind the scenes”. First, 2002 was not an easy year for Renault, with the failure of the Avantime model. In the 2002 Annual report (p. 177), Renault discloses that Matra Automobile announced that it was discontinuing production of the Avantime. This decision prematurely terminated the agreement under which the vehicle was produced by Matra and marketed by Renault.

Second, and more importantly, it is interesting to relate capitalized R&D (with its usually positive impact) to the operating margin. Renault itself makes this connection. In 2002, the first year of capitalization, Renault discloses the following information:

“GOAL 5: TRANSLATE SUCCESS INTO FINANCIAL PERFORMANCE

Renault must create value to provide the resources for independent development and meet shareholder expectations. In current market conditions, this means generating (...) an operating margin of 4 [percent] of revenues on average over a business cycle. (...)

Operating margin

Renault targets an operating margin of 4 [percent] on average over a business cycle. In 2002 the Renault group achieved an operating margin of 4.1 [percent] of revenues (2.5 [percent] before accounting for development costs under IAS 38) (...)” (Annual report 2002, Renault group strategy, p. 31).

Table 4 shows the 4.1 percent operating margin in 2002 with capitalization (column 2) and the 2.5 percent operating margin without capitalization (see column 4). Although we cannot assert that Renault reached its 4 percent operating margin objective only because of R&D capitalization, the above disclosure about the Renault group strategy and the fact that Renault discloses the 2.5 percent rate in the same sentence as R&D capitalization at least implies such a relationship.

In the period subsequent to 2002, it is interesting to compare the operating margin rates as reported (column 2) and the restated operating margin without capitalization (column 4). The restated operating margin is generally lower than the reported operating margin, with the exception of the years 2009 and 2010, when the net impact of capitalization is negative (see discussion above).

The changes in amounts of capitalized R&D over the period are also of interest. One solution is to look at the capitalized R&D in millions of euros (Table 3, column 2). Another, which we consider more informative, is to compute the percentage of R&D capitalized every year over the total R&D outlay (Table 5, column Renault). This shows that although the percentages are fairly stable over the years 2002 – 2005, there is a sharp increase in 2006 and 2007. Then, in 2009 – 2011, the percentages are back down to the levels of the first period 2002 – 2005.

**Insert Table 5 About Here**

A final point for attention is the “real” R&D activity, i.e., actual R&D outlays (Table 3, column 1). The full period under study can be divided into sub-periods: 2001-2004: stable

figures above 1,900 M€; 2005-2008: increase in R&D outlay with a peak of 2,462 M€ in 2007; 2009-2010: sharp decrease to a level even lower than in 2002; 2011: increase to an equivalent level to the years 2001-2004.

## 5.2 Analysts' Reaction

From reading and coding analyst reports, we identified three distinct phases regarding analysts' attitude to Renault R&D reporting. The first phase covers 2004 – 2006. During those three 2004, 2005 and 2006 years, analysts asked for clarification about the meaning of R&D figures. We label this phase the “questioning phase”. In 2007-2008, analysts clearly question the quality of Renault's R&D reporting: this is the “accusation phase”. In 2009-2010, the negative impact of R&D capitalization on earnings figures appears: this is the “Conclusion phase”.

### 5.2.1 The Questioning Phase

During the presentation of 2005 results, analyst John Baglund raised a question about whether R&D figures should be understood on a cash basis or an accounting (accrual) basis. Thierry Moulonguet, the then Renault CFO, clarified the difference between R&D outlays and R&D expense (after capitalization of certain development expenses and amortization of R&D assets).

During the presentation of Q1 2006 earnings, Max Warburton pushed the clarification questions further, asking about the mechanical effect of R&D reporting on future earnings and its incorporation into management guidance:

“Just a boring accounting question<sup>15</sup>, really. It looks like you capitalized over EUR200 million of R&D in the first half of this year. That's almost the same as an entire year 2005. Could you just give us an idea of what the full year capitalization will be and then what the change is into '07? Does capitalization stay at the same level in '07, or does it start to come down and is that incorporated within the guidance?”

Patrick Blain, the executive Vice-President in charge of Sales and Marketing, insisted in his reply that principles and rules were applied consistently throughout the period and that there would be a reversal in the income statement. By capitalizing, Renault was able to bring down the level of R&D expense, but amortization of the capitalized development costs would later have the opposite effect:

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<sup>15</sup> The reader will certainly enjoy the way the analyst apologizes for a “boring accounting question” (sic).

“Yes, you’re right, we have in the first half capitalized a little more than we have done in the first half of 2005, applying exactly the same rules and principle. [...] I would say on an average basis over years we’re expecting to capitalize between 35 and 38 [percent]. In the first half we are a little over 40 [percent]. At the same time, you’re going to see depreciation [amortization] growing, so at the end of the year this effect that you have identified in the first half will be neutralized. But this is the implementation of exactly the same accounting principles.”

The same analyst continued to ask questions during the 2006 Q3 conference call. He challenged Renault management on the future trend in expensed R&D (non-capitalized R&D outlays and amortization of the capitalized development costs). Thierry Moulounguet once again insisted that Renault practices were compliant with rules and standards:

“We are [...] investing and developing what is necessary to launch all the new products that you know starting in the second half of 2007 to see a high level of capitalization ratio. I have no idea at this point where precisely we’ll be at the end of this year. [...] I cannot tell you precisely where we will be, but 2006 is definitely not the same year as 2005 in terms of development of new vehicles. So, you have seen the logical development of this simple fact in the first half. We’ll see what it is in the second half.”

One feature of the Renault management team’s replies during this “Questioning phase” was their insistence on the company’s neutrality, as a passive observer of the effects of accounting standards. Renault claimed to be applying rules and standards as required, and nothing more. Its strategy involved greater R&D efforts, which generated a high R&D capitalization ratio, in other words an immediate increase in the operating margin despite higher R&D outlays.

### *5.2.2 Accusation Phase*

During conference calls in 2007, analysts began to ask more questions about R&D accounting. After observing increasing R&D outlays in 2005, 2006 and 2007, they also observed a parallel increase in the R&D capitalization rate (see Table 5, column “Renault”). Before any questions from analysts during the Q2 2007 presentation, Carlos Ghosn himself commented on the rate of capitalized R&D. Referring to an operating margin of 3.5 percent, he added:

“We would have preferred to be lower but in a certain way unfortunately the calculation of the R&D capitalization, but you know you have no margin of -- that’s one way to calculate them, and it happened that it came at 54 [percent], 54.5 [percent] while, frankly when we make the budget we were expecting something more around 51 to 52 [percent], and it came to 54.5 [percent] for a

good reason[...] as you know this percentage is a [division] between two numbers and the lower numbers which are the overall expense of R&D are really under tight control.”<sup>16</sup>

For the first time, he attributed the high R&D capitalization rate to action by Renault on the denominator (cash R&D expense) – but immediately afterwards, he insisted that Renault conformed strictly to rules and standards:

“we are conservative”

The analysts did not seem convinced. Avaneesh Acquilla, analyst at UBS, declared:

“If I look at your R&D, you’ve rightly pointed out that cash R&D is 5.9 percentage point[s] of sales. But the R&D that you are paying out is 4.4. If I look [at] Peugeot, then that R&D [is] 3.4 percent of sales cash and 3.3 in that P&L. So, when we talk about the margin target, is there any comparability between Renault and other companies? Do you commit to doing a margin target based on what you’d spend in cash on R&D or is that something that isn’t comparable between Renault and other companies?”

Other analysts also question the size of the discrepancy between cash R&D and expensed R&D. This point deserves additional comments. By construction, R&D capitalization leads to a difference between “cash R&D”, that is R&D outlays of the period, and the R&D reported in the income statement, or “expensed R&D”. The difference comes from the amount of cash R&D that is capitalized, and therefore excluded from the income statement. It also results from amortization of capitalized R&D. Table 5 and Figure 3 compares the percentage of R&D capitalization between Renault and Peugeot over the period 2001-2011.

### **Insert Figure 3 About Here**

Compared to Peugeot (Renault’s main competitor), Renault capitalized a much higher amount of cash R&D in 2006 and 2007, leading to a higher discrepancy between cash R&D and R&D in the income statement. Carlos Ghosn then had to justify the reported figures:

Exactly, we don’t have targets depending on accounting rules. We did not put the target. I think what you are seeing in turn from -- everything we understood what you are seeing in terms of R&D capitalization.”

He then stressed the transitory nature of this effect, saying that capitalized R&D and amortization of R&D should balance out in the long run:

“We are going to stabilize in a certain way at the high level our expenses of R&D, because we are going to renew this product, we are going to continue to expand our product offer. [...] we are

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<sup>16</sup> The figures computed and disclosed in Table 5, column “Renault”, are slightly different from those mentioned in the verbatim quotation of Carlos Ghosn. This could be because Carlos Ghosn is referring to quarterly figures and also, possibly, to a different computation method. However, the difference between the two sets of figures is not material enough to affect our conclusions.

going to be catching up with depreciation. I mean, this advantage is something for you to ride. You capitalize more, but the more you capitalize, the more you are going to have depreciation coming a little bit later.”

Ghosn used this argument of the transitory nature of the discrepancy between expensed R&D and R&D outlays to rule out any accusation of manipulation of earnings forecasts:

“So, I don’t see the advantage to give ourselves objective[s] with or without R&D capitalization, because at the end of the day it’s mainly accounting and moving between capitalization, depreciation from the other side.”

“I would have loved to [...] have lower margin in the first half, more in line with our guidance, but it’s impossible because the rules are the rules and you cannot even interpret at that. These are the number[s] which is given by the controller, it[’]s audited and that’s the way it is. That’s what I can tell you.”

During conference calls related to Q2 2008 results, Ghosn insisted that a conservative, prudent approach was being taken:

“As, again, we’ll be very prudent into the level of amortization, of R&D expenses, because some people may think we’re making our numbers because of this. We’re taking some very clear commitment in terms of milestones and it’s being fulfilled this year because, as we told you, these numbers are going down. So we do not spoil the quality of our numbers.”

### *5.2.3 Conclusion Phase*

During the year 2009, amortization of capitalized development expenses became significant, leading to a lower operating margin. As a consequence, to limit the decrease of the operating margin, Renault had reduced its R&D outlays. This reduction in R&D raised a question from an analyst, François Maury (Oddo):

“I have a [...] question regarding CapEx and R&D costs. [...] I understand the financial constraint but don’t you think that you can put your future at risk when everybody knows that the requirements in terms of R&D will increase in the future? And when we see what has already -- what your competitors have already disclosed in the previous days, it seems that they have not cut CapEx and not cut the R&D costs.”

The answer from Patrick Pelata (Renault Chief Operating Officer) was clear:

“No, I think we were just a little bit overspending there and a little bit fat. And not having enough synergies with Nissan. As you know, this is one of the fastest -- I mean this is one area where the synergies with Nissan, if they accelerate, can have the fastest impact and this is what we are working on. And as I told you on technology, so that means new powertrains, improvements of existing powertrains, new transmissions and electric vehicle[s] we are not cutting anything.”

“Altogether [Renault and Nissan together] are probably number three or number four right now [on] R&D expenditures in the world, as a Group. So the only question is how to do that 100



percent well, when it was probably not done 100 percent well. And now our people, our engineering people both sides at Nissan and at Renault are really doing that under, I would say, intensive top down pressure and it works.”

But the analysts were unconvinced, and criticized the impairment booked on capitalized development costs in 2008. For example, Max Warburton (Sanford Bernstein) declared:

“R&D accounting [...] was something that Renault and the analyst community had a long debate about in the years 2006 to 2008 when you were capitalizing a lot of this expense. Now you’re writing it down and saying it’s a one-off and therefore it can be put below the operating line. I mean just to confirm, when you say this is a one-off, are you telling us there is no risk of any further R&D write-downs? Because in my memory you still have about EUR 7b[n] on the balance sheet. Thanks very much.”

In Q4 2009, the full effect of R&D capitalization was revealed: lower EBIT and a lower operating margin. Carlos Ghosn added:

“We have been accused in the past to sneakily profit off the amortization. And we didn’t talk about it. So, today we’re not going to tell you. We’re now having the reverse impact. We knew there would be a reverse impact and it was part of the rule.

It’s true, when you have a rule like this, at a certain point in time, it benefits you. After this, you’re going to have to pay for it. We’re paying for it now. We’ll continue to pay for it.”

## 6. DISCUSSION

### Stakeholders and Accounting Models

A common hypothesis in the accounting literature is that investors should prefer a dynamic model of accounting, i.e., a system in which the emphasis is placed on the going concern (dynamic) approach. Such an approach implies that R&D outlays to be recognized as an asset if these R&D outlays are expected to lead to future revenues. As economic benefits begin to arise, such a R&D asset is amortized over a period that is matched with the duration of the economic benefits.

One important point to be underlined here is that this preference of investors for a dynamic system of accounting is *assumed* rather than *asserted*. The importance given to investors dates back to the Trueblood report which emphasizes the objective of using financial reports for the prediction of cash flows. As pointed out by Young (2006), accounting standard setters “construct” accounting standards to meet information needs of individuals that are “rational economic beings”. Investors are supposed to be calculative and the users in accounting standards are frequently depicted as adept at making quantitative estimates and in assessing diverse economic factors. Young (2006) questions the relevance of this underlying

representation of investors. Our paper does not address the issue of the validity of this approach, rather we investigate if agents that are calculative (financial analysts) do actually prefer dynamic accounting features.

Our study reveals that even financial analysts tend to challenge a dynamic representation of the firm. The exchanges between analysts and Renault's management reveal an overall skepticism about the level of R&D capitalization and difficulties to understand the consequences of R&D capitalization. Such an attitude may receive several explanations. First, analysts may be tied up with the old practice (of full expensing). Any change from the existing practice therefore needs some adjustment. Second, their critique of the accounting policy followed by Renault concerning R&D may also reflect the arbitrage between reliability and relevance of accounting information. Proponents of the immediate expensing method argue that expensing is preferable to capitalization because it eliminates the opportunity for managers to capitalize costs of projects that have a low probability of success or to delay writing down impaired R&D assets. Proponents of capitalization argue that capitalization helps investors to discriminate between successful and unsuccessful projects and therefore signal information about future performance to the market. While expensing R&D expenditures is objective and verifiable, capitalization of R&D expenditures has the benefit of conveying relevant but potentially less reliable information to the market. In other words, the decision to capitalize or expense R&D expenditures is a perfect example of the trade-off between reliability and objectivity managers face when deciding on accounting policies (see also Healy et al., 2002). Accounting standard setters are silent on how investors should consider this trade off. While the American standard setter (FASB) decided to prescribe a full expensing of R&D expensing, the IASB decided to mandate capitalization of successful R&D outlays. Our study suggest that analysts do value verification of information and therefore do not seem to advocate the use R&D capitalization. Per se, it illustrates that the information needs of investors and other stakeholders are not necessarily conflicting by contrast to the usual assumption in the accounting literature.

### **Information Needs and Mimetism**

Another point that deserves discussion is that analysts seem to disregard the potential information contained in R&D capitalization. As reported above, analysts compare and contrast the rate of R&D capitalisation between Renault and its main competitors. When analyst identify a divergence in the percentage of R&D capitalized, they tend to challenge Renault's management on the reliability of their figures. Such an attitude can be understood

as it is a mean for analysts to assess the reliability of the accounting figures of Renault SA. It also indicates that analysts are prone to discount firm specific information to favor a uniform accounting treatment.

By construction, a dynamic model implies that the management of the firm instils “inside information” in earnings numbers. In the case of capitalisation, managers must reveal to investors their expectations about the success of their R&D activity. Given the inherent information asymmetry of R&D activities, providing such expectations should help investors to predict future cash flows. By nature, it assumes that analysts are ready to accept firm specific information. However, analysts react negatively if the average rate of capitalization differs significantly from its competitors. This implies that analysts tend to disregard any information beyond the average which questions that ability of investors to trust a dynamic model of accounting. Our findings demonstrate a clear preference for R&D reporting policy with little room of firm-based judgment and with alignment to those among industry peers, i.e., the static conventions.

## **7. CONCLUSION**

This paper investigates how accounting choices meet the information needs of various stakeholders. Analyzing the R&D policy of Renault, one of the largest carmakers in Europe, over ten years (from 2002 to 2011), the paper illustrates how Renault modifies its R&D accounting policy from total expensing (a static convention) to capitalization (a dynamic convention), coping with the shift from State capitalism dominance to professional shareholder emphasis. Interestingly, while the R&D capitalization, promoted by IASB in line with its advocacy of investors’ interest as the principal recipient of accounting information, is supposed to help investors better understand the firm future cash flow, Renault’s choice has been constantly challenged, even doubted by analysts.

Our study makes significant contributions to the literature in several ways. First, it is widely accepted in the literature that different stakeholders are expecting different types of accounting information. Some researchers and standard setters (i.e., the IASB) even move one step further by making conjectures on which type of accounting fitting better to one type of stakeholder. However, these are more conjectures than facts backed by empirical evidences. Our study shows instead of applauded by financial analysts as expected by the standard setters and the adopting firm (Renault), the R&D capitalization is rejected by these information users. Second, the current literature often proposes that in order to better satisfy the information need of a more largely defined group of stakeholders, accounting reporting must go beyond its traditional boundaries (and extend to the corporate social reporting, for

example). This logic behind it is that the current financial reporting is only good enough for investors. Our study demonstrates that even in the scope of conventional financial reporting, improvements are still needed to better understand the needs of various stakeholders in order to better serve them. Third, the financial analysts' refusal of the dynamic approach of R&D accounting reflects also reflects a double role of accounting: on one side, it plays the informative role, where it helps the investors better assess the future value of the firm; on the other side, it also executes a control role over the excess of the shareholder model. In R&D case, although the R&D capitalization might contain more firm-specific information helping analysts better assess firm's future cash flow, analysts prefer to underscore this supposed benefit and opt to the practices not derived from those of the industry peers, because of high information asymmetry in R&D activity and of the possibility that the management might (ab)use it as an earnings management tool.

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Figure 1 - Louis Schweitzer and Carlos Ghosn - Chronology of appointments

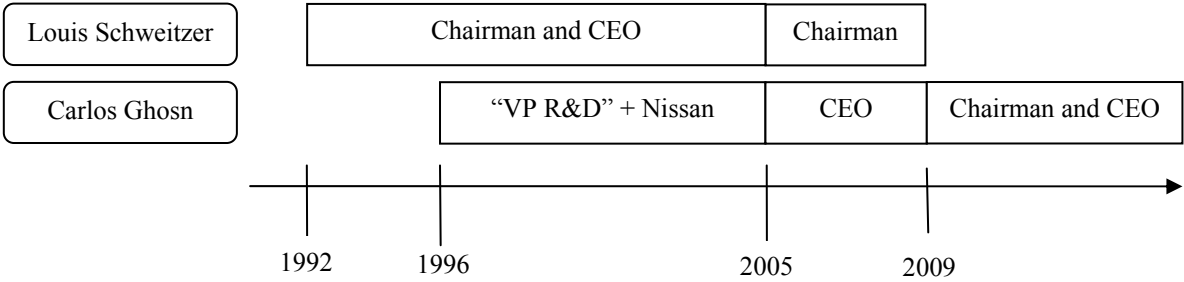




Figure 2 - Net impact of R&D capitalization on net income

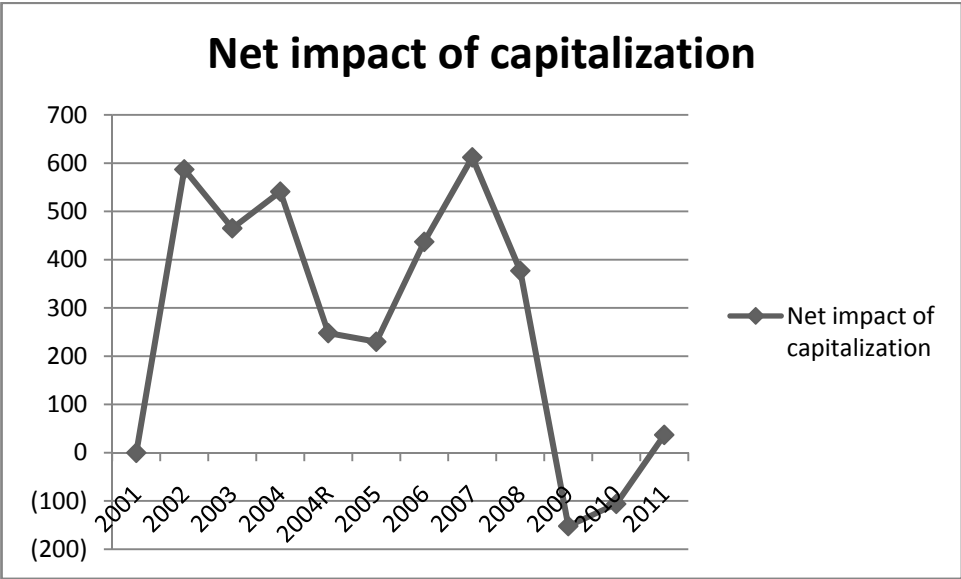
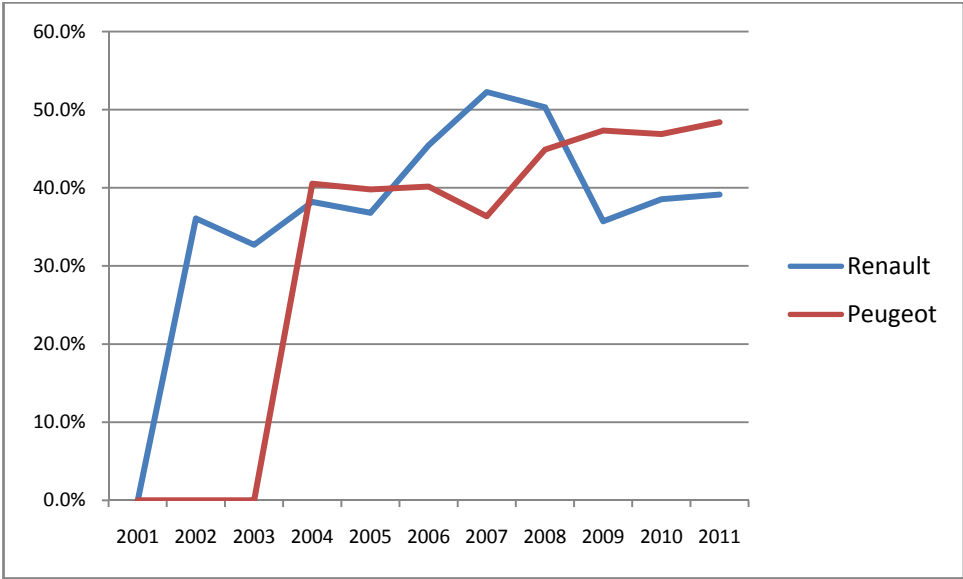


Figure 3 - Percentage of capitalization = Capitalized development expense/ R&D outlays\*



\* 2004 = financial statements restated in 2005 for the first application of IFRS.

Table 1 – Ownership structure at Renault

Investor type	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
French State	51.53	25.91	15.65	15.7	15.33	15.01	15.01	15.01	15.01	15.01	15.01
Strategic partners	3.67	18.31	19.08	18.3	18.62	18.52	18.11	18.34	18.34	21.32	21.16
Institutional investors	12.89	11.13	12.44	13.98	14.34	15.58	24.12	29.25	24.51	18.29	16.37
Public	31.91	44.65	52.83	52.02	51.71	50.89	42.76	37.4	42.14	45.38	47.46

Table 2 – Compensation policy for CEOs at Renault

	2002	2003	2004	2005	2006	2007	2008	2009	2010	
<i>Panel A: Criteria used to set the Bonus.</i>										
Economic performance in the previous year	x	x	x							
Difference between budgeted and actual operating margin	x	x	x	x	x	x	x	x	x	
Return On Equity	x	x	x	x	x	x	x	x	x	
Progress made towards reducing warranty costs	x	x	x							
Additional qualitative criterion linked to strategy and management				x	x	x	x	x	x	
Free cash flow threshold set by the Board of directors									x	
Bonus Level (as a % of fixed salary) Set at			0 and 150 140	0 and 150 100	0 and 150 116	0 and 150 116	0 and 150 17	0 and 150 18	0 and 150 138.24	
<i>Panel B: Compensation of the CEO</i>										
<b>CEO</b>	Louis Schweitzer	Louis Schweitzer	Louis Schweitzer	Louis Schweitzer	Carlos Ghosn	Carlos Ghosn	Carlos Ghosn	Carlos Ghosn	Carlos Ghosn	Carlos Ghosn
<b>Total</b>	€1,817,715	€1,981,812	€2,192,899	€1,232,926	€1,629,315	€2,629,663	€2,634,429	€1,238,014	€1,242,655	€2,901,535
Fixed	€747,000	€900,000	€900,000	€900,000	€800,000	€1,200,000	€1,200,000	€1,200,000	€1,200,000	€1,200,000
Variable	€1,050,000	€1,050,000	€1,260,000	€300,000	€800,000	€1,392,000	€1,392,000	€0	€0	€1,658,880
In kind	€4,215	€3,812	€4,899	€4,926	€4,815	€9,663	€14,429	€10,014	€14,655	€14,655
Director's fees	€16,500	€28,000	€28,000	€28,000	€24,500	€28,000	€28,000	€28,000	€28,000	€28,000

<sup>17</sup> On February 11, 2009 the Board of Directors, at the Chairman and CEO's request, decided to set the amount of his bonus at zero.

<sup>18</sup> The principles for consideration and related benefits of the Chairman and CEO comply with French decrees 2009-348 of March 30, 2009 and 2009-445 of April 20, 2009 concerning "the conditions for remuneration of managers of companies receiving State aid or support due to the economic crisis and directors of public companies".

Table 3 – R&D capitalization at Renault

Year	R&D outlays	Capitalized development expense	Amortization of capitalized development	Others (impairment of capitalized development and cost of goods sold)	Net impact of capitalization <sup>19</sup>	R&D expensed (total reported in income statement)
	(1)	(2)	(3)	(4)	(5)=(2)+(3)+(4)	(6)=(1)+(5)
<b>2001</b>	(1,935)	0	0	0	0	(1,935)
<b>2002</b>	(1,765)	637	(15)	(35)	587	(1,178)
<b>2003</b>	(1,737)	568	(74)	(29)	465	(1,272)
<b>2004</b>	(1,961)	749	(171)	(37)	541	(1,420)
<b>2004R</b>	(1,961)	749	(464)	(37)	248	(1,713)
<b>2005</b>	(2,264)	833	(603)	0	230	(2,034)
<b>2006</b>	(2,400)	1,091	(654)	0	437	(1,963)
<b>2007</b>	(2,462)	1,287	(675)	0	612	(1,850)
<b>2008</b>	(2,235)	1,125	(634)	(114)	377	(1,858)
<b>2009</b>	(1,643)	587	(739)	0	(152)	(1,795)
<b>2010</b>	(1,728)	666	(772)	0	(106)	(1,834)
<b>2011</b>	(2,064)	808	(771)	0	37	(2,027)

\* 2004 financial statements restated in 2005 for the first application of IFRS.

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<sup>19</sup> The net impact is computed as follows:

+ Capitalized development expenses

– Amortization of capitalized development expenses

– Others (Impairment of capitalized development expenses [this is unusual, and took place only in one year (2008)] and Impact on the cost of goods and services sold).

Table 4 – Operating margin at Renault

<b>Year</b>	Operating margin (as reported)	Operating margin (as reported) (% of revenues)	Operating margin (if all R&D is expensed)	Operating margin (% of revenues) (without capitalization)
	(1)	(2)	(3)=(1)-(5/ Table 1)	(4)=(3) / Sales revenue
<b>2001</b>	473	1.3%	473	1.3%
<b>2002</b>	1,483	4.1%	896	2.5%
<b>2003</b>	1,402	3.7%	937	2.5%
<b>2004</b>	2,418	5.9%	1,877	4.6%
<b>2004R</b>	2,115	5.2%	1,867	4.6%
<b>2005</b>	1,323	3.2%	1,093	2.6%
<b>2006</b>	1,063	2.6%	626	1.5%
<b>2007</b>	1,354	3.3%	742	1.8%
<b>2008</b>	212	0.6%	(165)	(0.4%)
<b>2009</b>	(396)	(1.2%)	(244)	(0.7%)
<b>2010</b>	1,099	2.8%	1,205	3.1%
<b>2011</b>	1,091	2.6%	1,054	2.5%

Table 5 – Percentage of capitalization – Comparison Renault – Peugeot

Year	Renault	Peugeot
2001	0.0%	0.0%
2002	36.1%	0.0%
2003	32.7%	0.0%
2004	38.2%	0.0%
2004R	38.2%	40.5%
2005	36.8%	39.8%
2006	45.5%	40.2%
2007	52.3%	36.4%
2008	50.3%	44.9%
2009	35.7%	47.3%
2010	38.5%	46.9%
2011	39.1%	48.4%