2008

The SEC's Global Accounting Vision: A Realistic Appraisal of a Quixotic Quest

Lawrence A. Cunningham
George Washington University Law School, lacunningham@law.gwu.edu

Recommended Citation

Lawrence A. Cunningham, The SEC's Global Accounting Vision: A Realistic Appraisal of a Quixotic Quest, 87 N.C. L. Rev. 1 (2008).

THE SEC'S GLOBAL ACCOUNTING VISION: A REALISTIC APPRAISAL OF A QUIXOTIC QUEST

*Lawrence A. Cunningham**

NORTH CAROLINA LAW REVIEW , VOL. 87 (2008)

Abstract

In the most revolutionary securities law development since the New Deal, the SEC is poised to jettison rules requiring companies to apply recognized US accounting standards by inviting use of a new set of international ones created by a private London-based organization. This radical shift follows decades of gradual movement towards international standards that has gained momentum since 2005 when all listed companies in the European Union were required to use them. For the US, the SEC could give companies the option to use either or establish a medium-term plan to move US companies to international standards within a decade.

Analysis of the SEC's vision for this quest reveals that it contains contradictions, paradoxes and ironies that suggest quixotic thinking. A contradiction: the SEC touts its vision as promoting comparability, yet proposes injecting choice and competition into accounting standards that would reduce it. A paradox: the SEC celebrates a single set of global standards while advocating changes that would create a double set within the US and overlooks factors that justify skepticism about the possibility of a single set of written standards translating into uniform application. An irony: the SEC acknowledges that pursuing global standards is "very complex" while its Chairman says the SEC has "declared a war on complexity" in accounting.

A more realistic vision of the quest appreciates that, under either an optional or mandatory route, the shift amounts to a leap of faith posing both large costs for the US and potentially large gains for it and the world. This realistic appraisal lowers expectations about actual comparability; highlights serious risks that competing standards would impair comparability; recognizes needs the SEC has scantly examined to render elaborate infrastructural changes; and, above all, faces the realization that the abrupt shift is less about the SEC's historical mandate to protect investors than about a newly undertaken mission to expand global capitalism.

---

* Professor of Law, George Washington University. Thanks to participants in a workshop at Yale Law School and Yale School of Management; participants in the Business Associations Section panel at the 2008 Annual Meeting of the Association of American Law Schools; and to Jacob Barney, Erik Gerding, and David Walker.

TABLE OF CONTENTS

INTRODUCTION

This Article probes the most revolutionary development in securities regulation since the New Deal: the Securities and Exchange Commission's willingness to jettison rules requiring companies to apply recognized US accounting standards by inviting use of a new set of international ones created by a private London-based organization.[1] The SEC believes such action benefits investors, at least as a matter of lip service. It suggests that competition among international and domestic standards is desirable, says that adopting international standards will result in greater comparability and imagines playing little more than a coordinating function among peer agencies in other countries.

Critical analysis of this vision indicates that the quest is quixotic. First, competition among accounting standards is inconsistent with comparability in financial reporting. Second, even were a single set of standards to emerge from either a competitive or standardization process, this would not necessarily increase net comparability: it could increase comparability among companies based in different geographic locations but reduce comparability within given countries, including the US. Third, any shift requires profound and extensive changes to the US and international infrastructure that will be costly, create considerable dislocation and be extraordinarily complex, despite SEC rhetoric extolling virtues of financial reporting simplicity. Fourth, it is not obvious that the transition benefits investors; they will bear significant costs for an uncertain share of any gains from success.

This critique does not reject the aspirations driving the momentous movement toward international standards. But it grounds them in the broader terrain of global capitalism and provides a more realistic assessment of its prospects than does the SEC. This alternative view interprets the quest for universal accounting, strongly backed by the European Union along with the SEC, as a giant collective leap of faith to expand global capitalism. It takes universal accounting as a pre-condition to global capitalism in the 21st century much as national capital accounting systems were pre-conditions to the flourishing of capitalism in the 18th and 19th centuries.[2]

This Article's investigation of the current status and pending challenges yields cautious optimism that the requisite infrastructure, at global and national levels, can be assembled to minimize costs and maximize gains so that, on balance, the quest is achievable and worthwhile. Throughout this analysis, attention to the expressed or implied vision embraced by the SEC reveals a naïve and sometimes myopic position on innumerable complexities and challenges that the SEC has faintly recognized and failed

---

[1] *See* SEC Concept Release on Allowing U.S. Issuers To Prepare Financial Statements in Accordance With International Financial Reporting Standards, Securities Act Release No. 8831, Exchange Act Release No. 56,217, Investment Company Act Release No. 27,924, 72 Fed. Reg. 45,600 (Aug. 7, 2007), at 40 ("The U.S. public capital market has experienced neither the wide co-existence of financial statements prepared under two sets of accounting standards, nor a change of a group of U.S. issuers from reporting under one set of accounting standards to another.") [hereinafter SEC Concept Release on Domestic IFRS].

[2] *See* MAX WEBER, ECONOMY AND SOCIETY, vol. 1, pp. 85 ff. (exploring how the development of capital accounting was a pre-condition to the flourishing of capitalism during the 18th and 19th centuries).

to address adequately. The analysis supplies more realistic assessments of the principal challenges and suggests ways to meet or cope with them.

Migration from national accounting systems to a universal one is propelled by the increasing existence of, and rising demand for, cross-border capital flows. Cross-border capital flows make capital allocation more efficient. By enticing more companies from more countries into global capital markets, this generates economic gains and increases national and global wealth. This form of international engagement spreads capitalism as an economic order which can, in turn, influence national interests and behavior. The EU and the US seek to spread capitalism as a matter of policy, especially to and by China and Russia and into the developing world. Universal accounting contributes to this objective by offering a common language to conceive of economic production and wealth creation.

To achieve universal accounting requires nations to relinquish traditional prerogatives of producing, interpreting and enforcing national standards according to local political, economic and cultural sensibilities. Such an achievement requires replicating each existing national infrastructure at the global level and then inducing all nations to assent to its legitimacy and defer to its operation. Direct costs of this exercise include establishing global mechanisms and implementing national coordination. Indirect costs of promoting a universal accounting system include those attached to relinquishing sovereignty. Indirect costs of spreading global capitalism are those that can accompany capitalism as an economic order, including increased ratio of rich to poor persons in the world, side-effects of industrialization such as excess carbon emissions and the angst of global cultural homogenization.[3]

A goal of any accounting standard is to treat like companies and transactions alike and to treat different companies and different transactions differently. The purpose of these treatments is to provide comparability, meaning that users of financial statements can readily compare the performance of alternative businesses. Promoting comparability is a purpose and effect of all national capital accounting systems. Comparability is also the cornerstone for promoting efficient cross-border capital flows and allocation. It requires that standards used to prepare statements are uniformly written, interpreted, applied and enforced. Essential to generating gains is designing a global infrastructure that promotes comparability of financial reports. Creating the capacity to promote comparability under universal accounting is a formidable task.

To win acceptance amid global diversity, written standards must be somewhat generic. The effect could be to increase comparability of reporting between companies from vastly different countries. However, given diversity in national business practices

[3] The term globalization is often used to refer to increasing cross-cultural exchange and cross-border transactions. The term global capitalism used here refers to the unimpeded flow of capital, especially financial capital, across national borders. This form of globalization is moving more rapidly than other forms, including cultural globalization. Capitalists are defined by return maximization and driven to move capital to highest valuing uses, forging power to transcend borders. In comparison, local cultural features evolve glacially. Yet global capitalism remains partially dependent on cultural globalization. To the extent that accounting is a cultural product, providing accounting that transcends cultural boundaries is both vital and difficult.

and legal environments, comparability will not be complete. The greater flexibility arising from more generic standards likely will lead to less comparability between companies within any given nation than now. The SEC's vision has not reflected the significance of this trade-off or these other stakes of the quest. But appreciating this trade-off and the magnitude of the other stakes is vital or else the entire quest could backfire by promoting inefficient capital allocation and increasing capital's costs.

The Article proceeds as follows. Part I assesses the immediate situation by tracing the main themes driving the rise of global accounting standards. Origins are found in capitalism's expansion, fueled by contemporary Euro-American politics, and pressured by transnational business enterprises. The SEC has long held an institutional commitment to international standards. But its recent lurch to embrace them is abrupt. It has provided limited public analysis of many issues, including its authority to ordain international standards. The SEC projects a quixotic quality to the current effort. This is attributable more to transitory political imperatives than to traditional institutional commitments. The SEC's move creates a crossroads for US capital markets, despite lack of preparedness and without examining many domestic implications. These implications may be manageable and must be faced, but require more effort, patience and risk than the SEC's public analysis suggests.

Part II analyzes international substantive challenges posed by an effort to replace, with a single set of accounting standards, the hundreds of national systems that have evolved over generations. The SEC likewise has given scant attention to national diversity, illustrated here by using recognized subjects within the field of comparative corporate law scholarship to show specific manifestations of their effects on accounting. Substantive challenges arise from worldwide variations in corporate finance, corporate governance and securities regulation. This diversity requires attention to matters of comparative investor protection, enforcement intensity, corporate purpose and the audiences that accounting reports target. To shift from national to global standards requires transcending these differences, a daunting challenge despite the SEC's reticence.

Part III considers structural challenges, to which the SEC has directed significant attention but with limited appreciation of their enormity. Challenges concern how to produce, interpret and enforce universal standards. The SEC's proposed model is based on one developed in the US and transplanted, at the SEC's urging, for operation in London to address all the world's constituents. That model succeeded in surmounting domestic administrative law challenges but these will multiply and convolute on the global stage. Problems of delegation and agency-principal relationships that vexed US participants for two generations reappear as more complex. This discussion explores how to coordinate national enforcement to promote global accounting standards and compares this to the SEC's vision. It reviews the literature concerning why people comply with law to assess the prospects that universal accounting standards will be applied uniformly around the world.

The conclusion absorbs these challenges and offers a broader prognosis. Despite SEC pronouncements mentioning investor interests and protection, the drive to international standards that the SEC is pushing has little to do with investors. The movement, instead, is a product of expanding capitalism and a way to reinforce its global proliferation. Despite SEC reticence on many issues, the transition is fraught with greater peril than the SEC acknowledges. It is possible that accounting can transcend international boundaries, as the metric system did globally in recent centuries or the euro does regionally today.[4] But, contrary to SEC optimism, the journey is far from over, easy, imminent or certain. A realistic assessment is tempered by comprehending how the momentous challenges could doom the quest for international accounting standards to the fate of Esperanto,[5] except at geometrically greater costs.

I. The Current Stage

Section A of this Part identifies the main forces driving the current situation as expanding capitalism, institutional SEC commitment and world economic and political conditions. The review ultimately sees the SEC's current vision as an abrupt lurch that requires explanation, apart from traditional institutional support of international accounting standards. Matters of political expediency, and a dose of personal ambition among the SEC's leadership, play a role. Section B presents and evaluates principal issues concerning the crossroads that the SEC has created in the move to global accounting standards. These pivot around embracing the SEC's vision to let US issuers choose between international and US standards or set a mandatory switch. Discussion addresses contradictions and limitations in the SEC's vision to examine domestic challenges that must be met whichever path is taken.

A. *Driving Forces*

During most of the latter 20th century, accounting systems used in most countries had developed within the traditions of each country and varied considerably across them. As globalization took hold in the century's final decades, appetite for a universal system emerged. On the global stage, US GAAP commonly was referenced as the gold standard for this purpose. Serious efforts to develop a comprehensive alternative international system began in 1973. After numerous fits and starts, international standards have begun to ripen in the early 21st century into a comprehensive system achieving broad international recognition. The SEC has maintained abiding institutional commitment to this process, which lately took a bold and perceptibly quixotic lunge to embrace them.

1. <u>Origins</u>. The motivation for the quest began when cross-border capital flows increased, including a spate of listings abroad and the expansion of transnational business combinations. Differences in national accounting standards and their application in different countries produced markedly different reports of income and equity. Difficulties

[4] The metric system is followed worldwide, even in the United States; the euro is adopted in nearly half the countries that are members of the European Union. Neither system has transcended national boundaries absolutely, but they are among the most impressive examples of relatively successful efforts. If international accounting achieved similar standing, it could be considered successful.

[5] Esperanto is a language invented with the hope of providing a single global discourse that all people in the world would speak. It has never been adopted in any country and is not known to be in wide use anywhere.

associated with understanding and reconciling those differences increased the costs of engaging in cross-border transactions.

Internationalization of accounting standards has centered in London. There, in 1973, a fledgling group of accountants assembled to begin a process of articulating global standards. The organization, originally called the International Accounting Standards Committee, was formed by agreement among professional accountancy organizations in Australia, Canada, France, Germany, Ireland, Japan, Mexico, the Netherlands, the UK and the US.[6] By 1983, IASC included all professional accountancy bodies that were also members in the International Federation of Accountants.

Between 1973 and 1987, IASC issued 26 accounting standards (and by 2000 had issued a total of 41 standards).[7] However, IASC lacked an effective governance structure and political clout to attract adherents. Few of its standards were recognized as worthy of serious attention, let alone constituting a complete accounting system. The standards were too vague and contained numerous optional approaches to reporting identical transactions. The products were valuable for some developing countries that lacked accounting standards and therefore adopted IASC's.[8] But the founding countries of IASC largely ignored the standards, preferring to use their own.

Efforts to strengthen IASC were redoubled in 1988 with backing from the International Organization of Securities Commissions. IASC began to review its standards, omit optional treatments, enhance disclosure and "specify in greater detail how each standard was to be interpreted."[9] The result was a formal 1995 agreement between IASC and IOSCO on a joint program to develop standards comprehensively. This project led IOSCO, in 2000, to endorse IASC revisions, although permitting national securities regulators to add requirements, such as disclosure, specificity and reconciliation.

During the 1990s, the SEC, long the overseer and protector of US GAAP, increased its interest in IASC and offered formal guidance to promote its visibility and effectiveness.[10] In 1996, Congress instructed the SEC to promote international accounting standards and to prepare a report evaluating how to achieve a universal system in the near or medium term. The SEC offered IASC substantive and procedural advice. On substance, the SEC emphasized that to achieve requisite stature, IASC

---

[6] *See* GARY JOHN PREVITS & BARBARA DUBIS MERINO, A HISTORY OF ACCOUNTANCY IN THE UNITED STATES: THE CULTURAL SIGNIFICANCE OF ACCOUNTING ___ (rev. ed. 1998).

[7] *See* SEC Proposed Rule, Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards without Reconciliation to U.S. GAAP, Release Nos. 33-8818; 34-55998 (July 2, 2007), at n. 23 [hereinafter, SEC Proposed Rule Rescinding Reconciliation].

[8] *See* DAVID R. HERWITZ & MATTHEW J. BARRETT, ACCOUNTING FOR LAWYERS 174 (4th ed. 2006).

[9] *Id*.

[10] *See* James D. Cox, *Regulatory Duopoly in U.S. Securities Markets*, 99 COLUM. L. REV. 1200 (1999).

needed to develop a comprehensive, high-quality, generally accepted basis of accounting. It would be characterized by transparency, comparability, and full disclosure and be susceptible to rigorous interpretation and enforcement.[11] On process, the SEC prescribed modeling IASC's governance structure after that of the US accounting standard-setting body, the Financial Accounting Standards Board.

The SEC was able to exert this power over IASC because of how it, and US GAAP, had consolidated a position as the gold standard in financial reporting. Beginning in 1983, non-US companies interested in accessing US capital markets were required to use US GAAP, at least by reconciling their home-country statements to it.[12] Some multinational enterprises adopted US GAAP completely, most famously Daimler Benz, when the German automaker switched from German GAAP to US GAAP in 1993 to gain a US listing.[13]

US GAAP's leadership paralleled US leadership in capital markets, which New York had dominated throughout the second half of the 20th century. The nearest competitor in capital market advancement was the UK, where London long rivaled New York. In the early 1990s, after the collapse of the Soviet Union and the end of the Cold War, world trade expanded and capital flows began to move more freely and rapidly across more national borders.

The existence of multiple, alternative accounting systems came to be seen as an imposition on cross border deals. Multi-national enterprises based in various countries moved from domestic accounting regimes toward internationally useful and recognized systems. Most often, this meant a shift from national accounting systems to US GAAP, although interest grew in the standards that IASC offered. Appetite for a universal accounting system increased during the late 1990s and early 2000s as market integration accelerated.

Amid global capitalism, several choices appeared to meet the appetite for a global accounting system. First, a single hegemonic power could provide its standards for the world, which is what the US did during the latter half of the 20th century. Second, a bloc of similarly-situated countries, engaged in extensive trading and other cross-border activity, such as the EU, could coordinate to reduce disparities and alternative approaches that national accounting standards authorized. Third, an international body attempting to represent all global constituents could perform this function. That was the original purpose of IASC and, as global capitalism spreads, is the approach being favored and pursued.

---

[11] International Accounting Standards, Exchange Act Release Nos. 33-7801, 34-42430, International Series No. 1215; 65 Fed. Reg. 8896 (Feb. 23, 2000) (codified at 17 C.F.R. pts. 230 & 240).

[12] *See* Securities Act Release No. 33-6437 (Nov. 19, 1982).

[13] *See* David Waller, *Daimler-Benz Gears Up For a Drive on the Freeway*, FIN. TIMES, Apr. 29, 1993, at 18; *Breeden Announces Daimler-Benz Will File to Trade Stock in U.S. Markets*, 25 SEC. REG. & L. REP. (BNA) 477 (Apr. 2, 1993).

Signaling belief in the possibility of moving from country-specific accounting standards to an international approach, in 2000 the SEC issued a concept release outlining essential elements of international standards.[14] The SEC did not pursue this concept, however, as accounting scandals at Enron Corp. and other companies diverted its attention. It entered a period of domestic regulatory activity that produced and implemented the Sarbanes-Oxley Act of 2002 (SOX).[15] Among the SEC's SOX-inspired exercises was a study of other accounting systems that was critical of US GAAP and praised an emerging approach to international accounting standards forged by IASC.[16]

Also in 2000, IASC, now boasting more than 100 professional accountancy bodies, revised its governance along lines that the SEC had recommended.[17] It modeled itself closely after FASB. This was represented in a new constitution akin to that used by FASB's parent organization, the Financial Accounting Foundation. IASC renamed itself the International Accounting Standards Board and renamed its standards as International Financial Reporting Standards. IASB propounded original and revised IFRS destined to set another gold standard in financial reporting. An example of the trailblazing quality of these efforts was a standard on accounting for stock options in 2002, an accomplishment that had eluded FASB for a decade due to domestic political resistance.[18]

IASB also began a vigorous marketing campaign with numerous countries and blocs to gain recognition.[19] This led, in July 2002, to the EU passing legislation to require all EU listed companies to use IFRS beginning in 2005 (subject to EU's endorsement of each new standard as it was produced).[20] IASB's campaign led scores of other countries, form Australia to Singapore, to embrace its standards (subject, in most cases, to the same endorsement mechanism). Others, including Japan and the US, agreed

[14] International Accounting Standards, Exchange Act Release Nos. 33-7801, 34-42430, International Series No. 1215; 65 Fed. Reg. 8896 (Feb. 23, 2000) (codified at 17 C.F.R. pts. 230 & 240) (desired attributes are effective, independent and high quality standards accompanied by auditing performed by capable auditing firms with quality controls and backstopped by regulatory oversight).

[15] *See* Roberta S. Karmel, *Securities Regulation: A New Watchdog for Public Accountants*, N.Y.L.J., (Aug. 15, 2002) (noting how SOX delivered reforms that the SEC long had sought).

[16] OFFICE OF THE CHIEF ACCOUNTANT, SEC.& EXCH. COMM'N, STUDY PURSUANT TO SECTION 108(D) OF THE SARBANES-OXLEY ACT OF 2002 ON THE ADOPTION BY THE UNITED STATES FINANCIAL REPORTING SYSTEM OF A PRINCIPLES-BASED ACCOUNTING SYSTEM (2003), *available at* http://www.sec.gov/news/studies/principlesbasedstand.htm [hereinafter SEC, SOX 108 STUDY].

[17] *See* IASC Strategic Working Party, *Recommendations on Shaping the IASC for the Future* (1999), *available at* http://www.iasplus.com/restruct/1999swpfinal.pdf.

[18] *See* ARTHUR LEVITT, TAKE ON THE STREET 109-113; 241 (2002).

[19] *See* David Tweedie, *Setting a Global Standard: The Case for Accounting Convergence*, 25 NW. J. INT'L L. & BUS. 589 (2005) (reflections of IASB's principal leader).

[20] Reg. Eur. Parl. & Council, No. 1606/2002; *see* http://www.iasplus.com/europe/0202iasreport.pdf.

with IASB to specific work projects to converge national standards and IFRS within a decade.[21]

During this period, increased coordination occurred between the US and EU. In June 2004, the SEC and the Committee of European Securities Regulators (CESR) agreed to increase collaboration on accounting convergence, including a commitment to concentrate on consistent application, interpretation and enforcement of IFRS. Within one year, this led the SEC to unveil a "roadmap" to convergence (including ending the US reconciliation requirement for non-US issuers by 2009 or sooner) and CESR to declare that US GAAP was substantially equivalent to the EU's IFRS.[22]

In August 2006, the SEC and CESR reaffirmed and deepened their earlier commitment in a formal work plan to accelerate joint investment in IFRS. Meeting the roadmap commitment, the SEC ended the reconciliation requirement in late 2007; more extraordinarily, it floated the idea of letting US issuers choose to adopt IFRS instead of US GAAP. It did so with a bootstrap argument: it said that if non-US issuers could use IFRS, then fairness required that US issuers should be able to do so too.[23]

This review demonstrates the SEC's steady support for international standards. Yet it can be difficult to ascribe a single institutional view to the SEC. The agency is large and complex; its leadership changes over time, is appointed by the President under statute requiring bipartisan diversity and its staff engages in projects that span leadership regimes. International accounting projects have been ongoing for decades. Official documents and decisions sometimes influence the range of possible positions that subsequent leadership can take, although leaders can shift the agency's vision. A striking example is how the SEC in 1983 adopted the reconciliation requirement and in 2007 rescinded it.

Nothing that the SEC did between 1983 and 2007 required this shift. Official SEC pronouncements routinely stated goals but no deadlines and few formal action plans.[24]

---

[21] *See* Press Release, International Accounting Standards Board, IASB and Accounting Standards Board of Japan Agree to Next Steps in Launching Joint Project for Convergence (Jan. 21, 2005), available at http://www.iasb.org/news; Financial Accounting Standards Board and International Accounting Standards Board, Memorandum of Understanding, "The Norwalk Agreement," available at http://www.fasb.org/intl/convergence_iasb.shtml (Sept. 18, 2002).

[22] *See* Donald T. Nicolaisen, *A Securities Regulator Looks at Convergence*, 25 NW. J. INT'L L. & BUS. 661 (2005).

[23] *E.g.*, SEC Concept Release on Domestic IFRS, *supra* note ___, at 12 (stating that the SEC's proposal to rescind reconciliation "*raises the question* of whether the [SEC] also should accept financial statements prepared in accordance with IFRS as published by the IASB from U.S. issuers") (emphasis added).

[24] *E.g.*, SEC Proposed Rule Rescinding Reconciliation, *supra* note ___, at 25-26 & SEC Concept Release on Domestic IFRS, *supra* note ___, at 4 ("The Commission has long advocated reducing disparity between the accounting and disclosure practices of the United States and other countries . . .").

True, the SEC expressed a clear direction in its 2004 roadmap[25] and support for cooperation with CESR and IOSCO and the IASB. But none of these expressions required contemplating either an optional or mandatory switch by US companies to IFRS.[26] It is this sharp forward shift that I shall be characterizing, diagnosing and criticizing as the SEC's global accounting vision.

Two explanations appear for this abrupt shift going beyond traditional institutional commitment. First, as to rescinding reconciliation, the EU exerts political pressure on the SEC. It threatened to require US companies listed there to reconcile US GAAP to IFRS. If the SEC failed to rescind its reconciliation rule, EU backlash likely would have occurred. Second, as to floating the domestic option, the SEC's leadership, especially Chairman Christopher Cox, invested in the issue as a matter of personal and political legacy.[27]

2. <u>Vagueness</u>. A combination of institutional vigor and political momentum thus enabled IASB to catapult itself onto the world stage in a visible and influential way during the early 2000s. Additional factors contributed to this impressive showing, many beyond the SEC's capacity to control, but unfolded at a propitious time for the SEC's vision. These centered on surprising global enthusiasm for the notion that IASB's standards, IFRS, took the form largely of principles, as opposed to rules, whenever that was possible. This enthusiasm was a stunning turnabout, since IASC standards set from 1973 to 1987 and into the late 1990s were criticized and did not catch on because they were too loose and vague. Participants had advised IASC to provide more detail and guidance to enable uniform interpretation and enforcement. The qualities of looseness and vagueness and absence of detail and guidance became an asset in the early 2000s.

---

[25] *See* SEC Press Release No. 2006-17, *Accounting Standards: SEC Chairman COX and EU Commissioner McGreevy Affirm Commitment to Elimination of the Need for Reconciliation Requirements* (Feb. 8, 2006), *available at* www.sec.gov/news/press/2006-17.htm. (SEC Chairman reaffirming commitment set out in roadmap described by the SEC's Chief Accountant in 2004).

[26] Nevertheless, the SEC's institutional interest and global pressure favoring IFRS generated considerable scholarly commentary in recent years. *See, e.g.*, George Mundstock, *The Trouble with FASB*, 28 N.C. J. INT'L L. & COMM. REG. 813 (2003); Bernhard Grossfeld, *Comparative Corporate Governance: Generally Accepted Accounting Principles v. International Accounting Standards?*, 28 N.C. J. INT'L L. & COMM. REG. 847 (2003); Samuel Wolff, *Implementation of International Disclosure Standards*, 22 U. PA. J. INT'L ECON. L. 91 (2001); Isaac C. Hunt, Jr., *It's a Small World After All: The SEC's Role in Securities Regulation Globalization*, 51 ADMIN. L. REV. 1105 (1999); Janice Grant Brunner, Comment, *All Together Now? The Quest for International Accounting Standards*, 20 U. PA. J. INT'L ECON. L. 911 (1999); Scott B. Novak, Note, *A Step Toward Globalization: The Move for International Accounting Standards*, 9 IND. INT'L & COMP. L. REV. 203 (1998); Eric M. Sherbet, *Bridging the GAAP: Accounting Standards for Foreign SEC Registrants*, 29 INT'L LAW. 875 (1995); Michael A. Schneider, *Foreign Listings and the Preeminence of U.S. Securities Exchanges: Should the SEC Recognize Foreign Accounting Standards?*, 3 Minn. J. GLOBAL TRADE 301 (1994).

[27] *See* Floyd Norris, *A Tower of Babel in Accounting?* NY TIMES (June 15, 2007) ("Christopher Cox, the S.E.C. chairman, is pushing for prompt action, which could make globalization of markets his legacy by the time he steps down after a new president takes office in 2009."). President Bush appointed Mr. Cox SEC Chairman effective in 2005; his background was in politics, having served as a Member of Congress for 17 years after practicing corporate law for 8 years and serving as counsel to President Reagan for 2.

Earlier objections to IASC's relatively vague standards were based on the requirement that an accounting system must provide sufficient definiteness. It must enable preparing financial statements that meet basic criteria, to be recognized worldwide, for reliability and usefulness. An accounting system is reliable when it is capable of transparently capturing, aggregating and summarizing vast quantities of transactions with varying qualities. That is possible only if standards are sufficiently comprehensive to address most transaction types and categories. To be useful, an accounting system must facilitate comparability across enterprises. One risk of principles that are too generic is that the role of subjective judgment diminishes the comparability of resulting statements.

Yet that risk of excessive generality is offset by forces that induced the global reversal from viewing IASC's standards as too generic to applauding that quality in IFRS. First, in the earlier period, there was less pressure for countries supporting IASC to adopt its standards. They had respected systems and IASC standards were generally only taken up by less developed countries that lacked accounting traditions. The pressure equation changed as the value to developed countries of international standards increased amid post Cold War globalization.

Second, to command acceptance among far flung participants, from the EU to the US and scores of other countries, it is helpful for accounting standards to be written at a relatively high level of generality. If too detailed or tailored to attributes of particular nations, the standards appeal only to those nations and not to others.

Third, it is necessary to translate the standards from their original language, English, into other languages in the world. Literal and functional translation costs are proportional to the relative generality or specificity of the original text. More general language is easier to translate into other languages and easier for readers of the translated texts to comprehend.

Fourth, the relative generality of IFRS was more appealing in the early 2000s than before because of events in the US that reverberated worldwide. Many exploited the Enron debacle to complain that US GAAP was too detailed and had too many rules. Enron's managers—and managers at other companies in the heady period—appeared to manipulate US GAAP's rules by designing transactions that could opaquely avoid triggering adverse accounting results and enable reporting beneficial ones. Critics of US GAAP, and foes of using rules in regulation generally, offered such examples as evidence that rules are costly and that it is better to regulate, and design accounting systems, using principles.[28]

These complaints overstated the case, since what Enron's managers did plainly violated US GAAP.[29] Yet critics argued persuasively that US GAAP had too many rules

[28] *E.g.*, Editorial, *Closing the GAAP*, WALL ST. J. (Dec. 12, 2007).

[29] *See* William C. Powers, Jr., *et al.*, *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp.* 4 (Feb. 1, 2002).

and left too little room for judgment. If only it used more principles and required more judgment, critics said, Enron's shenanigans would have been preempted. If rules were now bad, principles were not only good but a solution to a nettling problem bedeviling the US.[30] With loose, vague principles bearing limited detail and guidance in fashion, rhetoric emerged to classify and denigrate US GAAP as "rules-based" and to classify and extol IFRS as "principles-based." This labeling improved the marketability of IFRS and contributed to the declining appeal of US GAAP.

Despite the speciousness of such labeling, the issue was taken so seriously that SOX required the SEC to study it.[31] The SEC sensibly avoided endorsing the facile idea that there are such things as principles-based or rules-based accounting systems. Instead, it minted the concept of an objectives-based system. Rules and principles both are useful, the SEC correctly explained, although it expressed preference for principles over rules when possible. This position is repeated in official SEC releases.[32] An expert advisory committee, which the SEC formed to simplify accounting, opines that the so-called rules-principles debate is specious.[33] Most agreed, including two SEC Commissioners.[34] Yet, evidencing the strength of the IASB's marketing strategy, another Commissioner and the SEC Chairman parroted the call for "principles-based" systems.[35]

---

[30] Rhetoric aside, characterizing any complex system as "principles-based" or "rules-based" is facile at best. *See* Lawrence A. Cunningham, *A Prescription to Retire the Rhetoric of "Principles-Based Systems" In Corporate Law, Securities Regulation and Accounting*, 60 VAND. L. REV. 1411 (2007); David Alexander & Eva Jermakowicz, *A True and Fair View of the Principles/Rules Debate*, 42 ABACUS 132 (2006) (concerning rules-principles debate in accounting, "much of the debate at the regulatory and policy level is at best vague and confused, more likely disingenuous, possibly intellectually dishonest").

[31] SEC, SOX 108 STUDY, *supra* note ___.

[32] SEC Proposed Rule Rescinding Reconciliation, *supra* note ___, at 31 & SEC Concept Release on Domestic IFRS, *supra* note ___, at 26.

[33] *See* SEC Advisory Committee on Improvements to Financial Reporting, Subcommittee I: Substantive Complexity, Report for Discussion (report for discussion at Nov. 2, 2007 Committee Meeting) at 9 ("The subcommittee believes that the principles vs. rules dichotomy is a specious debate"), *available at* http://www.sec.gov/about/offices/oca/acifr/acifr-sc1-report.pdf.

[34] *See* Roel C. Campos, SEC Comm'r, Remarks at SEC Public Meeting (July 25, 2007) ("There's been a great deal of talk about the fact that IFRS is more principles-based, as compared to U.S. GAAP, which is supposedly more rules-based. . . . I think this is an oversimplification"), *available at* http://www.sec.gov/news/speech/2007/spch072507rcc.htm; Annette L. Nazareth, SEC Comm'r, Remarks Before the Council of Institutional Investors (March 20, 2007) ("There has been much discussion recently about the benefits of principles versus rules-based regulation. . . . I believe that this is a false dichotomy."), *available at* http://www.sec.gov/news/speech/2007/spch032007aln.htm.

[35] *See* Kathleen L. Casey, SEC Comm'r, Remarks at the 35th Annual AICPA National Conference on Current SEC and PCAOB Developments (Dec. 10, 2007) (describing the movement to IFRS as a "principles-based initiative" and contrasting it to the "current rules-based accounting system"), *available at* http://www.sec.gov/news/speech/2007/spch121007klc.htm; Christopher Cox, SEC Chair, SEC Roundtable on International Financial Reporting Standards (March 6, 2007) ("Enron and the wave of accounting scandals called into question the intensely rule-based approach of U.S. GAAP [and stating that] SOX expressly required that we examine the length of time that would be necessary to change from a rules-based

The rhetoric that condemned rules-based systems and extolled principles-based systems was echoed in a wider backlash against the Sarbanes-Oxley Act in the mid-2000s. Three widely-publicized domestic reports circulated criticizing the US regulatory environment, routinely calling it rules-based and advocating a principles-based approach to regulation.[36] The slogans in this context were used to support less regulation and more deference to targeted actors' judgments, the same effect of using principles instead of rules in accounting. All three reports blamed the US regulatory environment for an asserted decline in US capital market competitiveness, and all cited, among other culprits, too many accounting rules.[37]

The asserted link between using rules in accounting, or other regulations, and US competitiveness was overstated political oratory. It may have been backwards. Before the rise of IFRS, few countries had the infrastructure required to raise and trade large amounts of capital. By the early 21st century, many countries do.[38] As capitalism flourishes, US markets no longer are the principal place to generate capital; many companies raise it on local markets. This is a testament to US success in spreading capitalism, a feat capitalists should not lament but celebrate. If US GAAP had anything to do with this expansion, it was not to retard but to advance it. It's odd, then, to blame US GAAP for any decline in US competitiveness, real or perceived.

Growing interest in international standards, as opposed to US standards, coincided with other international opposition to US leadership. In the decades following the Soviet Union's collapse, the US became the world's lone super-power. It is common in geopolitical history for such hegemonic states to earn the enmity of other nations and their citizens. Enmity strengthens amid fears that the hegemonic power slides from that quasi-benevolent status into a more imperialist one. That fear gathered force during the period of IFRS's rise, from 2000 to 2008, the term of office of President George W. Bush, whose foreign policy aggressively projected US military and economic power.[39]

---

to a principles-based financial reporting system."), *available at* http://www.sec.gov/news/speech/2007/spch030607cc.htm.

[36] COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT (2006) [hereinafter PAULSON REPORT], *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf (report commissioned by U.S. Treasury Secretary Henry M. Paulson, Jr.); MCKINSEY & CO., SUSTAINING NEW YORK'S AND THE US' GLOBAL FINANCIAL SERVICES LEADERSHIP (2007), *available at* http://www.schumer.senate.gov/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf (study commissioned by New York City Mayor Michael Bloomberg and U.S. Senator Charles Schumer (NY)); U.S. CHAMBER OF COMMERCE REPORT (2007).

[37] *See* PAULSON REPORT, *supra* note ___, at ___; MCKINSEY REPORT, *supra* note ___, at ___; CHAMBER OF COMMERCE REPORT, *supra* note ___, at ___.

[38] Several cities had grown in significance as centers of capital activity, especially Hong Kong and Tokyo but also Frankfurt. Although tiny and nascent, even places like Moscow and Beijing embraced capital market activity, an astonishing reversal from erstwhile communist economic orders.

[39] *See* Jane Mayer, *The Hidden Power: The Legal Mind behind the White House's War on Tower*, NEW YORKER (July 3, 2006).

How much this political atmosphere contributed to declining US leadership prowess, competiveness or SEC authority is uncertain (and may be de minimus) but the environment certainly did not help on any of those fronts.[40]

In sum, the rise of IFRS from humble origins to world leadership is driven primarily by expanding global capitalism, reinforced by fortuities associated with a backlash against the US and rhetoric condemning the density of its accounting standards. Fueling demand for both capitalist expansion and vaguer standards is the need to compare enterprises regardless of geography. Most champions of IFRS, and even those preferring continued convergence of national into universal standards, emphasize comparability as the primary virtue of the quest. Comparability means broader and deeper low-cost capital flowing through a limitless number of global channels. Yet, as discussed next, realizing this virtue remains elusive and the SEC both discounts the significance of persistent divergence and floats policies that threaten comparability.

3. <u>Divergence</u>. The road to a single set of standards has emphasized projects to converge existing country standards, especially US GAAP, with IFRS. How to define the meaning, progress and purpose of convergence is contestable. Convergence could mean achieving identical standards or just sufficient similarity so that financial statements can be rendered comparable with little user effort. Substantial progress has been made towards having the two sets of standards address similar issues in substantially similar ways. But complete convergence remains a distant dream.

Variation endures between IFRS statements and US GAAP statements. Of the 130 SEC filings covering fiscal year 2006 by foreign private issuers, containing IFRS reports reconciled to US GAAP, only 2 reported identical income amounts.[41] The variations tend to result in higher IFRS earnings than US GAAP (there were 84 of these, by a median amount of 12.9%) although there were also 44 reporting lower IFRS earnings than GAAP (by a median amount of 9.1%). The wide variation is attributable to enduring differences between IFRS and US GAAP.

Evidence demonstrates increasing divergence rather than convergence between IFRS and US GAAP.[42] A study of 83 EU-US cross-listed firms shows the gap growing compared to earlier studies.[43] Most firms' IFRS results show materially higher income and lower equity compared to US GAAP. Across the EU, differences are significantly

---

[40] *See* STEPHEN BURMAN, THE STATE OF THE AMERICAN EMPIRE (2007).

[41] *See* Jack T. Ciesielski, *Testimony Concerning International Accounting Standards, U.S. Senate Committee on Banking, Housing and Urban Affairs* (Oct. 24, 2007).

[42] Some standards adopted during the period of conscious convergence actually increased divergence, including especially SFAS No. 157 that created new rules concerning fair value measurements.

[43] Elaine Henry, Steve W.J. Lin & Ya-Wen Yang, *The European-U.S. GAAP Gap: Amount, Type, Homogeneity, and Value Relevance of IFRS to U.S. GAAP Form 20-F Reconciliations* (April 2007) (revealing a widening of the gap compared to Harris & Muller (1999) and Donna L. Street, Nichols & Gray (2000)).

influenced by the legal origin of the firm's home country (*i.e.*, common law or civil law traditions).[44] Dominant reconciliation items are pensions and goodwill, despite being subjects of convergence projects. Other studies generally appear consistent with these conclusions justifying skepticism about current prospects for a global standard.[45]

Divergence also persists among companies purporting to apply IFRS. An SEC review of 2006 IFRS filings illustrates this.[46] There is variation in the basis of reporting used. Most companies report using IFRS as published by IASB. But the vast majority of these companies also assert that statements comply with various country-specific variations of IFRS. Accompanying auditing opinions tend to attest to the country-specific versions rather than to the IASB version.

The form of presenting financial statements varies, even among companies based in the same country and operating in the same industry. This may be due, in part, to IFRS allowing variation in forms, offering no specific directions concerning how the income statement should be presented. As a result, income statement totals use a wide variety of different names and omit customary line items. Moreover, it is not always clear how per share amounts are determined (such as on a diluted or other basis).

There is material variation in the presentation of statements of cash flows. Companies use different starting points to show how cash flows vary from accrual income figures. Some interpret the concept of cash equivalents in broader terms than the SEC's interpretation of the applicable international standard.[47] Some cash flows are wrongly classified as arising from investing activities compared to operating activities (especially cash flows relating to research or exploration costs).

---

[44] *See infra* text accompanying notes ___-___.

[45] *E.g.*, Donna L. Street, S. Gray & C. Linthicum, *Global Accounting Convergence: Do European Accounts Under IFRS and U.S. GAAP Provide Comparable Net Income and Shareholders' Equity Information?* (U. Dayton working paper 2007) (EU's adoption of IFRS effective in 2005 revealed increasing divergence between IFRS and US GAAP, with pre-2005 net income figures generally comparable but 2005 figures widening); S. Gray & R. Morris, *Australia's Adoption of International Financial Reporting Standards: The Impact on Net Profits and Equity* (U. Sydney working paper 2007) (similar widening divergence between IFRS and Australian GAAP); *see also* D. Jetuah, *Citigroup Lays out IFRS-US GAAP Gulf,* ACCOUNTANCY AGE (Aug. 30, 2007) (reporting on similar results from Citigroup survey).

[46] SEC, *Staff Observations in the Review of IFRS Financial Statements* (July 2, 2007); *see also* www.sec.gov/divisions/corpfin/ifrs_reviews (SEC comment letters on that year's FPI IFRS financial statements).

[47] The applicable international standard on cash equivalents is IAS No. 7. The fact that the SEC has an interpretation of its meaning that differs from the interpretations evident in the filings it reviewed suggests some of the problems that can arise from national interpretations or from using principles instead of rules in IFRS. Sustained variation in the statement of cash flows is a particularly significant because the SEC has allowed foreign private issuers to file non-GAAP cash flow statements without reconciliation to US GAAP since 1994. *See* SEC Release No. 33-7029 (Nov. 3, 1993) (proposal); SEC Release 33-7053 (April 19, 1994) (adoption).

Material variation appears in accounting for contexts that IFRS does not address or offers limited guidance. These include control transactions, such as mergers, recapitalizations, reorganizations and minority interests. It is often unclear why a company chose not to consolidate a subsidiary or to use the equity method of accounting for investments in certain affiliates. When IFRS is silent on a subject, it directs using a standard from another recognized system of accounting, which could include US GAAP. Companies do not always state the accounting standard they apply when IFRS does not supply one.

Finally, as a general matter, numerous topics pose problems of clarity or inconsistency. Many of these are fundamental in accounting. They include: revenue recognition; accounting for intangible assets and goodwill; asset impairment measurement and recognition; accounting for leases; contingent liabilities; and accounting for financial instruments.

Despite this evidence of persistent divergence, the SEC cites the data to suggest that it commands required expertise to operate in an IFRS environment. Its final rule rescinding the reconciliation requirement boasts that the "staff has gained an increasing understanding of the application of IFRS through its regular review of the periodic reports of publicly registered companies."[48] The SEC states that the issues observed in its review of IFRS variation "do not appear to be more pervasive or significant than those it has identified in U.S. GAAP financial statements."[49] It attributes some of the manifest divergence between US GAAP and IFRS to legacy differences that occurred before convergence efforts were undertaken and to differences arising from issuers' choosing from alternative accounting options permitted under IFRS and US GAAP.[50]

Even so, the SEC recognizes that, although a single set of standards should "have positive effects on investors" from comparability, variation poses costs to investors: "The benefits of a single set of globally accepted, high-quality accounting standards that improve financial statement comparability may be diminished if there is a wide latitude in application of IFRS that results in inconsistent reporting. This latitude potentially harms investors' ability to compare financial statements across companies and potentially allows more opportunity for obfuscatory [sic] reporting."[51] The SEC nevertheless dismisses these concerns, saying investors should be able to "understand and work" with IFRS reports, "likely resulting in a more efficient allocation of capital."[52] Its prognosis is based on hoped-for benefits from expected network effects: it theorizes that the more

---

[48] SEC Final Rule Rescinding Reconciliation, *supra* note ___, at 24.

[49] *Id*. at 26.

[50] *Id*. at 21 & 89.

[51] SEC Final Rule Rescinding Reconciliation, *supra* note ___, at 84.

[52] *Id*. at 84-85.

companies that use IFRS, the more others have incentive to do so and investor utility increases.[53]

The SEC's optimism, despite the evidence, contrasts with concerns expressed by its British counterpart, the Financial Services Authority, based on a similar study and findings of 284 filings with it.[54] In the FSA's review of the appeal and risks of IFRS, it cited inconsistent national application as a material risk. It noted the widely accepted premise that IFRS' value can only be realized by comparable applications across borders. Then it cautioned: "there may be relevant economic and legal differences between countries such that similar transactions might legitimately be reported in different ways. [S]hould local custom or national interest operate to threaten the consistent application of IFRS, much of this anticipated benefit [of comparability] could be lost."[55] This sensible cautionary note could be stated less diplomatically by adding that interest group politics within a nation can destroy any benefits of this quest too.

B. *Crossroads*

The SEC's longstanding institutional interest in international accounting standards, plus contemporary geopolitics and geo-capitalism, contributes to understanding the alacrity of its current vision. Yet, along with its discounting of significant persistent divergence, the factors discussed in the following analysis suggest that more than historical interest is behind the SEC's current embrace of IFRS. These factors include contradictions, the SEC's dubious assertion of power and inattention to numerous systemic implications.

1. <u>Comparability and Competition</u>. In the US, most agree on the goal of comparability and that achieving it requires a single set of standards. All agree that convergence between US GAAP and IFRS has been substantial, but is incomplete. Some favor continuing convergence before making any changes; others say moving to IFRS now will advance the goal of global comparability sooner.[56] Even the SEC's official pronouncements routinely emphasize the goal and virtue of comparability.[57]

---

[53] *Id*. at 85.

[54] UK FINANCIAL SERVICES AUTHORITY, FINANCIAL RISK OUTLOOK 2007 (2007).

[55] *Id*.

[56] When evaluating the pace of convergence, it is possible to accept that the progress to date, while slow, can continue and reach a stage of substantial similarity within the next decade or sooner. Conviction that rapid capital globalization is desirable could justify preference for equally rapid implementation of IFRS. On the other hand, IASB's investment in convergence projects with the US and other countries is stimulated by its desire to persuade those countries to recognize IFRS. Once recognized, that incentive likely will be reduced. As between the immediate optional or planned mandatory route, the analysis in this Article supports the latter because it will reduce the serious risks associated with these pressures.

[57] *E.g.*, SEC Press Release, *SEC Takes Action to Improve Consistency of Disclosure to U.S. Investors in Foreign Companies* (Nov. 16, 2007) (quoting SEC Chairman Christopher Cox as follows: "Consistent application of international accounting standards will help the two-thirds of U.S. investors who own foreign securities to understand and draw better comparisons among investment options than they could with a multiplicity of national accounting standards"); SEC Proposed Rule Rescinding Reconciliation,

Yet the SEC's proposals envision competition between FASB/US GAAP and IASB/IFRS. The SEC's Concept Release on domestic issuers offers to let issuers choose either US GAAP or IFRS without mentioning the possibility of an across-the-board mandatory switch to IFRS.[58] The latter idea originated in scores of comment letters, many showing coordinated responses from trade groups, especially the large auditing firms, and accounting standard setters such as FAF and FASB.[59] It is essentially impossible to square support for comparability with enthusiasm for competition. The contradiction leads to an SEC vision exhibiting, at times, a tortured logic, as when it heralds the value of a single standard while endorsing the existence of dual standards for the US.[60]

The SEC has nevertheless made the optional or mandatory route the major issue in pending debates. This is the major issue because it reflects and must be informed by all other issues associated with any movement towards international standards. The option would mean two sets of standards in the US. This would reduce comparability among domestic companies while promoting comparability among multi-national ones. It may be possible to tolerate some such non-comparability, but only for a short period. This is especially so if only a relatively smaller number of US issuers made that choice, which is likely given that the option would only certainly appeal to the largest corporations with a sizable global footprint.

Allowing the option would create head-to-head competition between IFRS and US GAAP. There may be benefits from such standards duopoly. Advantages of a market in accounting standards in which multiple standard-setters compete include creating incentives to develop innovative ways of presenting financial information that

---

supra note ___, at 35 ("the use of a common set of high-quality standards for the preparation of financial statements will help investors to understand investment opportunities more clearly and with greater comparability than if they had to gain familiarity with a multiplicity of national accounting standards."); *id*. at 53-54 ("Fostering the use of a single set of high-quality, globally accepted accounting principles, would, in our view, serve to protect investors and promote capital formation by enhancing comparability across companies and increasing access to foreign issuer investment opportunities for investors in the U.S. public capital markets while reducing regulatory burdens and costs for issuers."); SEC Concept Release on Domestic IFRS, *supra* note ___, at 18 ("The use of a single set of accounting standards in the preparation of financial statements could help investors understand opportunities better than the use of multiple differing sets of national accounting standards" whereas multiple standards "can cause confusion").

[58] *See* SEC Concept Release on Domestic IFRS, *supra* note ___, at 7 (seeking input to understand the public's interest in giving US issuers the option to file IFRS financial statements instead of US GAAP financial statements).

[59] *E.g.*, Comment Letters to SEC on SEC Concept Release on Domestic IFRS, *supra* note ___, from: AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (Nov. ___, 2007); DELOITTE & TOUCHE LLP (Nov. 13, 2007); ERNST & YOUNG LLP (NOV. 13, 2007); KPMG LLP (Nov. 9, 2007); PRICEWATERHOUSE COOPERS LLP (Nov. 12, 2007); FINANCIAL ACCOUNTING FOUNDATION (Nov. 7, 2007), *all available at* http://www.sec.gov/comments/s7-20-07/s72007.shtml.

[60] *See* SEC Final Rule Rescinding Reconciliation, *supra* note ___, at 6 (heralding the value of a single set of standards while endorsing the existence of two sets of standards).

can be more useful.[61] It is a tacit recognition that a single set of standards will not necessarily produce comparability in fact. Even so, several well-recognized downsides to accounting standards competition appear.

First, the purpose of accounting is to generate useful information in an environment where preparers have informational advantages (a problem of asymmetric information). Second, accounting standards are public goods in that investors enjoy their benefits without having to pay for them directly. That introduces a free rider problem that impairs the usual functions of supply and demand. Third, it is unlikely that market competition in standards production would enable preparation of comparable financial statements.[62] Fourth, in a global environment, prospects diminish for competition among standards to yield a comparable basis of accounting.

Besides these well-recognized downsides to competition among accounting standards, two novel points are revealed by the foregoing analysis. First, IASB's marketing campaign that celebrates IFRS as principles-based involves material misstatements. A precondition for effective regulatory competition is that decision makers command perfect information about alternative regimes. Misleading statements by regulatory officials, including accounting standard setters, can prevent meeting this condition and mislead participants into making incorrect choices.

Second, current demand for global standards rejects historical national standards competition. This is epitomized by the EU's mandate to replace dozens of competing national standards with the single set of IFRS for all members. It favors a single set to promote comparability for the sake of global capital flows—and expanding capitalism deeply into places as unlikely as China and Russia.[63]

In contrast to an optional approach, a planned mandatory switch for all US issuers would advance these objectives and promote comparability both internationally and domestically. To achieve broader objectives associated with global capitalism's expansion suggests that full-scale US adoption is desirable. The optimal solution could be to allow the option, accompanied with a plan, by a date certain, to switch all US issuers to IFRS. The SEC's concept release does not discuss this strategy. Yet virtues of

---

[61] *See* Shyam Sunder, *Introduce Regulatory Competition to Simplify Financial Reporting*, www.ssrn.com/abstract=969733 (Feb, 26, 2007); Ronald A. Dye & Shyam Sunder, *Why Not Allow the FASB and IASB Standards to Compete in the US?* 15 ACCT. HORIZONS (Sept. 2001).

[62] The familiar and essentially non-resolvable debate concerning whether standards competition would induce a race to the top, bottom, or nowhere in particular appears in this context as well.

[63] A third problem with accounting regime duopoly is the difficulty and cost of training participants in different standards. Adopting IFRS in lieu of US GAAP in the US would require an expensive one-time overhaul, a problem discussed further below. But overhaul costs are likely to be less than costs of ongoing education necessary to train people in two sets of standards. Ongoing costs would fall on both formal pedagogical institutions, like colleges and universities, and informal, on-the-job, training within firms. The costs affect accountants, auditors, managers, investors and all other users of financial information.

the broader plan include involving all participants in the transition and, as discussed in the next two sub-sections, providing time to make the tremendous adjustments required.

2. SEC Authority. A preliminary and profound adjustment concerns the SEC's authority to recognize standard setters other than FASB and systems other than US GAAP. The SEC routinely asserts that it has the power but, as the following elementary legal analysis indicates, this is a dubious claim.

Despite longstanding SEC flexibility to recognize accounting standard setters, dating to the 1930s, the Sarbanes-Oxley Act in 2002 imposed boundaries on SEC authority. It listed numerous criteria that any SEC delegate must possess in order for the SEC to recognize it as a US accounting standard setter.[64] The delegate must:[65] (1) be a private entity; (2) have a board serving the public interest, a majority of whose members are independent of the accounting profession; (3) be funded by Congressionally-levied fees;[66] (4) have procedures to consider promptly, by majority vote, needed accounting changes; (5) consider the need to keep standards current and converging internationally; and (6) be approved by the SEC based on ability to aid the SEC in discharging its responsibilities to protect investors under US securities laws.

These statutory requirements were nearly tailor made for FASB, with one adjustment. The adjustment was shifting from funding by private donation and product sales to the funding mechanism the statute required (levies on US listed companies). With that adjustment made, FASB applied to the SEC for recognition,[67] and the SEC approved its application.[68] The SEC noted that such recognition is permitted under SOX only when a standard setter is able to assist the SEC in meeting requirements of US federal securities laws, including by helping to improve the quality of financial reporting to protect investors under US law.[69] The SEC opined that FASB's overseer, the Financial Accounting Foundation (FAF), met this and other SOX requirements.[70]

---

[64] Sarbanes-Oxley Act, § 108(b), codified at 15 U.S.C. § 77s; Sarbanes-Oxley Act, § 109, codified at 15 U.S.C. § 7219.

[65] The first five of the listed criteria are set forth in Sarbanes-Oxley Act, §108(b)(A)(i)-(v) (codified at 15 USCS §77s); the sixth listed criterion appears in §108(B).

[66] This provision requires the body to establish an annual fiscal budget that is "reviewed and approved according to [its] internal procedures" and is funded by fees "assessed and collected against each issuer" so as "to pay for the budget and provide for the expenses of that standard setting body, and to provide for an independent, stable source of funding for such body, subject to review by the Commission." Sarbanes-Oxley Act, §109 (codified at 15 U.S.C. §7219).

[67] Letter dated August 16, 2002 to SEC Chairman Harvey L. Pitt from Robert H. Herz, Chairman, FASB and Manuel H. Johnson, Chairman and President, FAF.

[68] SECURITIES AND EXCHANGE COMMISSION, COMMISSION STATEMENT OF POLICY REAFFIRMING THE STATUS OF THE FASB AS A DESIGNATED PRIVATE-SECTOR STANDARD SETTER, Rel. Nos. 33-8221, 34-47743; IC-26028; FR-70 (April 25, 2003).

[69] *Id.*:

> recognition of standards set by a private sector standard-setting body as "generally accepted" is only appropriate under section 108 of the Sarbanes-Oxley Act if, among

Although IASB adopted governance attributes that the SEC had suggested in the late 1990s, it lacks or may lack some of the traits that SOX requires. Of the criteria listed in SOX, IASB clearly meets the first two—it is a private entity[71] with a majority of trustees independent of the accounting professions.[72] It clearly lacks two others and it is uncertain whether it meets the remaining two.

First, SOX requires a simple majority voting rule to approve new standards but IASB uses a super-majority rule.[73] This is a non-trivial feature. The voting rule influences the standard setting process and the probability that the body will have the capacity to respond quickly and independently to emerging accounting issues. The reason SOX included the simple majority voting rule requirement traces back to debates and changes over the years in the voting rule that FASB used.[74]

Second, IASB is not funded using the SOX mechanism. It relies on private donations from a small number of corporations, auditing firms and others. Private funding can create real or apparent conflicts, if donors contribute believing the board will return the favor by passing accounting standards that they prefer. SOX's funding provision eliminated that problem for FASB. Establishing independent and stable funding for IASB is vital. Despite this fundamental point, the SEC seemed at first unaware of it and later indifferent to it.[75]

> other things, the Commission determines that the private sector body "has the capacity to assist the Commission in fulfilling the requirements of . . . the Securities Exchange Act . . . because, at a minimum, the standard setting body is capable of improving the accuracy and effectiveness of financial reporting and the protection of investors under the securities laws."

[70] *Id.*

[71] The International Accounting Standards Committee Foundation is a not-for-profit corporation incorporated in the State of Delaware and is IASB's parent.

[72] It appears that a majority of the trustees have not been associated with a US registered public accounting firm at least 2 years. The trustees include the current CEO of PriceWaterhouse Coopers; a retired chairman of Ernst & Young; and a retired chairman of KMPG Hong Kong.

[73] Adopting an IFRS requires a vote of at least 9 of the 14 board members (as does issuing an Exposure Draft, a Standard, or final interpretation; simple majority at meeting with at least 60% attending for other matters of adding to agenda, publishing a discussion paper). IASC Foundation Constitution, ¶30. http://www.iasb.org/About+Us/About+the+Foundation/Constitution.htm.

[74] ROBERT VAN RIPER, SETTING STANDARDS FOR FINANCIAL REPORTING: FASB AND THE STRUGGLE FOR CONTROL OF A CRITICAL PROCESS 86-87 (1994).

[75] The SEC's first release contains serious errors and omissions concerning how FASB is funded. It states: "The FASB is overseen by the Financial Accounting Foundation ("FAF"), *which is responsible for funding the activities of the FASB* . . . ." SEC Proposed Rule Rescinding Reconciliation, *supra* note ___, at 23 (emphasis added). This is false. The proposal never mentions SOX's funding provisions. In summarizing the SEC-FASB relationship, the proposal says that the SEC oversees FASB activities, provides views on member selection and sometimes refers accounting issues to it, but never mentions that, under SOX, the SEC reviews FASB's annual budget. *Id*. at 24; *see* Sarbanes-Oxley Act, § 109(e)(1), codified at 15 U.S.C. § 7219. I identified these errors in a comment letter dated July 10, 2007. The errors were corrected but not

IASB may or may not meet two other SOX criteria. First, it is uncertain whether it promptly considers new standards. It did so in the early 2000s. But after numerous countries and the EU began recognizing IFRS, the costs of shifting from national accounting standards to IFRS appeared daunting to many companies. (The costs would be higher if, during the transition, companies also had to contend with continuing changes and updates.) As a result, IASB announced a policy to suspend adopting any new standards for a number of years to facilitate transition.[76]

Second, perhaps the most nettlesome SOX criteria for IASB to grapple with is SOX's quintessentially domestic character. SOX requires standard setters to have the capacity to assist the SEC in its responsibilities by "improving . . . the protection of investors under the securities laws."[77] That determination is for the SEC to make and IASB might have the capacity. But this poses a question concerning whether IASB can commit to protecting investors under US securities laws. Its mission is to produce standards of general applicability globally. Being responsive to international needs may lead IASB to subordinate US needs, including the needs of US investors. Although it is not impossible that the two objectives are co-extensive, this cannot be assumed.[78] Even the SEC recognizes its diminished capacity to influence IASB compared to FASB.[79]

Two further questions arise in considering whether IASB can qualify as an accounting standard setter under US securities laws. One concerns whether the SEC is authorized to delegate such powers to more than one body. It appears that this is possible, but is not obvious.[80] On one hand, recognizing multiple standard setters could

---

acknowledged in the SEC's next release a month later. SEC Concept Release on Domestic IFRS, *supra* note ___, at 8-9 (accurately explaining how FASB is funded). The errors were rectified but not acknowledged in the SEC's final rule rescinding the reconciliation requirement. SEC Final Rule Rescinding Reconciliation, supra note ___, at 16-17. In it, the SEC never mentions anything about its authority to recognize IASB given that IASB lacks attributes that SOX requires. The only reference is a citation to SOX in the section requiring a statement of the statutory basis of the rule. *Id.* at 94.

[76] IASB has set a self-imposed moratorium on any new standards until at least 2009. http://www.iasb.org/Current+Projects/No+new+major+standards+to+be+effective+before+2009.htm.

[77] Sarbanes-Oxley Act, § 108(b)(1)(B), codified at 15 U.S.C. § 77s.

[78] The challenge is suggested by the issues canvassed in the next Part concerning the varying corporate, financial, and investor cultures in the world. *See infra* text accompanying notes ___-___. The SEC provides no public analysis of these concerns.

[79] *See* SEC Final Rule Rescinding Reconciliation, *supra* note ___, at 87 ("We recognize that our relationship with the IASB is less direct than our relationship with FASB and there are more and varied constituents of the IASB than of the FASB. The result may be that our view will be one of many views that the IASB receives from around the world and considers when developing future standards.").

[80] That is the SEC's interpretation of SOX. *See* SEC POLICY STATEMENT REAFFIRMING FASB STATUS, *supra* note ___, n. 5 ("The Act does not restrict the Commission's ability to develop accounting principles on its own and does not limit the number of private-sector bodies the Commission may recognize."). The statute is not as obvious as this interpretation suggests. SOX Section 108 directs that the SEC may recognize as generally accepted any accounting principles established by "*a* standard setting body" meeting stated criteria. Sarbanes-Oxley Act of 2002, § 108 (emphasis added). This suggests that any number of

present reconciliation and conflict risks among competing standards. If so, then any number of potential standard setters can vie for SEC recognition, but the SEC ultimately would designate one. On the other, allowing recognition of multiple standard setters could be appealing if competition among them is desirable.[81] Companies would simply declare which body's standards they are using. Alas, SOX's text is unclear on whether to prefer competition to comparability.

The second further question concerns whether the SEC is authorized to delegate powers to bodies even if they lack the stated criteria. The SEC claims this authority;[82] an elementary analysis of the statutory language and purpose concludes that the SEC's position is untenable.[83] The statute provides that the SEC "may recognize, as 'generally accepted,' for purposes of the securities laws, any accounting principles established by a standard body" that possesses the stated attributes.[84] The statute adds: "Nothing in this Act . . . shall be construed to impair or limit the authority of the Commission to establish accounting principles or standards for purposes of enforcement of the securities laws."[85]

The SEC appears to believe that this latter provision means it can recognize standard setters not meeting the criteria stated in the former. A more faithful reading of the literal language is that the latter provision reserves pre-existing SEC authority to establish accounting standards and the former narrowly addresses its power to delegate that authority to others. This reading of the literal language is strengthened by a purposive understanding. The stated attributes express public policy values that would be

standard setters can vie for the SEC's blessing. However, Section 109, which contains funding provisions, refers repeatedly to "*the* standard setting body designated pursuant to . . . section 108." Sarbanes-Oxley Act of 2002, §§ 109(c)(1), 109(e), 109(f), 109(g). The definitive article suggests that there shall be one SEC-designated accounting standard-setter.

[81] *See supra* note ___.

[82] *See* SEC Concept Release on Domestic IFRS, *supra* note ___, at 9 (after noting that the SEC has historically relied on FASB and predecessors to generate accounting standards, stating that the securities laws, including SOX, "provide the [SEC] with the authority to set accounting standards") (citing SOX Section 108(c)). The SEC sought public comment on the following questions in SEC Concept Release on Domestic IFRS, *supra* note ___, at 23-24. It asked whether it would "make a difference" if the SEC "officially recognized the accounting principles established by the IASB." "Officially recognize" presumably refers to formal anointment of IASB as a sanctioned standard setter for purposes of US securities laws. This implicates issues associated with the different relationships the SEC has with IASB and FASB, including the SEC's statutory authority to recognize IASB, which the SEC blithely ignores.

[83] The issue of SEC's power is more than a legal quarrel. Even were the accompanying analysis incorrect and the SEC has the power, there is sufficient doubt that it would be a factor in any company's decision to opt for IFRS (for companies given the option). What weight this legal uncertainty should be given and its relative role in any decision will vary across companies. But it likely would be decisive in a meaningful portion of cases.

[84] Sarbanes-Oxley, § 108(b)(1).

[85] Sarbanes-Oxley, § 108(c)

rendered meaningless under the SEC's interpretation.[86] It is fortified by observing how SEC delegation to IASB would represent a non-trivial relinquishment of US sovereignty to an international non-governmental organization.

3. Systemic Implications. Numerous additional changes would be required, whether an optional or mandatory move to IFRS, and assuming SEC authority to accept IFRS. These adjustments are necessary because the entire US system assumes a single set of accounting standards and that single set is US GAAP. The SEC pays scant attention to many of these systemic implications.

a. *Non-SEC Entities*. The SEC's vision is dominated by public companies, those subject to its jurisdiction. Yet most US enterprises are not public companies and most rely on US GAAP. A movement to IFRS jeopardizes the continuing production of US GAAP. Plans must be made either to continue to have FASB or another body produce US GAAP or facilitate a move to IFRS by all private companies too. Continuing with US GAAP production for use by private companies would raise the cost to those companies of going public. But moving all companies to IFRS incurs the costs of a general transition. The SEC has not analyzed this problem, instead only asking for public comment on how recognizing IFRS would affect FASB.[87]

b. *Other Entities*. Many US companies are subject to special regulations or requirements that are tied expressly to US GAAP. Principal examples are banks, broker-dealers, public utilities and other regulated industries. All related regulations would require adjustment. The SEC does not analyze these issues but only asks for public comment on whether they would pose barriers to adopting IFRS.[88]

c. *Tax Policy*. Some important parts of US tax policy are linked to US GAAP. A switch to IFRS requires adjusting them. Many of these policies appear in the Internal Revenue Code. A principal example is its LIFO conformity rule.[89] This requires companies to use, for tax reporting, the same inventory convention they use for financial reporting. The SEC does not analyze these matters.[90]

---

[86] There is another curiosity about the language of non-limitation. It says nothing in SOX shall "limit the authority of the Commission to establish accounting principles or standards *for purposes of enforcement* of the securities laws" (emphasis added). This is ambiguous. The concept of enforcement could be read narrowly to address the specific context of SEC enforcement proceedings or broadly to capture the general context of implementing the overall system of securities regulation. The narrow reading would mean that other provisions, including the standard setter recognition provision, could limit the SEC's plenary powers to produce accounting standards ex ante. This seems unlikely. The broader reading would reserve the SEC's plenary powers while still curtailing its power to delegate.

[87] *See* SEC Concept Release on Domestic IFRS, *supra* note ___, at ___.

[88] *See* SEC Concept Release on Domestic IFRS, *supra* note ___, at 15 (question 6).

[89] *See* I.R.C. § [LIFO conformity rule].

[90] Other examples of tax provisions that rely heavily on provisions of US GAAP are those concerning the deductability of bad debt expenses and of executive compensation. *See*, respectively, §166(a)(2) ("When satisfied that a debt is recoverable only in part, the Secretary may allow such debt, in an amount not in

d. *Contracts*. Numerous private contracts that enterprises have in place use GAAP heavily, especially the ratios contained in debt agreements and triggers contained in compensation agreements. All these must be adjusted to conform to IFRS. This is not a simple matter of amending references to GAAP to become IFRS references. The measurements under the two systems may differ so that specific ratios and calculations require reconsideration and, in the case of some contracts, renegotiation. Nor does the SEC analyze these issues, again simply seeking public comment on whether they pose barriers to adopting IFRS. [91]

e. *Affected Regulations*. Numerous SEC regulations are intertwined with US GAAP in ways that would differ under IFRS. Consider safe harbors for forward-looking information. Under US law, forward-looking disclosure is presented outside the audited financial statements and is insulated from liability risk by various legislative, regulatory and judicial doctrines. Under IFRS, these are included as part of the audited financial statements and therefore not automatically subject to the same insulating doctrines. A broader set of examples are the form and content provisions of Regulation S-X, including Item 305, and the concept and limitations on the use of non-GAAP measures in financial disclosure. All these require amendment, which the SEC effected when adopting its final rule rescinding reconciliation for foreign private issuers.[92]

f. *Substantive Variations*. There are important areas where the difference between US GAAP and IFRS is like night and day. A leading example concerns accounting by investment companies, especially mutual funds. US GAAP contains an elaborate, industry-specific standard for this, highlighting a schedule of investments, calculation of net asset values, determination of brokerages fees, and treating the residual interest in the fund as owners' equity. IFRS presents all these matters in entirely different ways, or does not require the related presentation at all.[93] A second example concerns insurance contracts. This again is an elaborate and well-developed body of accounting under US

---

excess of the part charged off within the taxable year, as a deduction"); I.R.C. §§ 162(m)(1) & (3)(B) (limiting deductions of compensation paid to employees whose "total compensation is required to be reported to shareholders under the Securities Exchange Act of 1934 by reason of such employee being amount the 4 highest compensated officers for the taxable year").

[91] *See* SEC Concept Release on Domestic IFRS, *supra* note ___, at 15 (question 6).

[92] *See* SEC Final Rule Rescinding Reconciliation, *supra* note ___, at 37-68; *see also* SEC Concept Release on Domestic IFRS, *supra* note ___, at 36-39 (discussing conforming adjustments to Regulation S-X, investment company accounting, Regulation S-K and other SEC pronouncements on accounting matters). Other SEC regulations require adjustment to address the transition period between ending use of US GAAP and beginning use of IFRS. A leading example is how SEC regulations call for providing five years of historical summary financial data. When a company begins to report under IFRS, it will not have five years of IFRS history to report and the GAAP history it has will not necessarily be comparable.

[93] Strikingly, IFRS counts the residual interest in a mutual fund as a liability whereas US GAAP treats it as equity. This occurs under the general principle that interests that may be recovered by another party on demand, as with share owners in mutual funds, constitute liabilities.

GAAP, but receives limited and conflicting treatment under IFRS. The SEC recognizes such examples and expresses confidence that IASB will address them in the future.[94]

g. *Training and Education*. Among issues that the SEC mentions but ignores in substance, the most troubling is the scarcity of US expertise in IFRS. For generations in the US, GAAP has been the basis for training, education and examination of accountants, in schools and in practice. IFRS is barely known and rarely taught. So the entire US training, education and examination system requires revision. This extends to most auditing firms (some larger ones report possessing knowledge of IFRS), regulators (including the SEC), colleges and universities (few courses exist and none is required), and investors (only sophisticated internationalist investors have exposure to IFRS). The SEC recognizes this limitation but expressly assumes that, if the SEC leads the way on IFRS, training and education will follow.[95]

h. *Auditing Concentration*. Only the largest auditing firms claim to command any significant knowledge of IFRS. Smaller firms have comparatively fewer resources to make an immediate and significant investment in requisite training. This creates the possibility that moving to IFRS could increase the competitive advantage that larger firms enjoy compared to smaller ones. At present, the four largest firms dwarf the size of the next largest firms by a ratio of about 20:1 and the industry is moderately concentrated under traditional antitrust law analysis. Accordingly, a shift to IFRS could, at least in the short term, increase this concentration. The SEC does not dwell on these matters. Instead, it asks what role auditing firms can play in promoting comparability in IFRS applications (discussed in Section III.B. below).

i. *Responsiveness*. The shift to IFRS would involve a significant reduction in the ability of US constituents to influence accounting standard setting. Professional or trade associations, such as the American Bankers Association or Association of Life Insurance Companies, now regularly interact with FASB to exchange knowledge relevant to the production of standards. This opportunity will be diminished given that IASB will have many more constituents and is located abroad.[96] The SEC does not analyze these matters.

---

[94] *See* SEC Concept Release on Domestic IFRS, *supra* note ___, at ___; SEC Final Rule Rescinding Reconciliation, *supra* note ___, at ___.

[95] SEC Concept Release on Domestic IFRS, *supra* note ___, at 28-29 ("The use of IFRS by U.S. issuers would *create* the need for effective training and education.") (emphasis added); *id*. ("the education of most accountants in the United States . . . does not include a . . . curriculum around IFRS. . . . Consequently, all parties would likely need to undertake comprehensive training on IFRS."); SEC Final Rule Rescinding Reconciliation, *supra* note ___, at 23 (acknowledging limited knowledge in IFRS and then stating: "We anticipate, however, that by encouraging the use of IFRS as issued by the IASB, these amendments will help investors to understand international investment opportunities more clearly and with greater comparability in the long-term than if they had to continue to rely on a multiplicity of national accounting standards").

[96] Various solutions to this issue are readily imaginable, including creating regional IASB offices around the world (at present three would be sufficient, in Asia, Europe and North America, although consideration should be given to include South America and eventually Africa).

j. *Investor Protection*. The combination of reduced US sovereignty, increased use of principles and concomitant adjustments (some noted above and many others elaborated below), will diminish US investor protection traditions. True, increasing global capital flows should reduce the costs of capital and increase returns to investors. This can create a wider spectrum of investment opportunities from which to choose, adding to the possibility of portfolio diversification, risk management and risk-adjusted returns. To the extent that comparability is achieved these benefits would be real. But there are risks that comparability will be limited. The most significant risk is that uniform standards coupled with official, if rhetorical, SEC talk of comparability will produce a veneer of uniformity and comparability, disguising significant differences in practice.

The SEC offers only modest references to investor interests or investor protection. It repeatedly emphasizes, as benefits from moving to IFRS, increased cross border capital flows, with token recognition that achieving those benefits may also benefit or protect investors.[97] The SEC's asserted benefits for investors often are strained. For example, it says that companies using IFRS will enjoy savings from financial reporting activities, thus freeing up funds for them to invest in productive business activity.[98] That, the SEC says, will benefit investors. The SEC proceeds with its proposals on the strength of supportive comment letters from many non-investors and despite opposition or skepticism expressed by numerous investors.[99]

This limited SEC attention to investor interests in the context of accounting standards introduces another paradox and contradiction. Federal statutes require the SEC, in its rule-making and policy formulation, to balance goals of investor protection and capital formation.[100] Congress gives the SEC limited guidance on balancing these

---

[97] *E.g.*, SEC Proposed Rule Rescinding Reconciliation, *supra* note ___, at 25-26 ("The Commission has long advocated reducing disparity between the accounting and disclosure practices of the United States and other countries as a means to facilitate cross-border capital formation while *ensuring* adequate disclosure for the protection of investors and the promotion of fair, orderly and efficient markets.") (emphasis added); SEC Concept Release on Domestic IFRS, *supra* note ___, at 4 (same except changing the word ensuring to providing); SEC Proposed Rule Rescinding Reconciliation, *supra* note ___, at 35 ("The Commission has encouraged movement towards a single set of high-quality globally accepted accounting standards as an important goal both for the protection of investors and the efficiency of capital markets."); SEC Final Rule Rescinding Reconciliation, *supra* note ___, at 92-93 (noting that rule promotes efficiency, competition and capital formation and stating that "We believe that investors would have adequate information on which to base investment decisions and that capital may be allocated on a more efficient basis.").

[98] *E.g.*, SEC Concept Release on Domestic IFRS, *supra* note ___, at 13 (if an issuer saves money by preparing statements in IFRS instead of US GAAP and allocates the savings to higher earning opportunities without incurring an "increase in the cost of its capital as a result of using IFRS, investors will benefit in terms of a better rate of return."); SEC Final Rule Rescinding Reconciliation, *supra* note ___, at 86 (same).

[99] *See* SEC Final Rule Rescinding Reconciliation, *supra* note ___, at 8 ("commentators supporting the proposal, which included many foreign private issuers, accounting firms, legal firms [sic] and foreign standard setters, as well as some investors . . . ."); *id*. at 9 (the views of other commentators, including some institutional investors and rating agencies "were mixed").

[100] *See* 15 U.S.C. § 77b(b).

goals, granting changing SEC leadership discretion. On the other hand, in SOX, Congress explicitly directed how the balance is to be struck concerning accounting standards. It told the SEC to consider, when evaluating a standard setter, to determine that it has the ability to assist the SEC discharge its responsibility to protect investors.[101] Accordingly, when the SEC elevates capital formation above investor protection as a rationale to embrace IFRS and IASB, it contradicts this legislative directive.

All these complex matters may be manageable, but pose risks. The SEC considers some yet offers limited evaluation of many, including important ones, such as investor protection. Each of these domestic challenges, moreover, resides in a broader international framework presenting substantive and structural challenges that require further probing that the SEC likewise has failed to undertake with requisite rigor. Substantively, these matters raise issues about the character, purposes and interpretation of accounting standards, which the SEC has essentially ignored. Structurally, they raise practical issues of production, enforcement and compliance. The SEC has discussed these issues, although its analysis and plans appear more quixotic than realistic. The following two Parts explore these respective substantive and structural challenges before assessing the prospects of achieving universal accounting.

II. SUBSTANTIVE CHALLENGES

Many national or regional features influence accounting systems used in various countries. These are converging. Accounting is both following suit and likely to reinforce and hasten convergence. Still, some features are likely to be more resistant to change than others. All are relevant to the probable success and required shape of global accounting standard production and form. The following uses familiar classifications from corporate law scholarship to highlight aspects of accounting that are affected by national variation posing substantive challenges for establishing a universal system of global accounting. Although the SEC says little or nothing about such substantive challenges, they present considerable obstacles to any existing or potential SEC vision, whether designed to promote comparability or encourage effective competition.

A. *Legal Origins*

National accounting systems are connected to local legal traditions. A broad contrast among legal traditions distinguishes common law and civil law.[102] Accounting standards in common law countries, such as the US and UK, traditionally obtained

[101] *See supra* text accompanying notes ___-___ (discussing SOX-mandated attributes of an accounting standard setter, including ability to help the SEC protect investors).

[102] *See* Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *The Economic Consequences of Legal Origins* (Nov. 2007) (synthesizing extensive research on relationships between national legal origins and regulatory provisions and economic outcomes); Edward Glaeser & Andrei Shleifer, *Legal Origins*, 117 Q. J. ECON. 1193 (2002).

authority through general acceptance by the profession;[103] accounting systems in civil law countries, including most continental European countries (the Netherlands is the major exception) obtain legitimacy by enactment as law.[104] Japanese accounting exhibited a blending of these traditions. These legal origins explain some of the observed persistent divergence among companies purporting to use IFRS discussed earlier.[105]

These origins also play out in different views on how to apply identical accounting requirements. A salient manifestation of how legal origins influence the application of identical accounting requirements concerns the principle that financial statements should present a true and fair view of the business and financial condition of an enterprise. This edict, perhaps the most famously flexible and contingent notion in all of accounting, can mean different things in different contexts and different cultures.

Substantive disagreements exist concerning the relationship between the principle and other accounting standards. The issue arises when applying the standards could impair the objective. Three stances appear.[106] In the UK, an override is required so that the true and fair view is privileged and conflicting standards ignored; in Europe, overriding the written rules is repugnant, despite the true and fair view concept; and in the US, overrides have generally not been used because litigation risks induce people to comply with rules. It appears unlikely that any international standard will be capable of reconciling these disagreements; local cultural influences will retain a role in how the principle is applied.

This skepticism is reinforced by observing how efforts to define "true and fair view" show a struggle suggesting cultural contingencies. In England, *fair* denotes that reports are within a range of fidelity to business records and economic reality; *true* negates its opposite—false.[107] Until the UK joined the EU, the concept was alien to non-Dutch Europe; the EU's 1978 Fourth Directive introduced the requirement. The Italian translation of true and fair is "true and correct" (*rappresentare in modo veritiero e corretto*),[108] which is then equated with Italian civil law requiring "straightforwardness

---

[103] This is also true for Dutch accounting, despite a civil law tradition, and due in part to its use of a specialized commercial and company law court. *See* DAVID ALEXANDER & SIMON ARCHER, EDS., MILLER EUROPEAN ACCOUNTING GUIDE 700 (3d ed. 1998).

[104] *Id*., at 1-2.

[105] Evidence summarized above diagnosed variation among IFRS users to different legal origins. *See supra* text accompanying notes ___-___.

[106] *See* Lawrence A. Cunningham, *Semiotics, Hermeneutics and Cash: An Essay on the True and Fair View*, 28 N.C. J. INT'L & COMM. L. 893 (2003).

[107] Alternatively, "true" is defined as complying with the letter of rules and "fair" as complying with the spirit of rules. T. K. Cowan, *Are Truth and Fairness Generally Acceptable?*, ACCT. REV. (Oct. 1965), at 188-194.

[108] In earlier legislation, Italy translated the phrase as faithful picture (*quadro fedele*). DAVID ALEXANDER & SIMON ARCHER, EDS., MILLER EUROPEAN ACCOUNTING GUIDE 581 (3d ed. 1998).

and truth" (*evidenza a verita*).[109] Many translations replace the compound phrase with a single word. In Greece this is the equivalent of "real"; in Belgium, France, Luxembourg, the Netherlands and Spain it is the equivalent of "faithful."[110] In the US, the concept is embedded in the requirement that financial statements "fairly present" an enterprise's financial condition and results of operations.

B. *Securities Regulation*

Legal traditions continue to influence the shape of securities regulation in different countries. Securities regulation, in turn, influences accounting. The most forceful examples of these relationships appear in the contexts of investor protection and enforcement intensity.[111] In the US and UK, investor protection is among the principal purposes of securities regulation and accounting principles are designed to bolster investor protection. In many countries, interests of constituencies other than investors matter and investor protection is one among several competing goals of securities regulation. Enforcement intensity refers to the relative strength of legal institutions equipped to police adherence to securities regulations, including accounting provisions. The US employs an intense enforcement apparatus, one that includes the SEC, private litigation as well as various other state and federal authorities. Few other countries match this level of enforcement intensity and many exhibit a weak enforcement apparatus.[112]

The differences pose implications for a range of accounting issues. A general example concerns the preferred form that standards assume, ranging from detailed rules to vague principles. Indeed, many attribute the relative rules-density of US GAAP to the existence of an intensive enforcement environment. Litigation threats lead preparers and auditors to value clarity in accounting standards, leading to extensive provision of detailed guidance. European and Asian companies and constituents may be able to accept relatively more generic accounting standards, in part, because of the comparatively lower level of private and public enforcement of securities laws through regulation and litigation.

Predicting the effects of cultural variance on the future of IFRS is not easy. It is conceivable that relative enforcement intensity, and the value of investor protection, can

---

[109] DAVID ALEXANDER & SIMON ARCHER, EDS., MILLER EUROPEAN ACCOUNTING GUIDE 583 (3d ed. 1998) (discussing Civil Code, Article 2217, section 2). Italian accounting also requires presentation with clarity and precision (*chiarezza e precisione*). *Id.* (citing Civil Code, Article 2423, section 2).

[110] *See* Chrisopher W. Nobes, *The Imagen Fiel Requirement: Impact On and Of the Fourth Directive*, 24 ACCT. BUS. RES. 35 (1993). Similar translation differences exist across Europe, such as right-looking and according to facts (Denmark) and true and appropriate (Portugal). *Id*.

[111] *See* John C. Coffee, Jr., *The Political Economy of the Berle-Means Corporation: Enforcement Intensity and Capital Market Competitiveness*, 156 U. PA. L. REV. ___ (2007); Howell Jackson, Enforcement Intensity, [citations].

[112] The issue of required enforcement in a global accounting environment is considered more extensively in Part III's evaluation of structural challenges that the shift to universal accounting system presents. *See infra* text accompanying notes ___-___.

converge worldwide. That would mean making US legal changes to reduce the role of liability risk and litigation threats on preparers and auditors to curtail demand for detail or increasing those levers in other nations. Both prospects entail momentous changes with uncertain prospects and payoffs. Even substantial reductions in the scope of legal liability for accounting violations are unlikely to eliminate litigation as a dispute resolution mechanism in the US.[113] Intensifying enforcement activity in other countries is possible but by no means certain or desirable.[114]

C. *Corporate Governance*

Corporate governance, referring to the combination of corporate purpose and organizational arrangements designed to achieve it, vary worldwide. Broadly defined, corporate purposes range from a shareholder profit maximization philosophy to a pluralistic conception of corporate constituencies that includes shareholders, creditors, employees, suppliers, communities and the state.[115] Organizational arrangements reflect these purposes through devices such as the design, composition and duties of boards of directors.

Boards may have one or two tiers, members may be elected by shareholders only or by other groups and duties may range from maximizing profits to assuring the corporation's long-term sustainability. Accounting in systems characterized by shareholder profit maximization naturally tends to emphasize the measurement of profit from period to period whereas in more pluralistic systems may emphasize net worth and consistent levels of profit over time.

The role of employees, at both the senior executive levels and the broader level of laborers, can have significant effects on accounting philosophy. Labor plays an active role in corporate governance in many countries, a role unknown in the US. For example, employees are formally represented on boards of directors in Germany and the Netherlands.

As for senior executives, the most pronounced global difference concerns levels and forms of compensation. US corporations pay executives considerably greater compensation than elsewhere, often by staggering multiples and often in the form of

---

[113] An additional explanation for the relatively greater use of principles in IFRS is simply its relative youth. Repeated application of even the vaguest standard reduces that vagueness. A maturing IFRS can be expected to exhibit metamorphous from principles to rules.

[114] The SEC addresses, to a limited extent, concerns arising from certain aspects of securities regulation. But its focus is not on variation in enforcement intensity or relative importance of investor protection in different countries. Instead, the SEC's focus on securities regulation issues is on the challenge of coordinating global authorities to enforce accounting standards within the world's varying systems. This daunting challenge is discussed in Section III.B below.

[115] In Germany, to give a well-known example, short-term profits are subordinated to long-term financial survival. *See* Wolfgang Ballwieser, *Germany: Individual Accounts*, in 2 DIETER ORDELHEIDE & KPMG, TRANSNATIONAL ACCOUNTING 1241 (2d ed. 2001).

stock options and other compensation that is contingent on varying measures of corporate performance. Setting the benchmarks of corporate performance and calculating compensation levels are important roles of accounting in such a system that assume less or no importance in cultures where executive compensation packages are more modest.[116]

In the most general terms, the varying corporate purposes and organizational designs around the world reflect varying forms of capitalism.[117] National accounting traditionally reflects competing conceptions of capitalism. Although these and other distinctive traditions are converging, enduring diversity in views on capitalism are likely to continue to exert influence at national levels, posing challenge to the formulation, acceptance, application and enforcement of international standards.[118]

D. *Corporate Finance*

Even within corporate governance systems that exhibit family resemblance there may be differences in corporate finance that lead to sharply different conceptions of accounting's purpose and audience. Corporate finance refers to the sources of capital employed to fund a corporation and the corporation's resulting capital structure. The chief categories of capital are equity and debt securities. The combination, identity and role that the two forms of investment play influence the audience for whom accounting is designed.[119]

Needs and interests of debt and equity investors differ. For equity investors, accounting standards and statements should be useful to form judgments concerning business value. Standards quality is evaluated in terms of the relationship between reported accounting figures and resulting stock market prices or returns. For debt investors, accounting standards should make contract negotiation more efficient. Standards quality is evaluated in terms of whether they translate into financial statements that are useful for establishing covenants and other contractual provisions that regulate the rights and duties of lenders and borrowers.[120]

Corporate finance characteristics also influence the relative importance of transparency that accounting can provide. Anglo-American finance is oriented towards

---

[116] This difference may explain how difficult it was for FASB to adopt accounting standards requiring the expensing of stock options compared to the IASB's much swifter adoption of such standards.

[117] *See* David Levi-Faur, *The Global Diffusion of Regulatory Capitalism*, 598 ANNALS 12 (2005) (discussing varieties of capitalism and aspects of convergence).

[118] *See* JOSEPH A. MCCAHERY, *ET AL.*, EDS. CORPORATE GOVERNANCE REGIMES: CONVERGENCE AND DIVERSITY (2002).

[119] The list of potential audiences for accounting information can be extended beyond debt and equity investors to include regulators, vendors, tax authorities, management, and potential merger partners.

[120] *See* Raymond J. Ball, Ashok Robin & Gil Sadka, *Is Accounting Conservatism Due to Debt or Equity Markets? An International Test of "Contracting" and "Value Relevance" Theories of Accounting* (working paper 2005).

equity and open capital markets, often attracting dispersed and uninvolved equity owners, making transparency in financial reporting vital. Traditionally, Euro-Japanese finance relies on banks, which exercise considerable power within corporations. That reduces the importance of reporting transparency for external users.

The relative needs of equity or debt investors also bear on how accounting standards and statements address uncertainty. The traditional US approach to uncertainty is conservatism, meaning asymmetric recognition of losses compared to gains.[121] Investors and other constituencies may have different demands for relative conservatism. In general, debt demands greater conservatism than equity.[122] Managers compensated heavily using stock options or other devices based on reported accounting results will demand a different level of conservatism than managers not so compensated. Managerial demand for conservatism relative to that demanded of equity or debt investors will differ accordingly.

Corporate finance also can influence the relative weight one assigns to the income statement or balance sheet. This sometimes follows from the traditional forms of capital structure that prevail. To the extent that debt capital dominates, there is a greater reliance on the balance sheet to provide a basis for estimating solvency; in societies where equity capital dominates, emphasis is placed more heavily on the income statement to provide a basis for evaluating performance. It is also possible for the relationship between financial and tax reporting (and the role of the state) to influence the relative importance of, and the relationship between, the income statement and balance sheet. Accounting for inventory illustrates both points.

It is conceptually defensible to assume that goods in inventory are sold either in the direct order that they are produced (first-in-first-out or FIFO) or in reverse order of production (last-in-first-out or LIFO). In a period of rising prices, FIFO is more faithful to economic reality in the balance sheet, by listing the inventory asset at more current values; LIFO is more faithful to economic reality in the income statement, by recording the costs of goods sold at more current costs.[123] US GAAP permits choosing between

[121] *See* Sudipta Basu, *The Conservatism Principle and the Asymmetric Timeliness of Earnings*, 24 J. ACCT. & ECON. 3 (1997).

[122] *See* William W. Bratton, *Shareholder Value and Auditor Independence*, 53 DUKE L.J. 439, 477 (2003) (debt investors prefer conservative accounting because they do not enjoy capital appreciation and so concentrate on negative analysis of default risk and rely on hard assets for ultimate recovery).

[123] During periods of rising prices, FIFO presents inventory costs on the balance sheet more accurately by recording it at current costs but presents expenses on the income statement less accurately because it does not match current costs of goods sold (COGS) with current sales (COGS are based on the costs of the oldest items in inventory while sales are being made and reported at current prices). As such, during inflationary periods FIFO tends to understate COGS and report artificially high profit. In contrast, LIFO is generally more accurate in the income statement (it reflects current COGS) and less accurate in the balance sheet (it reflects historical costs). Since balance sheet inaccuracies tend to err by understating costs (and hence carrying amounts) of inventory LIFO is more harmonious with US GAAP's principle of conservatism. On the other hand, the degree of accuracy in the income statement depends on the entity continuing to maintain quantities of inventory at least equal to the quantities reflected on the balance sheet.

these measurements, allowing enterprises to determine whether balance sheet or income statement fidelity is more important; IFRS requires using FIFO, suggesting balance sheet primacy.

Concerning taxation, the Internal Revenue Code, as noted, requires conformity between inventory accounting for financial and tax reporting purposes. A company must use LIFO for both or FIFO for both. The rationale is simple. In a period of rising prices, FIFO results in reporting higher income compared to LIFO. Managers may prefer FIFO for financial accounting to show investors higher income while preferring LIFO for tax accounting to pay the government lower taxes. The Code conformity requirement reflects how US culture generally considers tax and financial accounting separate subjects with generally different standards whereas in many countries the two subjects are substantially co-extensive.

A broader point about the cultural contingency of giving greater weight to the income statement or balance sheet concerns which is more susceptible to manipulation (sometimes referred to as tunneling in the academic literature).[124] In countries with dispersed equity ownership, such as the US, manipulating the income statement is better for controlling persons, whose payoffs are a function of earnings per share. In those with concentrated ownership, as in Europe and Japan, manipulating the balance sheet is better for controlling persons whose payoffs come from allocating corporate assets to themselves rather than serving as stewards for other claimants.

It is not obvious whether IFRS provisions are designed to influence managerial propensity to manipulate the income statement or the balance sheet. It is also uncertain whether accounting standards could completely eliminate those propensities by proper design. Still, the cultural differences that lead to these differential incentives matter in assessing universal accounting standards, both in production and application. Now it is more important for investors in US companies to constrain discretion over the income statement and for investors in European companies to constrain discretion over the balance sheet. If all use the same set of standards, it may be impossible to enable making these distinctions.[125]

Time horizons, referring to the distinction between the long-term and short-term, can be of great significance in conceiving appropriate accounting standards. Consider the case of Germany, which expressly permits and can require the recognition of revenue or expense through hidden reserves across multiple time periods. These have little to do with recognition concepts in US or UK accounting which reflect more immediate time periods.

---

[124] *See* Simon Johnson, *et al*., *Tunneling*, 90 AM. ECON. REV. 22 (2000); John C. Coffee, Jr., *A Theory of Corporate Scandals: Why the U.S. and Europe Differ,* 21 OXFORD REV. ECON. POL'Y (2005).

[125] On the other hand, a single set of global accounting standards may make more transparent the kinds of tunneling activities in which managers or insiders are engaged. *See* Vladimir Atanasov, Bernard Black & Conrad S. Ciccotello, *Unbundling and Measuring Tunneling* (working paper 2007).

The use of hidden reserves, also followed in other European countries, including Austria, Denmark, Finland and Switzerland and to lesser degrees in Spain, would constitute earnings management in the US and UK and be a violation of both accounting standards and securities laws.[126] Even if these principles were abandoned for enterprises using IFRS, traditional knowledge and sensibilities associated with each tradition would likely play a part in applications. That means that preparers in different countries could, in good faith, apply identical standards in different ways.

E. *The Market*

The relative role of markets in corporate activity covered by accounting reports can influence the character and sensibilities related to the content and application of accounting standards. An example appears in the fundamental accounting issue of measuring assets. In general, there are two choices: measuring assets based on observed transactions (known as historical cost accounting) or measuring assets based on prevailing market conditions (known as fair value accounting).

National accounting systems take differing stances on whether to prefer historical cost or fair value accounting in general and in specific circumstances. Many are dual-attribute models, in which some items are measured using historical cost and others using fair value. The choice is determined according to trade-offs between accounting's goals of relevance versus reliability.

The appeal of historical cost accounting is that measurements arise from observed transactions, such as the purchase price of an asset, which leads to reliable figures. Judgments are required to allocate that cost over the asset's life. As time passes, the historical cost figure becomes less relevant in the context of prevailing conditions.

The appeal of fair value accounting is that measurements are based on prevailing conditions, such as market prices of an asset, which leads to relevant figures. Cost allocations may require adjustment; a limitation occurs when exact markets prices are inaccessible (either because the asset does not trade on a market or because it has few substitutes), making it less reliable than historical cost figures.

US GAAP traditionally preferred historical cost accounting, subject to a "lower of cost or market principle" that used market values when these were lower. A US trend toward favoring fair value accounting began in the latter 20th century.[127] IFRS favors fair

[126] *See* ENNO W. ERCKLENTZ, JR., 2 MODERN GERMAN CORPORATE LAW 440-64 (1979); DONALD E. KIESO, *ET AL*., INTERMEDIATE ACCOUNTING 826 (10th ed. 2001).

[127] *See* Stanley Siegel, *The Coming Revolution in Accounting: The Emergence of Fair Value as the Fundamental Principle of GAAP*, 42 WAYNE L. REV. 1839 (1996); *see also* G. A. Swanson, *Accountability and the Drift Towards 'Fair Value Measurement'*, AM. ACCT. ASS'N REGIONAL MEETING PAPER, SSRN ID = 487043 (Apr. 6, 2004); see generally FIN. ACCT. STNDS. BD., STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 7, USING CASH FLOW INFORMATION AND PRESENT VALUE IN ACCOUNTING MEASUREMENTS (Feb. 2000). Other prominent FASB standards reflecting this movement are FASB No. 133, 155, 157 and 159.

value accounting, in part as a product of the projects designed to converge IFRS and US GAAP.[128] Other national accounting systems vary in their relative preference for historical cost and fair value accounting. Any choice IFRS makes thus will entail cultural adjustment in some countries.

A putative advantage of fair value accounting is its use of markets as a basis for asset measurement. This is an appealing notion when IFRS are designed, in large part, to expand capitalism. Yet a limitation arises if markets are imperfect or unavailable to measure particular assets. When that occurs, preparers and auditors must estimate fair value using judgment based on hypothetical valuation modeling tools.

This activity raises a broad question of how much deference these actors should receive when making such judgments compared to how much power investors and other users of financial statements should have to challenge those judgments. The national significance of this question will vary according to local investor demographics, including the mix of debt and equity in a capital structure and the degree of ownership concentration or dispersion.[129]

F. *The State*

The role of the state varies across nations, even within capitalist societies. In comparative terms, the social democrat traditions prevalent in many continental European nations demand a state role consciously committed to protecting its citizens, including in economic terms. This sensibility often also results in the identification of some corporations as national champions and some constituent groups, such as labor unions, as entitled to special status. In contrast, US sensibilities, certainly among conservatives and even among many centrists and liberals, evince a more individualistic proclivity that reduces the role of the state in economic life (and other spheres). There are no or few national corporate champions.

The consequence of these sensibilities appears in differences between traditional French accounting compared to US (and UK) accounting. French accounting is heavily linked to, and co-extensive with, state fiscal policies; in the US, tax accounting and financial accounting are distinct. Also, the UK/US income statement is designed to present information in forms useful to decision making by equity owners; traditional

[128] The most prominent IASB standard reflecting this appetite is IAS No. 39.

[129] Whether to prefer historical cost or fair value accounting raises the question of whether accounting estimates of fair value are likely to be better than market estimates of the same. Accounting reports need not try to capture market values. So long as reports reflect historical activity, investors can perform analysis that translates data into current valuations. Investors are good at estimating fair value, assembling information, assessing risks, and modeling probable outcomes in light of market conditions. Accountants are good at presenting useful information for these tasks, at tracking activity, measuring it, allocating it, aggregating it. Accounting should focus on verifiable data; investors should focus on interpreting and extending it into estimates of fair value. That stance aside, outside the US and a dozen other countries boasting deep and liquid capital markets, present prospects are dim for reliance on markets for direct or modeled valuation measures.

French income statements were organized according to a statutory scheme that reflected an orientation towards the French state.[130] Similarly, US/UK balance sheets conceptualize assets in economic terms whereas traditional French accounting conceives of them in a "patrimonial sense" of interests in tangible property.[131]

The state's role also bears on relative conservatism. States may prefer a level of conservatism in accounting designed to generate desired tax revenue from corporations subject to tax within their jurisdiction. The exact appetite may depend on population demographics, the manner of raising fiscal revenue and the influence of economic theories on national policy, such as views on what supply-side effects have on production and total tax revenue. Whatever the appetite is, it may differ from those of other constituents within a country and differ from those prevalent in other countries.

A state's net appetite for relative accounting conservatism may be influenced by the demands of corporations and their constituents domiciled within the country. In countries that tend to identify national champions among their corporate elite, a national solicitude toward their interests is likely to interact with fiscal policy making. The net appetite also likely will be influenced by the historical relationship between financial and tax accounting. In the US, because those have been distinct, financial accounting can generally be evaluated independently of fiscal policy; for the many countries in which financial and tax accounting are co-extensive, the state's interest will continue to influence desired choices within financial accounting.[132]

The foregoing substantive challenges suggest that achieving comparability may be unlikely.[133] Particular national cultural and legal features shape the development of accounting standards and those features are unlikely to cease exerting pressure even if all nations nominally recognize IFRS. The likely result would be enduring differences and impaired comparability. If so, this may justify foregoing the quest for comparability in

[130] *See* Jacques Richard, *France: Group Accounts*, in 2 DIETER ORDELHEIDE & KPMG, TRANSNATIONAL ACCOUNTING 1137 ff. (2d ed. 2001).

[131] *Id*.

[132] An emerging literature investigates the relationship between IFRS reporting and traditional European tax accounting, finding substantial congruence between the two. *See* Eva Eberhartinger & Margret Klosterman, *What If IFRS Were a Tax Base? New Empirical Evidence from an Austrian Perspective*, Acct. Euro. (forthcoming 2008), *available at* www.ssrn.com/abstract_id=1080512. It is likely that difference rather than similarity would exist between US tax reporting and IFRS by a wider margin than existing differences between US tax reporting and US GAAP. If so, these comparatives suggest, incrementally, that IFRS is better tailored to European contexts than to US contexts. If this hypothesis is incorrect, and IFRS-US tax reporting is less divergent than US GAAP and US tax reporting, this could support wider adoption of IFRS in the US (and, even justify and enable the process of converging accounting and tax reporting in the US). *See generally* Wolfgang Schon, *The Odd Couple: A Common Future for Financial and Tax Accounting?*, 58 TAX L. REV. 111 (2005).

[133] The SEC expressly acknowledges this likelihood. *See* SEC Concept Release on Domestic IFRS, *supra* note ___, at 34 ("it is likely that not everyone will apply accounting standards consistently or appropriately").

favor of obtaining the offsetting advantages of competition. This would support the SEC's proposal to allow companies to choose which reporting system to use. But, as discussed next, other apparatuses the SEC discusses and is creating or coordinating to meet structural challenges are expressly designed to increase comparability.[134] Returns on that investment in comparability are likely to be greater without competition. The necessary institutions and coordination devices are worth less if competing standards vie for recognition in the marketplace. This tension further reflects limitations on the SEC's global accounting vision and its quixotic quality.

III. STRUCTURAL CHALLENGES

Convergence processes and demand for universal accounting can help meet many of the substantive challenges. But structural challenges will face any international accounting standard setter and its supporting regime. In contrast to under-appreciation of substantive challenges, the SEC has discussed structural challenges extensively. But even this attention is modest when compared to the actual stakes. Structural challenges raise a host of issues concerned with contemporary global governance.[135] A general challenge lies in adapting to the international governance level domestic organizations that are embedded in a local system of administrative law.[136] For accounting, this requires attention to matters of production, enforcement and compliance, which this Part analyzes in turn.

A. *Production Models*

The SEC has spoken firmly concerning recommended institutional attributes and governance design for IASB. The SEC's current vision is a direct product of previous SEC views, especially those that led IASB to reform itself in 2000.[137] Its effort to encourage IASC to reorganize itself into the IASB using FASB's model may have been good advice. Yet numerous differences exist between producing national standards and producing international standards, many of which the SEC overlooks or provides scant analysis, at least publicly.[138]

1. <u>Delegation</u>. US securities laws vest the SEC with authority to define generally

---

[134] *Id*. (due to the likelihood of variation in application, SEC must coordinate with other national regulators to promote comparable applications).

[135] *See* Benedict Kingsbury, Nico Krisch & Richard B. Stewart, *The Emergence of Global Administrative Law*, 68 L. & CONTEMP. PROBS. 15 (2005).

[136] Walter Mattli & Tim Buthe, *Global Private Governance: Lessons from a National Model of Setting Standards in Accounting*, 68 L. & CONTEMP. PROBS. 225 (2005).

[137] The SEC's earlier influence posed some of the difficulties associated with the SEC's power to recognize IASB. *See supra* text accompanying notes ___-___.

[138] *See* David Zaring, *International Law by Other Means: The Twilight Existence of International Financial Regulatory Organizations*, 33 TEX. INT'L L.J. 281 (1998) (extensive analysis of numerous bodies, including IOSCO).

accepted accounting principles.[139] The SEC traditionally discharges this responsibility by delegation. In 1973, the SEC formally recognized FASB pronouncements as authoritative.[140] This ordained a delegation model with agency-principal issues that have required adjustments in governance design and care in stating rationales over the sometimes volatile history of FASB's life.

The SEC delegated to FASB for several reasons. The general reasons, applicable to many agency delegations, include efficiency from specialization, deflecting blame for failure and conserving its resources. Others are more specific to accounting, and include that standards are complex, technical and fast changing. Few government employees have required knowledge—and training and retaining them is costly. Assigning responsibility to a private agent can be efficient.[141]

Many of the same grounds for the SEC to delegate to FASB remain applicable to delegations to IASB. But additional factors come into play. Ultimately, the motivation is to create global standards that promote international comparability and facilitate the continued spread of global capitalism. That presents vastly different stakes than the SEC's delegation to FASB, including sacrifices in national sovereignty.

2. <u>Agency</u>. In any delegation, a principal vests discretion in the agent. The extent of discretion may be narrow or broad, according to the relative strength of the relationship. In traditional US administrative law practice, the relation between such principals and agents is complex but familiar. A series of principal-agent relationships exists (beginning with citizens functionally delegating to legislators), ultimately vesting FASB with agency powers exercised on behalf of the SEC as its principal.

The agency issue for US administration is whether the delegate is serving the public interest as a neutral, independent expert or is captured by special interests and doesn't represent public interest. FASB faces pressures from managers and investors and many other constituencies, including auditors, and business enterprises.[142] All can wield

---

139 *See e.g.*, section 7, 19(a) and Schedule A, items (25) and (26) of the Securities Act of 1933, 15 U.S.C. 77g, 77s(a), 77aa(25) and (26); sections 3(b), 12(b) and 13(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(b), 78l(b) and 78m(b); sections 8, 30(e), 31 and 38(a) of the Investment Company Act of 1940, 15 U.S.C. 80a-8, 80a-29(e), 80a-30 and 80a-37(a).

140 Securities and Exchange Commission, Accounting Series Release No. 150 (December 20, 1973).

141 The accounting context also amplifies the general blame-deflection rationale of delegation in two ways. First, financial accounting scandals are inevitable so that the value of delegation to avoid blame increases. Second, standard setting rarely pleases many constituents and often displeases them intensely.

142 The Business Roundtable, a trade organization composed of chief executives of the largest US companies, is an active participant. Substantive examples include the standard on foreign currency translation, first proposed in 1976 and finally revised under heavy criticism in 1979. Governance examples include getting FASB to create an Emerging Issues Task Force to respond to developments promptly. Process examples include getting representation on the Financial Accounting Foundation, the trustees who oversee FASB. A mixed example concerned stock option accounting, which the Roundtable helped block for more than a decade by gaining by-law changes relating to setting FASB's technical agenda.

influence directly through lobbying campaigns and comment letters on proposed standards and meetings.[143] The stakes are high: FASB standards affect many interests, sometimes pitting against each other the interests of preparers (managers) versus users (investors and others) and often presenting serious implications for capital allocation, stock prices, investment selection and executive compensation.

The consensus view is generally that FASB has managed to preserve its independence and the main theory is that the SEC-FASB agency relationship is strong. It is strong because their missions are aligned in the name of protecting investors. The bond is reinforced by shared accounting expertise and a cooperative approach to policy formulation and standard setting. Importantly, the SEC also carries a big stick: it can overrule FASB and has the power to revoke its authority. Indeed, the SEC has plenary power over establishing accounting standards in the US. Its delegation to FASB, or to any other body, is revocable at will.

At the global level, delegation is more complex. As an initial matter, the SEC and its regulatory counterparts in other countries each delegate to the 105-member IOSCO (and each of them, in turn, exercises authority delegated to it by its respective national legislature or equivalent). Each regulator as well as IOSCO then delegates power to IASB (or, more precisely, to a Foundation that in turn oversees IASB). On the surface, this model can be imagined as no more complex than the SEC-FASB model. It simply substitutes an IOSCO-IASB relationship for the SEC-FASB one.

Yet greater complexities bubble beneath the surface. IOSCO is unlikely to be a unified principal to IASB in the way that the SEC is to FASB. After all, it consists of 105 principals. Members can be expected to exhibit different views of what constitutes suitable accounting standards. The goal of promoting global comparability in financial reporting or facilitating cross-border capital flows may provide a basis for consensus. But that may be constrained by national variations in securities regulation, corporate governance and corporate finance and other contexts discussed earlier.

When IASB adopts a standard, it affects many more interests than when FASB does. Preparers and users in a global context are vastly more heterogeneous than they are within one country. At the global level, each of these groups also has a cultural and perhaps even geographic home. Different demands can be expected from UK compared to French companies and from Russian compared to American investors. The agency issue may remain whether the private body is serving the public interest; but it is vexing to evaluate the public interest in a global context. IASB can expect to face pressures

---

[143] FASB's formal structure includes the Financial Accounting Foundation, which is responsible for governance operations of the board. Constituents also exert influence in standard setting by lobbying activities directed to that Foundation. It is possible to conceive of FAF as adding an additional principal to the model. But FAF is a mere agent too, whose fortunes are tied directly to FASB's. Both serve, together, at the pleasure of the SEC. True, FAF has different members and a different mission than FASB, but it is directly linked to FASB's mission.

from constituencies just as FASB does. But, given scale and diversity, it may be infeasible to consider and evaluate their overtures, or respond to or to resist them.[144]

Potentially missing from this arrangement is the power of the principal to overrule the agent or revoke its power. In theory, it should be possible for IOSCO to exercise principal-like powers over IASB. But that likewise depends on conceiving of IOSCO as a unitary agent on behalf of each member, which seems unlikely. This problem has generated considerable debate concerning the process by which IASB standards should be recognized within each country.

One alternative is the deference approach. National interests are addressed solely at the governance level, meaning that IOSCO members have direct input into the structure and leadership of IASB and its Foundation. Beyond that power ceases. When IASB adopts a standard, it becomes binding in member states without additional national action. National sovereignty to override an IASB standard or interpretation is exercised only in extreme cases.[145] The goal and effect of the deference approach is to maximize global consistency and comparability. The price is a sacrifice in national sovereignty.

Another alternative is the endorsement approach. National interests are protected at the adoption stage. IASB pronouncements are not binding until a sovereign authority formally enacts them, either through official action of the national securities regulator or by legislation. This has been the practice with most sovereigns to date, including the EU,[146] Hong Kong, Singapore and others. It retains maximum national discretion and preserves national sovereignty. But it threatens the quest for consistency and comparability worldwide by consciously injecting local politics into putatively international standards.

The EU follows the endorsement approach. The EU must specifically acknowledge particular standards, and translate them into numerous languages, before they become law. The process invites political input through a series of consultations with four discrete bodies.[147] EU law states conditions that standards must meet:

---

[144] *See* Stephen A. Zeff, *"Political" Lobbying of Proposed Standards: A Challenge to the IASB*, ACCT. HORIZONS (March 2002). Potentially adding complexity is the support for IASB from numerous other global bodies, including the World Trade Organization, International Monetary Fund, World Bank, Basel Committee on Banking Supervision, the EU, and the G7 Finance Ministers and their Central Bank Governors. These variegated bodies no doubt will have interests and preferences that differ from those of securities regulators—and possibly from investors, businesses and auditors and from each other.

[145] Besides this situation, there is no direct legislative authority over IOSCO or IASB in the same way that Congress wields authority over the SEC and FASB.

[146] Endorsement is not required by individual member countries within the EU, which have ceded accounting standard setting authority to it.

[147] These bodies are: the European Financial Reporting Advisory Group, which provides private input into the process from business groups; the Accounting Regulatory Committee, a political body representing each member state; the Economic and Monetary Affairs Committee of the European Parliament; and a Standards Advice Review Group, which provides input from accounting experts.

consistency with the true and fair view requirement, conduciveness to the "European public good" and meeting the "criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management."[148] EU law requires taking account of competitive effects of accounting standards on EU companies, including precluding IFRS that would lower reported income compared to US GAAP.[149]

From a national perspective, setting aside political dimensions of EU accounting law,[150] preferences for the deference or endorsement approach may depend on whether IOSCO can design governance features to assure that standards are likely to be acceptable to each country.[151] That would mean that national overrides (withdraws of endorsement) are exercised in rare circumstances. Achieving necessary comfort would require confidence in members' ability to coordinate and achieve consensus. There must be enough coordination to assure that, as a principal, IOSCO can assert authority over IASB to provide credible, but not excessive, threats to overrule it or revoke its power.

Assessing the probability of optimal coordination and results depends on considering the potential problems IOSCO will face from collective action, free riding and divergent interests. Predictably, IOSCO member incentives will be proportional to the scope of activities under their respective jurisdictions that IASB can affect. In the initial term, the most interested members will be the SEC and CESR, followed closely by national securities regulators in Brazil, Hong Kong and Japan, and perhaps China and Russia.

Members with smaller stakes may have fewer incentives to monitor. That means both that they can free ride and will find it harder to form blocs to protect their interests when those are opposed to interests of larger stakeholders. Solving this problem tends to support the desirability of the deference approach. Each member must commit to a pact of non-interference with IASB. To avoid allowing this to reduce joint power of

---

[148] The latter criteria are contained in IASB's own framework so should rarely be a formidable problem (but the concepts are sufficiently vague that this could certainly occur).

[149] *See* HERWITZ & BARRETT, *supra* note ___, at 177 (quoting the EU directive).

[150] By 2007, EU had exercised this acknowledgement on numerous separate occasions with the result that substantially all IFRS had been adopted. But this is not inevitable and not all IASB standards may make its way into EU Law, at least not without modification or delay, as has occurred on several occasions. *See supra* text accompanying notes ___-___.

[151] Despite differences, the deference and endorsement models may yield similar results. The issue is the default rule. The deference model makes IASB standards binding absent contrary action; the endorsement model makes them binding with supporting action. The extent of resulting similarity depends on how norms develop and how fast official regulatory or legislative actions are taken. Under the deference model, standards assume effectiveness promptly and remain in effect unless coordinated local political action can be mounted to reverse them. More standards are likely to be in effect. Under the endorsement model, standards are not effective until that political process has been completed. It is possible that just as many standards would become effective and that the process would simply be protracted. More likely, fewer standards would actually be in effect in all parts of the word.

revocation or censure, consensus on the circumstances when that may be justified is necessary.

The SEC has not taken a public position on whether it would prefer or recommend the deference or the endorsement model for the US. Clues suggest a willingness to take the deference approach. First, the SEC emphasizes recognizing IFRS only as issued by IASB. This implicitly rejects the endorsement model, if used by other countries, unless the endorsement contains no modifications. Second, the SEC appreciates how different its relationship is with IASB compared to its relationship with FASB and has long sought to influence IASB to establish an institutional basis to justify a deference approach.[152] Beyond these clues, however, the SEC offers no public analysis of these matters.

3. <u>Design</u>. Formal governance design is important to FASB's operations and effectiveness. Since its founding, FASB gradually adopted design features that resemble those that characterize US federal administrative agencies. FASB refers to these as "due process" attributes, many copied form the Administrative Procedure Act. These include procedures governing the development and public review of standards, holding open meetings and other features associated with transparency.

Governance design issues include the qualifications and selection process for board members, rules governing approving new standards, and the use of formal advisory bodies to represent interests of various groups, especially investors. Maintaining the model's efficacy has never been easy. Periodic redesign of these devices has been an important factor in FASB's survival and effectiveness. The endless revision is a product of prevailing and changing sensibilities concerning the private-public balance familiar within the US administrative state.

On the global scale, each country must take responsibility for enabling its representation through a national securities regulator or similar body. Most operate through IOSCO (though nothing prevents the non-105 member countries from seeking separate audience). IOSCO's internal procedures must enable it to determine how its members will be represented in IASB leadership and governance. Powers concern final approval over trustee and board member selection, reviewing standard setting procedures and assuring proper funding.[153]

---

[152] Evidence of continuing efforts to project US influence into the IASB emerged amid rumors that circulated in late 2007 concerning the possibility of a merger of FASB and IASB and reshuffling of FASB's governance structure. *See* Floyd Norris, *Overhaul Proposed in Accounting Standards Board*, NY TIMES (Dec. 18, 2007).

[153] In choosing trustees and board members, issues include national and regional representation plus constituent representation, including investor/user and preparer/auditor groups. It is responsible for forming IASB and determining its membership and setting governance rules concerning such matters as what committees to create and what authority they should have as well as voting rules to pass standards and other policy matters including agenda review, timing of production (including setting any moratoria). Funding must be based on contributions from IOSCO or member countries. *See* [*supra*] text accompanying notes ___-___.

The SEC's Chairman discusses these matters with counterparts from the EU and Japan but the SEC provides no public analysis. It issued one vague press release about future collaborative steps;[154] this instantly attracted considerable criticism.[155] A particularly troublesome oversight is how the SEC acknowledges the limited investor voice within the IASB without expressing any proposals or plans to correct it.[156] The SEC expressly recognizes the problem of multiple principals but indicates an essential capitulation to this circumstance.[157] It seeks to maintain, but probably not expand, its current role in IASB.[158]

4. Rationale. Within these design sensibilities and agency relationships, FASB's founders made vital substantive decisions concerning the rationale by which it would operate. In governance design and in implementing the SEC-FASB principal-agency relationship, it avowed adherence to a model of public responsiveness embedded in traditional models of US administrative agencies.[159] This required embracing the stance that FASB would be independent. At the same time, it also positioned itself squarely on the side of investors (and other external users of financial statements) rather than on the side of business or auditors. It did this by announcing, in its initial conceptual framework, an overarching rationale in accounting called "decision usefulness."

Decision usefulness refers to assuring that accounting information puts first the interests of external users of financial information for making choices, especially investment choices for investors. Internal or managerial needs are subordinated. The primacy of decision usefulness responds to the costs, recognized by information

---

[154] This appears to be the idea under discussion among national securities regulators. Press Release, http://www.sec.gov/news/press/2007/2007-226.htm (joint press release of various securities regulators discussing adding a "new monitoring body" to the IASB governance structure as "a means of accountability to . . . governmental authorities charged with protecting investors [through] formal ties between important securities regulatory stakeholders and the IASC Foundation."). The press release was issued jointly by SEC Chairman, Christopher Cox, jointly with European Internal Market and Services Commissioner Charlie McCreevy, Financial Services Agency of Japan Commissioner Takafumi Sato, and IOSCO Executive Committee Chairperson Jane Diplock.

[155] *See* Floyd Norris, *Bye Bye Independence*, N.Y. TIMES (on-line) Nov. 6, 2007), *available at* http://norris.blogs.nytimes.com/2007/11/06/bye-bye-independence/

[156] *See* SEC Final Rule Rescinding Reconciliation, *supra* note ___, at 13 (noting comment letters on proposed rule critical of IASB's structure, including enhancing geographic diversity of board and closer alignment with investor interests).

[157] *See* SEC Final Rule Rescinding Reconciliation, *supra* note ___, at 87 ("We recognize that our relationship with the IASB is less direct than our relationship with FASB and there are more and varied constituents of the IASB than of the FASB. The result may be that our view will be one of many views that the IASB receives from around the world and considers when developing future standards.").

[158] *See* SEC Final Rule Rescinding Reconciliation, *supra* note ___, at 13-14.

[159] *See* William W. Bratton, *Private Standards, Public Governance: A New Look at the Financial Accounting Standards Board*, 48 B.C. L. REV. 5 (2007).

economics, of information asymmetries between managers and investors.[160] This desideratum of decision usefulness helped earn FASB legitimacy among investors while using a rationale that managers could not reasonably object to. After all, accounting information is necessary to enable managerial decision making too, for internal resource allocations and enterprise stewardship. But FASB's embrace of decision usefulness makes only a gesture towards these by making investors and markets its primary constituents.[161]

The concept of decision usefulness could work, and be acceptable, given US culture. Once information is seen as a public good, the need to generate it to reduce information asymmetries appears. That is important to promote deep, active, liquid and efficient stock markets. It also is important in corporate culture like the US, characterized by the separation of investor ownership from managerial control. All these defenses of the decision usefulness goal, central to FASB's success, are distinctively US ideas and resonate strongly there.

IASB must make the kinds of vital substantive decisions that FASB made concerning the rationale for its standards. But this too is more complex at IASB than at FASB. IASB appears to embrace the decision usefulness rationale and acknowledges investor primacy. Both signals are fuzzy. First, the notion of decision usefulness may not have the same meaning within a global environment. It also is unlikely to perform the same political or legitimacy functions among investors that it supplied for FASB in the political environment of the US in the 1970s.

Second, references to investor interests in IASB policy statements equivocate. Numerous IASB documents repeatedly refer to a mission of protecting the "public interest" but rarely refer to protecting investors, whether international or US. Instead, investors are mentioned in lists of constituents that include "employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public."[162] Such statements often are followed by qualifying assertions that name investors as a top priority, noting that if financial statements are useful to investors they will also be useful to other constituencies.[163] This heterodoxy is oddly congruent with the SEC's token recognition of investor interests within its current global accounting vision.[164]

5. History. On balance, FASB has succeeded, based on the delegated agency model coupled with suitable governance design and a defensible substantive rationale for its standards. Yet it would be a mistake to conclude that this success was easy or

---

[160] *See supra* note ___.

[161] Additional principles in FASB's conceptual framework reinforce this orientation, especially the ideas of consistency and comparability, which also constrain managerial discretion.

[162] *E.g.*, IASB Due Process Handbook, ¶ 19 (April 2006).

[163] *Id*. ¶ 20.

[164] *See supra* text accompanying notes ___-___.

inevitable. On the contrary, FASB has faced regular periodic threats to its survival since its creation in 1973. Moreover, FASB did not emerge from whole cloth. It was created by drawing on the lessons of its two predecessors, which dissolved due to failure in struggles for legitimacy.[165]

FASB's standards frequently provoke political controversy, often by corporate managers campaigning against them. In the 1990s, the toughest fight was over accounting for stock options which led Congress to threaten to close FASB down if FASB adopted such standards.[166] In the 1980s, FASB fought corporate managers over accounting for employee pensions and retirement benefits. Life-threatening debates from the 1970s include FASB's standards on loss contingencies, loan losses and accounting for exploration costs and reserves in the oil and gas industry.[167] FASB managed to survive despite these battles.

Just as FASB did not grow from whole cloth but from fits and starts and the elimination of predecessors, IASB faces kindred struggles. A similar fate befell IASB's predecessor, the IASC. It struggled through the 1980s and 1990s and ultimately terminated and reconstituted itself as IASB in 2000. It is possible for IASB to survive. But survival on the world stage will be thornier for IASB than survival in the US has been for FASB. Participants should be prepared for failure and the endless need to revise the system and all its components. It is not evident from official SEC documents or Commissioner speeches that the agency appreciates IASB's fragility.

B. *Enforcement Strategies*

Apart from how production and interpretation functions must be lodged in a single entity to achieve the quest for global comparability, enforcement must likewise be centralized or coordinated to the same end. Additional challenges arise for enforcement strategy given absence of a single global enforcer along with wide global variation in enforcement intensity.[168] Rather, enforcement powers operate at national levels.

Three solutions to this challenge appear. First, the most obvious solution is for the various national regulators to coordinate efforts. The SEC pins its hopes on this solution. Second, in the longer run, it may be possible to imagine some form of global enforcement authority, perhaps lodged within an arm of IASB and consisting of formal involvement of pre-existing authorities. The SEC does not discuss this. Third, a

---

[165] FASB's predecessors were Committee on Accounting Procedures (CAP) (1938-1953) and Accounting Principles Board (APB) (1962-1973).

[166] In the case of stock option accounting, Enron and contemporaneous scandals led to passage of the Sarbanes-Oxley Act of 2002 and political winds favorable to FASB that enabled it adopt the standard.

[167] In the case of oil and gas, companies had been capitalizing drilling costs when FASB said it wanted them expensed. Amid the energy crisis, Congress wrested control of the situation and directed the SEC to write the standards.

[168] *See* Coffee, *The Political Economy of the Berle-Means Corporation, supra* note ___.

functional source of enforcement occurs within the large multi-national auditing firms. The SEC asked for public comment on this strategy. Each solution is considered in turn below.

1. International Coordination. Now, national securities laws, and related accounting standards, are enforced at national levels. Within the US, companies that violate accounting standards are subject to an elaborate enforcement apparatus, including by the SEC and private parties. In the UK, the Financial Services Authority plays a role functionally equivalent to that of the SEC. Within each European state, and most other countries, one or more local securities regulator performs enforcement functions. For the EU as a whole, the Committee of European Securities Regulators (CESR) is the coordinator. The possibility of private enforcement varies across countries.

The SEC acknowledges that national securities regulators have national, not global, mandates.[169] It states: "Because it is likely that not everyone will apply accounting standards consistently or appropriately, securities regulators are developing infrastructure to identify and address the application of IFRS globally."[170] The SEC is confident in its partnerships and information sharing arrangements with CESR and ISOCO.[171] The SEC's sole stated grounds for this confidence are: (1) in 2007 IOSCO started a "database for cataloguing and sharing securities regulators' experience on IFRS application around the world" and (2) the SEC agreed with CESR "that regulators should endeavor to avoid conflicting conclusions regarding the application and enforcement of IFRS."[172]

The SEC believes that these arrangements are sufficient to meet the challenge, although without offering analysis to support its confidence.[173] Several conditions, none of which the SEC mentions, would have to be met for the local securities regulatory apparatus to succeed. First, all securities regulators in the world would have to agree on what each IFRS provision means. This is possible, although neither inevitable nor likely. The principles-oriented character of many of the standards may impede uniform enforcement across countries.

Second, regulators would have to insist that each standard be applied in accordance with that shared understanding by all enterprises subject to their respective jurisdictions. This is also possible but adds doubt. All important accounting decisions require judgments. People making those judgments, including preparers and regulators,

---

[169] SEC Concept Release on Domestic IFRS, *supra* note ___, at 34.

[170] SEC Concept Release on Domestic IFRS, *supra* note ___, at 34.

[171] *E.g.*, SEC Proposed Rule Rescinding Reconciliation, *supra* note ___, at 48 (discussing database shared with IOSCO members that became operational in January 2007 and an SEC-CESR information-sharing work plan agreed in August 2006).

[172] SEC Concept Release on Domestic IFRS, *supra* note ___, at 34.

[173] SEC Final Rule Rescinding Reconciliation, *supra* note ___, at 26-28.

do so in local, not global, environments. Judgments likely will differ across countries to reflect local political, economic and cultural realities, including those noted earlier arising from legal origins or manifesting in varying contexts of securities regulation, corporate governance, corporate finance and the roles of markets and states.[174]

Third, governments in each jurisdiction would have to support these efforts. This issue of sovereignty, considered earlier in the context of production and interpretation, may pose more considerable challenges in the context of enforcement. If governments are reluctant to cede sovereignty in the production and interpretation of standards, preferring the endorsement to the deference approach, they may be even less likely to cede such powers in terms of enforcement. Too many variables are potentially implicated in enforcement decisions to cede such power ex ante.

The production, interpretation and enforcement aspects of accounting are interrelated. A country can cede power ex ante over all three, using the deference approach in production and interpretation, and tying one's hands ahead of time to an IOSCO-ordained enforcement policy. To preserve some measure of sovereignty, one may adopt a deference approach in production and interpretation, while reserving plenary power over enforcement. Or a country could reserve power over production by adhering to the endorsement approach and agree ex ante to follow a standardized enforcement policy. Ultimately, whatever countries or national securities regulators may agree to, there always will be grounds later to violate the agreement by citing national sovereignty.

A pessimistic and optimistic case may be made for evaluating the SEC's confidence in its partnerships to achieve enforcement coordination and promote comparability. For the pessimistic case, consider that the EU has told members to use IFRS. Are companies in those countries doing so uniformly? The evidence summarized in Part I of this Article provides grounds for skepticism.[175] Some members are notorious for ignoring EU directives, especially Czech Republic, Greece, Italy, Luxembourg and Portugal. Many members—which include such diverse countries as Cyprus, Germany, Hungary and Spain—have altered IFRS to reflect local needs. Beyond the EU, IFRS endorsers include such assorted countries as Armenia, Korea and Kuwait. It may be naïve to believe that accounting standards will be enforced uniformly in all these places.

For the optimistic case, it may be possible for governments to value the virtues of capitalistic convergence sufficiently highly as to reduce the frequency or occasions that will prompt intervention. These may be limited to extraordinary circumstances of national urgency. Examples may include the experience of Japan in the late 1990s. When accounting rules required Japanese banks to record big losses on large loans in the 1990s, Japan's government intervened against doing so to avert a national financial crisis. On the other hand, they may recur with surprising frequency. Consider how, after IASB adopted rules for financial instruments, the French government lobbied the EU to obtain

[174] *See supra* text accompanying notes ___-___.

[175] *See supra* text accompanying notes ___-___.

an exception to reduce volatility in reports of French banks. Steps like these will continue and, depending on frequency, could stealthily destroy global uniformity.

2. Global Authority. The foregoing points suggest that it may be necessary to consider creating and anointing a global enforcer but equally suggest that the prospects for that are dim. It is not impossible to imagine and devise a more centralized global enforcement body that achieves legitimacy, recognition and support. But near term likelihood of that seems low. Longer term, the struggles of the coordination effort that are likely and probably necessary may forge pathways towards a more centralized global enforcement authority. The process of coordination may lead gradually to the de facto emergence of a global enforcer.

It probably is a mistake to believe that the SEC would emerge as the global compliance enforcer. It lacks jurisdiction over most companies in the world and it seems doubtful that many countries would cede national enforcement policy to a foreign government. Moreover, the SEC is recognized as doing a reasonably good job of taking enforcement actions against US companies that violate US GAAP but a less effective job against foreign private issuers. It is possible that its historical practice will change following recognition of IFRS. However, even if it did, comparability may increase among US listed companies and remain divergent throughout the rest of the world.

3. Auditing Firms. Large auditing firms worldwide can be seen as a source of functional enforcement that can contribute to promoting global uniformity. The SEC acknowledges uncertainty about the capacity of firms to develop requisite skills and notes reason to question whether firms will maintain quality controls across global networks to promote consistent application.[176] Notwithstanding those concerns, the SEC asked for comment on how firms may promote comparability.[177] Several conditions would have to be met for auditing firms to succeed in promoting uniform application; the SEC does not discuss any of them.

First, each firm must be sufficiently integrated so that its firm-wide policies facilitate intra-firm coordination and the firms, as a group, must sufficiently coordinate to prevent excessive inter-firm variation. Both requirements are more readily achievable now than before. Each firm is a global network of members that are integrated and share information on a global scale. There are far fewer large firms than historically (four that are pan-global and a handful with global potential or aspirations). The firms once competed on the basis of quality reporting that led to identifiable variation in firm policy, but those days are gone. Uniformity should be more easily achieved. Still, many national and local affiliates of the large firms enjoy considerable autonomy so that issues of competence, conflicts of interest and susceptibility to local pressures endure.

Second, the firms would need incentives to induce client compliance. Incentives can arise from economic payoffs, reputational stakes and legal liability risks. It is

[176] SEC Concept Release on Domestic IFRS, *supra* note ___, at 33-34.

[177] SEC Concept Release on Domestic IFRS, *supra* note ___, at 34.

uncertain whether firms currently have requisite incentives concerning US GAAP; the incentives are likely to fall in a global IFRS reporting environment. Indeed, the largest firms all support moving the world, including all US issuers, to IFRS. But their support is made expressly conditional on changes to law and business to increase their and their client's rights to exercise judgment when applying the principles in IFRS. This stance includes calls to reduce auditor liability risk, which is an important stimulus for inducing client compliance. These positions suggest that it may be unwise to rely much or at all on firms to promote enforcing standards that increase uniformity or comparability.

Third, the audit firms face conflicting interests and are susceptible to activities that result in violation of securities laws, including accounting and auditing standards. To the extent that their power increases, compared to smaller firms, in a global IFRS environment, the risks of this conflict-driven behavior may rise. The more the largest firms provide the pivotal functions, the more they will be subject to capture risks by clients. That risk rises as the firms operate outside the supervisory jurisdiction of given national enforcement authorities. If there is no global enforcement authority to police managers and companies, there is equally no enforcement authority to police auditors.

Finally, audit firms cannot overcome contrary national pressure to subordinate global accounting uniformity to national objectives. Consider how Ernst & Young, pressured by China's four state banks, in 2006 withdrew its report on the banks' non-performing loans.[178] The firm estimated these to be $358 billion while the official figure put them at $133 billion. Similarly, PriceWaterhouse Coopers, pressured by the Russian government, in 2007 withdrew audit reports on Yukos, the oil group.[179] There is no way that auditing firms can contend against such powerful national political pressure.

C. *Compliance Theory*

Aside from production, interpretation and enforcement of international standards as a basis for promoting comparability, attention is warranted to the fundamental issue of compliance. Many people may voluntarily comply with a standard, even a new set of accounting standards, without variation, by virtue either of enforcement systems tailored to local conditions or compliance norms that pervade a culture. These possibilities can be evaluated by reference to the sizable body of literature addressing why people comply with law, in general and in particular contexts including financial reporting. The SEC pays essentially no attention to compliance matters, aside from those embedded in its extensive discussions of enforcement coordination strategies.

1. <u>Calculation and Norms</u>. Two broad theories contribute to explain compliance. One looks to incentives and the other to norms. Gary Becker theorized obedience in terms of positive law, depicting actors as rational wealth maximizers who choose

---

178 *See* Richard McGregor, *E&Y Withdraws China NPL Report*, FIN. TIMES (May 15, 2006).

179 *See* Catherine Belton, *PwC Withdraws Yukos Audits,* FIN. TIMES (June 25, 2007).

compliance or violation according to the applicable cost-benefit calculation.[180] Yet enforcement is costly, and enforcement costs rise as willingness to comply declines.[181] Tom Tyler offered instead a normative account, through which compliance is influenced by prevailing norms that guide behavior. Most likely, a combination of these features plays a role in differing contexts.[182]

The Becker thesis relies heavily on the existence of credible enforcement threats which, as discussed in the preceding section, are complex to calibrate for global accounting. Enforcement may be uneven across countries with a variable cost-benefit calculus that frustrates enforcement-induced compliance and hence comparability. In addition, the incentives to comply or mis-report may vary across countries according to factors outlined earlier. Acutely, the phenomenon of tunneling, where insiders extract value from firms, is more prone to balance sheet manipulation in concentrated ownership cultures and to income statement manipulation in dispersed ownership cultures.[183]

The Tyler thesis envisions voluntary compliance when standards are fashioned in accordance with procedures that endow them with a requisite degree of legitimacy. This hypothesis reinforces the importance of the points previously discussed concerning IASB's structure and production amid a muted role for national interpretations. IASB's structure and process must be seen, universally, as legitimate. The degree of relinquishment of national sovereignty must be seen, by country, as satisfying local legitimacy criteria.

2. <u>Individuals and Firms</u>. For individuals and firms, calculative and normative theories of compliance suggest special problems for global accounting standards. First, concerning calculative conceptions of compliance, the issue at the individual level concerns assessing the relative costs and benefits of decisions to comply or not. Costs are assumed to be a function of the probability of detection and magnitude of sanctions.[184] Benefits are associated with direct payoffs from violations and/or differential executive compensation levels.

Both can be complicated depending on factors such as last period problems, which arise when a person is approaching retirement or departure or a firm is

---

[180] Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968); see also RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 201-27 (1986); Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968); George J. Stigler, *The Optimum Enforcement of Laws*, 78 J. POL. ECON. 526 (1970).

[181] KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 72 (1974).

[182] *See* TOM R. TYLER, WHY PEOPLE OBEY THE LAW passim (1990) (survey research that suggesting that people comply with law because they perceive its moral legitimacy, not so much from its deterrence threat); *id*. at 64 (primary reason people comply with law is comportment with sense of right and wrong).

[183] *See supra* text accompanying notes ___-___.

[184] *See* Jennifer Arlen & William Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 ILL. L. REV. 691.

approaching bankruptcy. Other incentives may include meeting financial reporting targets, avoiding financial distress and concern for reputation.[185] This summary suggests that the variables, especially matters of compensation, meeting targets and enforcement risks, will require considerable tailoring in different cultures to promote consistency and comparability at the international level.[186] Comparative research in securities regulation supports this conclusion.[187]

Second, concerning normative conceptions of compliance, the issue at the individual level hinges around a complex set of cultural variables that by definition will vary across countries. Reputation is one part of this constellation and generally plays a role only when broader and deeper norms exist to promote a culture of compliance.[188] These norms refer to spontaneously generated standards of conduct, the departure from which is shameful.[189]

The norms are formed through a complex and innumerable range of forces that include trust that arises when managers appreciate that they are acting on behalf of others,[190] guilt that accompanies departures from conventional expectations[191] and hortatory expressions in official legal pronouncements.[192] Although these components neither exhaust the landscape nor command unanimous assent, they reflect the heavy emphasis on the normative dimensions of corporate compliance.[193] This summary suggests several implications for corporate officials acting in a global IFRS environment.

---

[185] See Cindy R. Alexander, *On the Nature of the Reputational Penalty for Corporate Crime: Evidence*, 42 J. L. & ECON. 489 (1999).

[186] *E.g.*, Peng Sun & Yi Zhang, *Is There Penalty for Crime: Corporate Scandal and Management Turnover in China*, EFA 2006 Zurich Meetings (June 3, 2006), http://ssrn.com/abstract=891096.

[187] *See* Utpal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading*, 57 J. FIN. 75 (2002); Laura Nyantung Beny, *Do Insider Trading Laws Matter?: Some Preliminary Comparative Evidence*, 7 AM. L. & ECON. REV. 144 (2005).

[188] *See* Mark C. Suchman, *On Beyond Interest: Rational, Normative and Cognitive Perspectives in the Social Scientific Study of Law*, 1997 WIS. L. REV. 475.

[189] David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1735, 1811 (2001).

[190] Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1796-97 (2001); *compare* Lawrence E. Mitchell, *Trust and Team Production in Post-Capitalist Society*, 24 IOWA J. CORP. L. 869, 889-897 (1999) (commenting on earlier work by Professors Stout and Blair to provide insights on the problems of norm compliance and calculation in the context of trust).

[191] Melvin Aron Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1259 (1999).

[192] Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L REV. 1009, 1011 (1997).

[193] *See* Cynthia A. Williams, *Corporate Compliance with the Law in the Era of Efficiency*, 76 N.C.L. REV. 1265. n. 395 (1998) (noting descriptive assumption of rational choice accounts of law compliance is the cost-benefit calculus of rationale actors is not supported by empirical research from Tyler and others. But rather it shows a more complex calculus including "a general sense of moral and civic obligation and of

Consider difference of scale. Norms induce compliance most effectively in smaller communities than in larger ones. For example, a coterie of directors of multinational US corporations can develop a shared sense of behavior that can establish the basis to identify what constitutes shameful departures.[194] That is less likely to occur on an international scale. The important influences are cultural products, including notions of shame, guilt, trust and reputation. Recalling again the varying dimensions of corporate culture across the world, competing conceptions of corporate purpose and constituencies will influence norms.

Identical accounting decisions may be seen as shameful in some locales and faithful in others. At polar extremes, contrast a vision that embraces corporate social responsibility with one that emphasizes short-term shareholder (and executive) wealth maximization.[195] Propensities to comply may also be influenced by the source of a standard's authority, a variation on the theme of perceived legitimacy. IASB standards may be perceived as bearing legitimacy within one nation and bear a degree of "foreignness" that neutralizes compliance propensities in others.[196]

Additional factors that bear on probabilities of compliance operate at firm level.[197] Norms of compliance must contend with other norms, some of which may be point in opposite directions. A firm's internal norms can trump broader social norms animating the larger culture in which a firm operates.[198] Competing norms combined with strategic opportunities can reduce compliance even in the face of a compliance norm, particularly when applicable regulations are ambiguous.[199] Internal controls may mitigate this problem when designed to designate compliance exercises as routine organizational

---

fairness" and social relationships, peer judgments, internal sense of obligation rooted in a sense of moral duty or recognition of lawmaking authorities as legitimate).

[194] Rock, *Saints and Sinners*, *supra* note ___, at1013-14.

[195] Cynthia Williams, *A Tale of Two Trajectories*, 75 FORDHAM L. REV. 1629 (2006).

[196] This hypothesis is reflected in the intense debates on the subject of using foreign law in US constitutional adjudication. *See Lawrence v. Texas*, 539 U.S. 558 (2003). Propensities may be hypothesized to decline along a continuum from domestic criminal statutes, to foreign constitutional norms, to a principle of international accounting.

[197] *See* Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 NYU L. REV. 687 (1997) (focusing on liability threats to induce preventive controls).

[198] *See* Geraldine Szott Moohr, *An Enron Lesson: The Modest Role of Criminal Law in Preventing Corporate Crime*, 55 FLA. L. REV. 937, 956-73 (2003) (evaluating limitations of economic and normative models of compliance, the former from behavioral limits on calculability and the latter from by competing social forces at sub-group levels such as corporate culture).

[199] *See* Timothy F. Malloy, *Corporate Decision-making: Disclosure Stories*, 32 FLA. ST. U.L. Rev. 617 (2005).

matters.[200] Yet a movement from external control to internal control can reduce legal risk and thus neutralize an important compliance stimulus.[201] Nor can one count on audit firms to induce the correct norms of compliance, given that those firms may suffer from like challenges.[202]

None of this means that voluntarily compliance is unlikely. It only suggests that the capacity to predict it, and to design incentives and mechanisms to promote it, will be knottier for global compliance with IFRS than for domestic compliance with national accounting standards. Again, the SEC offers no public analysis of these challenges.

3. Accounting's Expressive Function. Law can perform an expressive function of what norms are,[203] by both reflecting and changing them.[204] This function is one way that law can influence behavior.[205] Several conditions are necessary to enable law to do so, for law can be ignored or circumvented or be accompanied by dilutive exceptions.[206] Vital to law's expressive function is a sense that its production is legitimate and its acceptance is, in some sense, voluntary.[207] But adopting laws with the intention of using them for transformative purposes can backfire by provoking backlash, as occurs with certain reforms designed to induce social change.[208] Subject to these difficulties, a modest consensus assumes that law can perform this expressive function.

Can accounting do so? There is a good case that accounting does perform this function.[209] The case is reinforced by appreciating that, in many countries and

---

[200] *See* Timothy F. Malloy, *Regulation, Compliance and the Firm*, 76 TEMP. L. REV. 451 (2003) (conceiving regulatory compliance as another routine for an organization pursued the way other routines are, to offer a more pragmatic and realistic appraisal compared to either typical profit-maximizing and law-abiding images).

[201] *See* Kenneth A. Bamberger, *Regulation as Delegation: Private Firms, Decisionmaking, and Accountability in the Administrative State*, 56 DUKE L.J. 377 (2006).

[202] *See* Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight into Securities Fraud Litigation*, 95 NW. U. L. REV. 133 (2000).

[203] *See* Janice Nadler, *Flouting the Law*, 83 TEX. L. REV. 1399 (2005).

[204] *See* Lawrence E. Mitchell, *Understanding Norms*, 49 U. TORONTO L.J. 177, 239-45 (1999) (drawing on Adam Smith's *Theory of Moral Sentiments* to demonstrate how law can influence norms).

[205] *See* Cass Sunstein, *On the Expressive Function of Law*, 144 U. PA. L. REV. 2021 (1996); Bernard Black & Reneir Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911 (1996).

[206] *See* Katharina Pistor, *The Standardization of Law and Its Effect on Developing Economies*, 50 AM. J. COMP. L. 97, 112-17 (2002).

[207] *See* Tyler, *supra* note ___, at 178.

[208] *See* Linda Hamilton Kriege, *Socio-Legal Backlash*, 21 BERKELEY J. EMP. & LAB. L. 476, 477-88 & 492-93 & 497-98 (2000).

[209] *See* David I. Walker, *Financial Accounting and Corporate Behavior*, 64 WASH. & LEE L. REV. 927 (2007).

increasingly in the US, accounting is a formal or functional part of law.[210] If so, can accounting's expressive function be harnessed for the international arena? This question is more daunting. The transplanting and borrowing that may be an essential element of formulating IFRS, evident in convergence projects, can prevent resulting standards from performing an expressive function.[211] True, to the extent that accounting expressions reflect shared aspirations and conjectures, they may be capable of spawning informal norms that promote comparability.[212] Yet for accounting to perform this expressive function requires cooperation among many nations whose support is essential to communicate requisite legitimacy.

4. Nations. There is considerable scholarly disagreement concerning why nations comply or refuse to comply with applicable standards. Stances replicate those from debates in political theory. As polar examples, these contest whether states are generally prone to act according to the principles of realpolitik or according to principles of mutual recognition and reciprocity.[213] Despite debate, it seems safe to suppose that compliance propensities vary with subject matter and context. It also seems safe to say that national compliance propensities can be influenced by the form of ordainment the relevant standard takes, whether by treaties, pacts, or international norms.

Where is accounting along the range of subject matters and contexts that may induce stronger or weaker national compliance? Accounting may not be as hotly or popularly contested a subject as nuclear non-proliferation, climate change, or human rights. Yet accounting standards can pose significant issues of national urgency and interest, akin to trade agreements and other economic pacts. A few highlights make the point.

Some EU member states are notorious for violating EU directives on economic matters, including foreign takeovers of domestic companies deemed to be national

---

[210] *See* Thomas C. Pearson, *Creating Accountability: Increased Legal Status of Accounting and Auditing Authorities in the Global Capital Markets (U.S. and EU)*, 31 N.C.J. INT'L L. & COM. REG. 65 (2005).

[211] *See* Pistor, *Standardization of Law*, *supra* note ___.

[212] Belcher, *Regulation by the Market: The Case of the Cadbury Code and Compliance Statement*, J. BUS. L. 321-42 (1995).

[213] Other points of contention include whether to think of the relevant actors in a disaggregated sense, applying traditional individual decision making analysis to them, or see the state as a unitary actor with an additional or different calculus. Competing views between realists and legalists appreciate how states either can act solely in their own national interests (realists) or seek to abide by adopted and prevailing international laws and norms. Contemporary exemplars of positions within this vast scholarly literature include the following: Harold Hongju Koh, *Bringing International Law Home*, 35 HOUS. L. REV. 623 (1998) (how law influences norms in the context mainly of promoting state compliance with international law); Eric A. Posner, *International Law and the Disaggregated State*, 32 FLA. ST. U.L. REV. 797 (2005) (locating decision making at the level of individual actors whose decision making accords with rational economic calculation models); Charles K. Whitehead, *What's Your Sign? International Norms, Signals, and Compliance*, 27 MICH. J. INT'L L. 695 (2006) (attempting more precise delineation of how norms translate through individual actors into state decisions).

champions. Japan was a notable hold-out in the process of generating and enforcing financial accords reached in the Basel system and refused to enforce its own accounting standards in the late 1990s to avert a national financial crisis. The US did a similar thing when Congress ousted FASB of jurisdiction to set oil and gas accounting standards amid the 1970s energy crisis. China and Russia, as noted, compelled auditors to withdraw independent reports on financial statements of important domestic enterprises.

Propensities will likely be proportional to national contributions to IASB's governance design and production. They may depend, in part, on whether nations use a deference or endorsement approach to accepting its products.[214] On the other hand finally, it may not be necessary that every nation always comply to a tee. It may be sufficient if a large portion of nations, including the largest and most influential ones, substantially comply with most of the standards most of the time. Measured that way, there is reason for cautious optimism concerning national propensities to comply.

The SEC addresses the need for consistent application in practice. But it presents this issue by saying "proper application encompasses not only faithful adherence . . . but also understandable standards . . . ."[215] It then admits, given its lack of experience with IFRS, that: "we would not have direct experience to assess the extent to which IFRS would be properly applied by U.S. issuers." Instead, it says it would make judgments based on whether the requisite infrastructure was in place in the US.[216] This does speak to the point that compliance propensities depend on the surrounding cultural and infrastructural context. Yet what works in one country, including the US, will not necessarily work in others. As with so many of the daunting challenges facing its global accounting vision, the SEC has not publicly reflected on these challenges.

CONCLUSION

The SEC's global accounting vision appears to be quixotic. This may be due to its emergence from a combination of political pressure and idiosyncratic ambition. Its public materials scratch the surface of the many challenges to be faced, domestically and internationally. A dose of realism underscores how daunting these challenges are. On the other hand, the proliferation and pressure of global capitalism induces the drive toward universal accounting standards and it can be difficult for any centralized authority to control that journey.

It may be possible to bridge diversity using a universal set of accounting standards that concentrates on points of congruence while appreciating the consequences of difference. After all, inchoate but real convergence is occurring in important aspects

---

214 *See* Pistor, *The Standardization of Law*, *supra* note ___, at 111-112.

215 SEC Concept Release on Domestic IFRS, *supra* note ___, at 30 (section entitled Application in Practice).

216 *Id*.

of modern culture. These include the melding of legal traditions, a coalescence around some forms of capitalism and expansion of global coordination and governance in many spheres of human activity. Yet diversity endures in many of those spheres, including those that affect accounting, especially law, economics, politics and language.

Other cultural phenomena have proven more or less susceptible to such transcendence. Consider the metric system, a standardized, uniform method of measurement. This innovation was important to expanding international trade. It was begun by France in the late 18th century and gradually adopted by all countries, except the US and two smaller ones. Even in the US, however, people are familiar with the metric system and it is in widespread use in everything from consumer goods to industrial production. Although accounting is more complex and involves more than just measurement, measurement is an important aspect of accounting.

Accounting's more complex attributes explain the hackneyed adage that accounting is the language of business. This is a half-truth. Accounting is a means of communication and has that in common with natural languages. It also is a system of measurement, as noted, plus a system of recordkeeping, aggregation, and classification. Of course, thousands of languages exist in the world and hundreds are in use in the US alone. Still, English has emerged as a widely-spoken, nearly-universal language, at least among active participants in international matters. On the other hand, conscious efforts to create a universal language have failed. The infamous example is Esperanto. This was a high quality language, grammatically sound and coherent, with a sizable vocabulary capable of extensive expression. Yet it never caught on and is not widely used anywhere.

International coordination is required to guide IFRS to a fate similar to the metric system rather than Esperanto. This invites noting a third potential parallel, the adoption of the euro by a dozen European states in 1999. For centuries, these countries, which include France, Germany, Italy, the Netherlands and Spain, used separate currencies. These were fundamental expressions and devices of sovereignty as well as important cultural symbols. National relinquishment of currencies in favor of a common one was a bold and daring experiment. It succeeded. This feat provides a basis for optimism about IFRS. True, the number of countries involved with IFRS is much larger. But the sacrifice in national sovereignty is slight in comparison.

Establishing IASB resembles the quest for facilitating international arrangements akin to the institutions led by the US during preceding generations, especially the United Nations, International Monetary Fund, World Bank and World Trade Organization.[217] These institutions, which are thoroughly capitalistic, created financial relationships among the most influential countries. The relationships increased economic inter-dependency. They established norms for how countries should relate to one another, with salubrious effects like reducing propensities to resolve disputes by armed conflict and

[217] IASB Press Release, *IASB Tops Global Rankings for Stakeholder Participation; Identified as "Higher Performer" for Transparency and Evaluation* (Dec. 2, 2007) (reporting publication of One World Trust's rankings of "world's most powerful global organisations").

increasing global economic growth. It is not surprising that many proponents of global accounting cite promoting world economic growth.

Max Weber explained how capital accounting was a pre-condition to flourishing of capitalism. A global financial reporting system is a pre-condition to real flourishing of globalization.[218] Earlier, capital accounting offered participants the capacity for rational calculation, in terms of money, in an evolving economy that reflected inchoate systems of democracy and helped to spread them, along with capitalism, against tribalism, fundamentalism and theocracy. As Weber also observed, rational calculations of the capitalist can lead to overlooking social needs or interests that arise in spheres that are not susceptible to its benevolence. Weber's distinction between formal rationality of economic action and substantive rationality warrants continued attention in the journey toward global capitalism.[219] His insight requires appreciating the different forms of capitalism and the different conceptions of corporate purpose and constituencies discussed in this Article.

Criticism of the SEC aside, perhaps an elaborate, informed, reflective plan or policy statement infused with realism would bear little fruit. Maybe the expedient path is just the one the SEC takes, laying out simple visions in two releases followed by some roundtables and final rule adoptions. However, the SEC's actual products make it hard to believe that its strategy was thought out in these terms either. More likely, the SEC, responding to political pressures, drawing on decades of institutional commitment, and seizing political opportunities, opted to lurch forward. Its lip service to investor protection notwithstanding, the SEC must be aware that its quest has at least as much to do with the proliferation of capitalism as with investor interests.[220] But forces driving the quest for global accounting can exhibit evolutionary qualities beyond its capacity to control.[221]

---

[218] *See* Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781 (2001) (accounting as one precondition to strong securities markets).

[219] MAX WEBER, ECONOMY AND SOCIETY, vol. 1, pp. 85 ff. Weber explained that formal rationality of economic action is the extent of rational calculation or accounting possible and applied (and are calculable and definite); substantive rationality is the degree that provisioning is shaped by economically oriented social action under some criterion of ultimate values (which are ambiguous because they depend on ethical and political matters hinging on varying philosophies, such as utilitarian, hedonistic, feudal or egalitarian and all have at their core varying conceptions of social justice and equality).

[220] *See* SEC Final Rule Rescinding Reconciliation, *supra* note ___, at 92 (in providing required securities law discussion of impact on the economy, competition, efficiency and capital formation, the SEC emphasizes the benefits of rescinding the reconciliation requirement as promoting capital formation, increasing efficiency, competition and capital formation); SEC Concept Release on Domestic IFRS, *supra* note ___, at 18 ("Key forces favoring a single set of globally accepted accounting standards include, but are not limited to, the continued expansion of the capital markets across national borders, and the desire by countries to achieve strong, stable and liquid capital markets to fuel economic growth.").

[221] *See* Sudipta Basu & Gregory Waymire, *Recordkeeping and Human Evolution* (working paper Nov. 8, 2005).

Even so, the SEC cannot escape the foregoing criticism, some of which may be harsh but is supported by the record. Fortunately, it is not too late to redress the oversights.[222] The most important concrete step is for the SEC to provide public evaluation of the challenges identified in this Article to which it has given scant or no attention. This could be accomplished through the widely recommended procedure to develop a medium-term plan to move all US issuers to IFRS within a decade. That movement would not avoid need to confront challenges. But it would enable a coordinated effort among participants to resolve them and accept the costs that must be borne to obtain expected benefits. It is as important for the SEC to concentrate on the needs of US investors, which it has not done, as it is to expand global capitalism by focusing on the needs of companies to form capital and facilitate capital formation and flows.

[222] There is little question that the SEC's recent proposals concerning IFRS (both rescinding reconciliation and contemplating letting US issuers use either) were produced hastily and show weaknesses that are inconsistent with the SEC's traditional professional standards. A slapdash character plagues similar documents and actions used by the SEC's peer institutions globally amid the spell of principles-based rhetoric and rush to IFRS. The common flaws do not excuse the SEC's departure from traditional standards of excellence.