Whose Trojan Horse? The Dynamics of Resistance against IFRS

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For helpful comments we thank Larry Cunningham and Christine Tan.

Abstract

The introduction of International Financial Reporting Standards (IFRS) has been debated in the United States since at least the accounting scandals of the early 2000s. While publicly traded firms around the world are increasingly switching to IFRS, often because they are required to do so by law or by their stock exchange, the SEC seems to have become more reticent in recent years. Only foreign issuers have been permitted to use IFRS in the US since 2007. By contrast, the EU has mandated the use of IFRS in the consolidated financial statements of publicly traded firms since 2005. In the US, IFRS, which are promulgated by the London-based International Accounting Standards Board (IASB), are often seen as an attempt by Europeans to colonize US accounting standard setting, in other words an element of a foreign legal system alien to US capital markets and securities law. In this article, we suggest that this perception is actually a myth, which we are trying to debunk. In fact, the introduction of IFRS in Europe, particularly Continental Europe, was far from controversial. IFRS were promoted by Anglo-Saxon jurisdictions and strongly supported by the United States, particularly when capital markets internationalized in the 1990s. They were – and still are – in many ways at odds with the Continental European accounting cultures of countries such as France and Germany, on whose examples we draw. In spite of the EU mandate for publicly traded firms, accounting law in these jurisdictions has still not fully absorbed IFRS; nevertheless, for now a solution that reconciles traditional and international accounting have been found. In this article, we explore the problems and resistance of IFRS in Continental Europe and seek to draw lessons for the United States. We argue that given the shared heritage of US GAAP (Generally Accepted Accounting Principles) and IFRS as investor-oriented accounting standards their introduction in the US should be considerably easier than it was on the other side of the Atlantic.

Keywords: IFRS, IAS, GAAP, international accounting, EU Company Law Directives, Fourth Directive, Seventh Directive

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The introduction of International Financial Reporting Standards (IFRS) has been debated in the United States since at least the accounting scandals of the early 2000s. While publicly traded firms around the world are increasingly switching to IFRS, often because they are required to do so by law or by their stock exchange, the SEC seems to have become more reticent in recent years. Only foreign issuers have been permitted to use IFRS in the US since 2007. By contrast, the EU has mandated the use of IFRS in the consolidated financial statements of publicly traded firms since 2005. In the US, IFRS, which are promulgated by the London-based International Accounting Standards Board (IASB), are often seen as an attempt by Europeans to colonize US accounting standard setting, in other words an element of a foreign legal system alien to US capital markets and securities law. In this article, we suggest that this perception is actually a myth, which we are trying to debunk. In fact, the introduction of IFRS in Europe, particularly Continental Europe, was far from controversial. IFRS were promoted by Anglo-Saxon jurisdictions and strongly supported by the United States, particularly when capital markets internationalized in the 1990s. They were – and still are – in many ways at odds with the Continental European accounting cultures of countries such as France and Germany, on whose examples we draw. In spite of the EU mandate for publicly traded firms, accounting law in these jurisdictions has still not fully absorbed IFRS; nevertheless, for now a solution that reconciles traditional and international accounting have been found. In this article, we explore the problems and resistance of IFRS in Continental Europe and seek to draw lessons for the United States. We argue that given the shared heritage of US GAAP (Generally Accepted Accounting Principles) and IFRS as investor-oriented accounting standards their introduction in the US should be considerably easier than it was on the other side of the Atlantic.

"IFRS are dangerous and obsolete."
(from a French accounting textbook published in 2011)[1]

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1. Introduction

The US is the last major economy that has not yet adopted International Financial Reporting Standards (IFRS) while, from Europe to Canada, from Australia to China, around 120 countries are already requiring or permit-

[1] “Les IFRS sont dangereux et obsolètes.” JACQUES RICHARD, CHRISTINE COLLETTE, DIDIER BENSADON & NADINE JAUDET, COMPTABILITE FINANCIERE. NORMES IFRS VERSUS NORMES FRANÇAISES 1 (9th ed. 2011).

ting IFRS; this figure will likely rise to 150 countries in the near future.[2] The introduction of IFRS has been debated in the United States for several years. The Securities and Exchange Commission (SEC) first issued a paper that includes a plan for possible implementation, and several SEC Staff Reports followed up until the July 2012 Final Staff Report with regard to the work plan.[3] However, whether domestic issuers should be permitted to use IFRS is very controversial. Obviously, the "internationalization" of accounting would have far reaching consequences for US firms, for the relationship between managers and investors, for the accounting profession, and for the position of FASB within the framework of securities law.

The European Commission's decision in 2000 to mandate the use of IFRS starting from 2005[4] and the unprecedented worldwide acceptance of IFRS since then prompted a debate about the relations between the In-

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[2] *See* IFRS website for countries adopted IFRS for publicly traded firms*, available at* http://www.ifrs.org/Use-around-the-world/Pages/Use-around-the-world.aspx., Toronto Conference 2008. *See* Lawrence A. Cunningham, *The SEC's Global Accounting Vision: A Realistic Appraisal of a Quixotic Quest*, 87 N.C. L. REV. 1 (2008).

[3] SEC Concept Release on Allowing U.S. Issuers To Prepare Financial Statements in Accordance With International Financial Reporting Standards (Aug. 7, 2007); Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers (November 14, 2008); SEC Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers (February 24, 2010); SEC Staff Paper, Progress Report on the SEC Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers (October 29, 2010); SEC Staff Paper, Exploring a Possible Method of Incorporation: Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers (May 26, 2011); SEC Staff Paper, A Comparison of U.S. GAAP and IFRS: Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers (November 16, 2011); SEC Staff Paper, Final Staff Report: Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers (July 13, 2012) (all available at http://www.sec.gov).

[4] To be precise, the requirement only applies to the consolidated financial statements of all those companies governed by the law of a Member State and listed on a regulated market in a Member State. *See* Regulation (EC) 1606/2002 of 19 July 2002, 2002 O.J. (L 243) 1 [hereinafter IAS Regulation]. The Lisbon European Council of 23 and 24 March 2000 set the deadline of 2005 to implement the Commission's Financial Services Action Plan and urged that steps be taken to enhance the comparability of financial statements prepared by publicly traded companies.
http://ec.europa.eu/internal_market/accounting/docs/studies/2007-eu_implementation_of_ifrs.pdf. The requirement applies to Member States of the European Economic Area (EEA), which consists of the 27 EU member states plus Iceland, Liechtenstein, and Norway. Regarding the application of the Accounting Directives in the EEA *see* Paul Pacter, *What exactly is convergence?*, 2 INT. J. ACCT., AUDIT. & PERF. EVAL. 67, 75 (2005). *See* Deloitte, IAS Plus, *IFRS in Europe – Background information*, http://www.iasplus.com/en/resources/ifrs-in-europe. *See also* Robert K. Larson & Donna L. Street, *The Roadmap to Global Accounting Convergence Europe Introduces 'Speed Bumps'*, CPA J.*,* Oct. 2006.

ternational Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB).[5] An important argument in the US debate is the idea that IFRS, which are promulgated by the London-based IASB, are dominated by Europeans. In the United States, IFRS are therefore often seen as a "Trojan horse" proposed by Europeans (and others) to replace American accounting culture, which is still based on GAAP (Generally Accepted Accounting Principles) promulgated by FASB (Financial Accounting Standards Board). To slightly exaggerate the argument, IFRS is seen as an effort of the European accounting tradition to colonize the US with an allegedly inferior set of accounting standards.[6] In this article, we suggest that this perception is a myth. In fact, IFRS have rather been an element of Anglo-American accounting culture, developed with the support of FASB, that Continental European countries have been encouraged, and ultimately forced, to accept by way of the EU with encouragement from the US. In other words, IFRS have been the Trojan horse of the US that had and still has to overcome a significant level of resistance in Europe.

Our article is to counter the majoritarian view by shedding light on the purpose and origins of IFRS, and to draw possible lessons from the

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[5] UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT [UNCTAD], PRACTICAL IMPLEMENTATION OF INTERNATIONAL FINANCIAL REPORTING STANDARDS: LESSONS LEARNED (2008).

[6] *See e.g.,* Paul Meller, *International Auditing Rules Urged on U.S.*, N.Y. TIMES, February 22, 2002, W1; Floyd Norris, *The Case For Global Accounting*, N.Y. TIMES, May 11, 2012, B1; Kara Scannell & Joanna Slater, *SEC Moves To Pull Plug On U.S. Accounting Standards*, WALL STREET J., 28 Aug 2008, A.1; Charles Niemeier, Keynote Address on Recent International Initiatives 2008 Sarbanes-Oxley, SEC and PCAOB Conference, New York State Society of Certified Public Accountants (Sept. 10, 2008) at 3 & 6 (arguing political pressure from Europe, primarily from Angela Merkel of Germany is the reason why the US moved towards IFRS); Harold S. Bloomenthal & Samuel Wolff, *Harmonizing Accounting Standards and Auditing Procedures – A Survey*, 10 INT'L CAP. MARKETS & SEC. REG. § 1:44 (arguing that the EU was pushing the US to accept financial statements prepared by EU firms in accordance with IFRS and that the SEC found itself "between a rock and a hard place"); James E. Rogers, *Going Too Far Is Worse Than Not Going Far Enough: Principle-Based Accounting Standards, International Harmonization, and the European Paradox*, 27 HOUS. J. INT'L L. 429, 451 (2005) (arguing that IAS are similar to British and other European principles of accounting and very different from those of the US); Robert Bruce, *Now How Does It All Fit Together?*, FIN. TIMES, Sept. 15, 2003, at 1; Cunningham *supra* note 2, at 15 (arguing that the EU was pressuring the SEC on the adoption of IFRS); Neal F. Newman, *The U.S. Move to International Accounting Standards – A Matter of Cultural Discord – How do we Reconcile?*, 39 U. MEM. L. REV. 835, 841, 868-871 (2009) (comparing the US with Germany and suggesting that Germany is a better fit the IFRS than the US); Kathik Ramanna, *The International Politics of IFRS Harmonization*, 3(2) ACCT. ECON. & L. 1, 9-12 (2013) (seeing IFRS as a product of the EU and considering it reasonable to treat the EU, including Britain, as a common accounting jurisdiction backing IASB). Interestingly, IFRS is often defined as "the European equivalent of US GAAP." *See, e.g.*, John Armour, Gerard Hertig & Hideki Kanda, *Transactions with Creditors,* in THE ANATOMY OF CORPORATE LAW 115, 126 (2nd ed., Reinier Kraakman et al. eds., 2009).

“internationalization” of accounting standards applicable to publicly traded European firms. While these firms are required by EU law to use IFRS in their consolidated accounts, we show that IFRS developed out of an accounting tradition similar to the US with its Anglo-Saxon financial reporting approach. Both US GAAP and IFRS share a common basis, the assumption that the purpose of public accounting is to provide a useful basis for decision-making by participants in capital markets.

This was not the case in Continental Europe before the 1990s, where other purposes such as taxation and creditor protection played key roles. The objections to IFRS in Continental Europe were far more severe than the ones brought in the United States today. European accounting since the 1970s has been characterized by the EC Accounting Directives, which set forth a supranational framework for national accounting laws and standards; however, these directives had many gaps and created intended and unintended options that were effectively used by the Member States to maintain their previous accounting systems, which were often very different from that of the US or the UK. By and large, they reflected a very different orientation in the purpose of accounting based on Member State traditions. Thus, IFRS faced considerable resistance when they were initially introduced in Continental Europe, and some issues have still not been fully resolved. We focus in particular on France and Germany, whose accounting traditions had originally strongly inspired the directives. German accounting standard setting was institutionally very different from both US-GAAP and IFRS, given that they were not set by an accounting standard setter, but enacted as statutes and interpreted as such. Their purposes were also historically different, an important emphasis being on creditor protection and taxation. With the possible introduction of IAS looming on the horizon in the late 1990s, there was an enormous debate on how to best reconcile these goals with the capital-market-oriented “Anglo-Saxon” accounting erupted. Similarly, in France the influence of government actors on the accounting standard setting process was considerable. IFRS – like US GAAP – are frequently criticized for only taking the interests of investors on the capital markets into account. French standards, in this view, were subject to a process that took the interests of a wider set of corporate stakeholders into account. The changeover to IFRS can thus be seen as a larger element of a transition toward Anglo-Saxon corporate governance practices that is still encountering resistance.

In a number of key EU countries, including these two, the use of IFRS is still limited to consolidated accounts, and primarily to those of publicly traded firms. Traditional domestic accounting standards tend to remain in parallel use for the financial statements of other entities, as well as for the entity-level accounting even of publicly traded firms. Convergence in accounting has therefore remained superficial.

Paradoxically, most of the arguments in the US against IFRS today relate to how they are supposedly an accounting system emerging from a foreign legal system that would provide a bad fit for the US economy and its legal and corporate governance environment. As our article demonstrates, these arguments are false. Culturally, economically, and legally, the US capital market is much closer to the biotope from which IFRS developed than Continental Europe is. Since other countries had to make much greater strides, we argue that the purported hurdles in the US should be considered comparatively unimportant and rather easy to overcome. Moreover, given the historical support of IFRS from the US and capital market actors in the Anglosphere in general, the SEC's present reticence to endorse IFRS is almost surprising. Now that the US has helped to foist an accounting tradition it shares on everyone else, it is surprising that the country itself would not go all the way and embrace IFRS. We discuss whether a changeover would lead to substantive changes in accounting, and what implications the inevitable institutional changes would have, looking at various possible policy strategies for the future.

The article proceeds as follows. Section 2 gives an overview of the current debate in the United States and discusses the objections currently brought in the US against the introduction of IFRS. Section 3 looks at the implementation of IFRS in the European Union and discusses hurdles they had – and still have – to face in these countries. We focus on the institutional and historical context of the EU Accounting Directives and accounting standard setting, as well as the function of accounting, in Germany and France. Section 4 uses this comparative account to suggest that the problems in the US are relatively small and should therefore – in theory – be easier to overcome. Section 5 concludes.

2. The US debate about the introduction of IFRS

2.1. FASB-IASB relations over the past decade

Up to around 2000, policymakers in the US and the SEC were confident that US GAAP were the best available accounting standards in the world.[7] However, the Enron scandal in 2001 and other subsequent scandals shook the confidence in the US GAAP and accelerated the discussions about whether IFRS, supposedly based more strongly on principles as opposed

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[7] *See, e.g.*, Cunningham, *supra* note 2 at 8; George Mundstock, *GAAP Did Their Job during the Economic Meltdown*, 4 FLA. INT'L U. L. REV. 463, 470-471 (2009); Edward F. Greene et al., *Hegemony or Deference: U.S. Disclosure Requirements in the International Capital Markets*, 50 BUS. LAW. 413, 430 (1995); Lisa M. Brown, *United States Accounting Standards: Do The SEC Requirements Regarding U.S. GAAP Violate GATS?*, 28 N.C. J. INT'L L. & COM. REG. 1007, 1019 (2003); Arthur Goldgaber, *Global Investing: How to Research Foreign Companies to Find Opportunities*, SEEKING ALPHA, Jul 16, 2013, *available at* http://seekingalpha.com. *See e.g.*, Bernard Colasse, *Harmonisation Comptable Internationale. De la résistible ascension de l'IASC/IASB,* GERER & COMPRENDRE, March 2004, at 80-81 (suggesting that in the early 90s Americans no longer saw the need to support IOSCO/IASC because foreign firms were adopting US GAAP voluntarily).

to rules, would be more successful in preventing frauds in the financial reporting.[8]

In 2002, Section 108(d) of the Sarbanes-Oxley Act required the SEC to conduct a study and report to the Congress on the adoption of a principles-based accounting system. The report submitted in July 2003 concludes that global accounting standardization would produce merit benefits such as:

i. greater comparability for investors across firms and industries globally,

ii. a more efficient allocation by markets of scarce capital among investment alternatives, and

iii. lower costs of capital, since global accounting standards would eliminate the duplicate cost of preparing two sets of financial statements, and make it easier for companies to have access to capital in other markets.[9]

In the same year, the 2002 Norwalk Agreement between FASB and IASB showed that the US was committed to the goal of "establishing a single set of high quality, globally accepted accounting standards."[10] The February 2006 Memorandum of Understanding issued by FASB and IASB laid down specific milestones to be reached by 2008.[11] Subsequent revisions brought the two sets of standards closer to each other.[12] In 2007, the SEC

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8 Sarbanes Oxley Act, PUB. L. NO. 107-204 §108(d) (2002); John C. Coffee, Jr., *Understanding Enron: "It's about the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403, 1416-17 (2002); John C. Coffee & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. 707, 749-759 (2009); Lawrence M. Gill, *IFRS: Coming to America*, J. ACCT., June 2007; Kern Alexander et al., *Financial Supervision and Crisis Management in the EU: Commissioned Report by the EU Parliament* (2007), *available at* http://www.europarl.europa.eu/activities/committees/studies/download.do?language=en&file=26588.

9 SEC, 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, July 25, 2003, http://www.sec.gov/news/studies/principlesbasedstand.htm [*hereinafter* SEC Study 2003].

10 The Norwalk Agreement, September 18, 2002, FASB-IASB, *available at* http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175819018817&blobheader=application%2Fpdf.

11 For a discussion on FASB/SEC interactions with IFRS and strengthening the influence of FASB on IASB standard making process, *see* Luzi Hail, Christian Leuz & Peter Wysocki, *Global Accounting Convergence and the Potential Adoption of IFRS by the US (Part II): Political Factors and Future Scenarios for US Accounting Standards*, 24 ACCT. HOR. 567 (2010).

12 BRUCE MACKENZIE, TAPIWA NJIKIZANA, DANIE COE TSEE, RAYMOND CHAMBOKO, AND BLAISE COLYVAS, WILEY IFRS 2011: INTERPRETATION AND APPLICATION OF INTERNATIONAL FINANCIAL REPORTING STANDARDS (2011) [hereinafter: WILEY IFRS 2011]; Larson & Street, *supra* note 4. *See also* FASB, Completing the February 2006 Memoran-

dropped the "reconciliation to US GAAP" requirement for foreign companies reporting in a manner fully compliant with IFRS as issued by IASB.[13] This decision was widely seen as an acknowledgement by the SEC that the IFRS constituted a fully acceptable set of "high quality financial reporting standards."[14] This change constitutes considerable progress from the perspective of foreign companies listed in the U.S. who considered it costly and confusing to have two different financial statements for the same year.[15]

The elimination of the reconciliation requirement permitted scholars to compare the value relevance of IFRS-based and US-GAAP-based accounting information by looking at the relation between accounting information and stock market values.[16] While some scholars found positive or mixed results, others found no evidence of change.[17] While scholars are

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dum of Understanding, September 2008, *available at* http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175819018778&blobheader=application%2Fpdf.

[13] SEC, 17 CFR Parts 210, 230, 239 and 24, Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards without Reconciliation to US GAAP, *available at* http://www.sec.gov/rules/final/2007/33-8879.pdf; SEC Press Release, SEC Takes Action to Improve Consistency of Disclosure to US Investors in Foreign Companies, Nov. 15, 2007, http://www.sec.gov/news/press/2007/2007-235.htm; CPA Letter, *SEC Eliminates Reconciliation Requirement for Foreign Companies; AICPA Recommends SEC Use International Accounting Standards*, January 1, 2008, *at* http://www.ifrs.com/updates/aicpa/SEC_Eliminates_Reconciliation.html.

[14] WILEY IFRS 2011, *supra* note 12. This is not the only acknowledgment on that matter. For example on Feb. 24, 2010, the SEC issued a release expressed its continued support for the convergence of US GAAP and IFRS (Release Nos. 33-9109 and 34-61578, Commission Statement in Support of Convergence and Global Accounting Standards).

[15] Larson & Street, *supra* note 4; James D. Cox*, Coping in a Global Marketplace: Survival Strategies for a 75-Year-Old SEC*, 95 VA. L. REV. 941, 985 (2009).

[16] *See e.g.*, Robert W. Holthausen & Ross L. Watts, *The Relevance of the Value-Relevance Literature for Financial Accounting Standard Setting*, 31 J. ACCT. & ECON. 3 (2001); *see* Mary E. Barth, William H. Beaver, & Wayne R. Landsman, *The Relevance of the Value-Relevance Literature for Financial Accounting Standard Setting: Another View*, 31 J. ACCT. & ECON. 77 (2001); *see also* Ahsan Habib, *Legal Environment, Accounting Information, Auditing, and Information Intermediaries: Survey of Empirical Literature*, 26 J. ACCT. LIT. 1, 13-18 (2007), and Wayne R. Landsman, Edward L. Maydew, and Jacob R. Thornock, *The Information Content of Annual Earnings Announcements and Mandatory Adoption of IFRS,*53 J. ACCT & ECON 34 (2012) (both suggesting that the significance of accounting depends on the strength of legal enforcement in the respective country).

[17] *See e.g.,* Yontae Kim, Haidan Li, and Siqi Li, *Does eliminating the Form 20-F reconciliation from IFRS to U.S. GAAP have capital market consequences?* 53 J. ACCT & ECON 249 (2011) (finding no evidence of a negative impact on market liquidity cost of equity); Xuefeng Jiang et al, *Did Eliminating the 20-F Reconciliation Between IFRS and U.S. GAAP Matter?*, MICHIGAN STATE UNIVERSITY WORKING PAPER (2010) (finding no evidence that reconciliation is associated with abnormal trading volume and return volatility); Tzu-Ting Chiu, & Lee, Yen-Jung, *Foreign Private Issuers' Application of IFRS Around the Elimination of the 20-F Reconciliation Requirement*, 48 INT'L J. ACCT. 54, 57

yet to find a better way to evaluate the switch,[18] today, 450 companies using IFRS are listed in the US report, with an aggregate market capitalization exceeding five trillion dollars.[19]

Overall, the 2007 decision of SEC was welcomed by many with the hope that US capital markets would regain competitiveness as compliance with SEC regulations would become easier and less costly.[20] At that time, the argument was that US capital markets had become less likely to attract foreign issuers because of excessive regulation, including the requirement of filing financial reports according to US GAAP.[21] The study of the Committee on Capital Markets Regulation found that "[f]oreign companies are not only choosing to stay away from the U.S. public market, those that have come are leaving."[22] Yet, the decision seems not to have strongly affected the competitiveness of US markets. If anything, the number of foreign issuers newly listed in the US slightly decreased since 2007, although the decision to cross-list is driven by a variety of factors, including the financial crisis.[23]

In 2008, when the global financial crisis highlighted the interdependence of global financial markets, the leaders of the G20 called for global accounting standards and urged FASB and the IASB to complete

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(2013) (finding that accounting data under IFRS and U.S. GAAP are of similar quality, but that quality is reduced by reconciliation)

[18] Muhammed Jahangir Ali, *A Synthesis of Empirical Research on International Accounting Harmonization and Compliance with International Financial Reporting Standards*, 24 J. ACCT. LIT. 1, 44 (2005).

[19] Hans Hoogervorst, *Defining Profit or Loss and OCI… Can It Be Done?*, Tokyo speech, February 5, 2014, at 3.

[20] *See*, e.g. Woo, *id.* at 121.

[21] Larson & Street, *id.*; Cox, *supra* note 15; *Id.*; Donald C. Langevoort, *U.S. Securities Regulation and Global Competition,* 3 VA. L. & BUS. REV., 191, 192 (2008); Scannell & Slater, *supra* note 6; Roberta S. Karmel & Claire R. Kelly, *The Hardening of Soft Law in Securities Regulation*, 34 BROOK. J. INT'L L. 883, 909 (2009).

[22] COMMITTEE ON CAPITAL MARKETS REGULATION, THE COMPETITIVE POSITION OF THE U.S. PUBLIC EQUITY MARKET, December 4, 2007, available at www.capmktsreg.org. *Also see* Christopher Hung Nie Woo, *United States Securities Regulation and Foreign Private Issuers: Lessons From the Sarbanes-Oxley Act*, 48 AM. BUS. L.J. 119, 130-134 (2011) (stating that "accounting and disclosure appear to be the biggest costs for most foreign private issuers").

[23] In 2007, 74 foreign companies were newly listed either in NYSE or NASDAQ. After the financial crisis, there had been a sharp decline in the newly listed companies. For instance, there were only 32 newly listed companies in 2008. Most recently 62 new foreign companies were listed in 2011. (Data from World Federation of Exchanges Statistics, available at http://www.world-exchanges.org).

their convergence projects by 2011.[24] For many, the introduction of IFRS in the US seemed inevitable in today's global capital markets.[25]

The same year, FASB and IASB agreed on a "Roadmap" for potential use of IFRS by US issuers and targeted a successful convergence between IFRS and US GAAP.[26] It underlines the point that, as trading and investment become more global, investors face an increasing need for disclosure that facilitates comparison of financial information across investment alternatives in different parts of the world.[27] Organizations such as the G20 and AICPA had concluded that IFRS provide the best available set of global accounting standards,[28] and the SEC seemed set to achieve convergence by 2011 and adoption by 2014.[29]

However, when Mary Shapiro took office as the SEC chair in 2009, she declared that the move towards IFRS, "if it were to occur," should take place more slowly than had previously been indicated.[30] In line with this, the SEC's April 2011 Progress Report disclosed that the two Boards had extended the timetable for the convergence projects beyond June 2011 "to permit further work and more intense consultation with

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[24] G20 Washington Summit 2008, reaffirmed on G20 Pittsburgh Summit 2009. Washington Summit Declaration is *available at* http://g20.org/images/stories/docs/eng/washington.pdf; Pittsburgh Summit Declaration 2009, *available at* http://g20.org/images/stories/docs/eng/pittsburgh.pdf.

[25] Moritz Pöschke, *Incorporation of IFRS in the United States: An Analysis of the SEC's Options and the Implications for the EU*, 9 EUR. COMPANY & FIN. L. REV. 51 (2012); William W. Bratton & Lawrence A. Cunningham, *Treatment Differences and Political Realities in the GAAP-IFRS Debate*, 95 VA. L. REV. 989 (2009); Stephen A. Zeff, *IFRS Developments in the USA and EU, and Some Implications for Australia*, 18 AUSTRALIAN ACCT. REV. 275 (2008); Sharda Sharma, *The Impact of the Adoption of International Financial Reporting Standards on the Legal Profession*, 10 HOUS. BUS. & TAX L. J. 139 (2010).

[26] Nov 2008 SEC Roadmap, *supra* note 3.

[27] *Id.*

[28] 2009 Summit, *supra* note 24, SEC Press Releases. *Also see* PWC, *IFRS and US GAAP: Similarities and Differences*, October 2011, p. 3. *See also* Harvey Goldschmid, *US Incorporation of IFRS is a National imperative*, Keynote Address at IFRS Foundation/AICPA Conference in Boston, 5-7 October, 2011 (stating that the goal of a single set of high quality global accounting standards is so important for SEC too and this realistically can only be IFRS). Ervin Black, Greg Burton, & Spencer Paul*, US Perspectives on Implementation of IFRS*, in LAW, CORPORATE GOVERNANCE AND ACCOUNTING: EUROPEAN PERSPECTIVES 19, 19 (Victoria Krivogorsky ed., 2011).

[29] 2008 Roadmap, *supra* note 26. In November 2008, the SEC proposed making a decision in 2011 to mandate IFRS adoption with a planned phase-in of adoption dates-2014 for larger accelerated filers, 2015 for mid-sized companies, and 2016 for small companies.

[30] Mary Schapiro, *Questions from Senator Carl Levin for Mary Schapiro, Nominee to be Chair of the Securities and Exchange Commission*, January 8, 2009, http://levin.senate.gov/imo/media/doc/supporting/2009/PSI.SchapiroResponses.012209.pdf.

stakeholders."[31] The first half of 2012 was targeted for the completion according to the press release of the projects, and a decision on the specific date for mandatory IFRS for US companies was expected thereafter. However, to date, there is still no definite decision as to "whether, when, and how the current financial reporting system for US issuers should be transitioned to a system incorporating IFRS."[32] While the Final Staff Report of the SEC had been expected to make a clear recommendation, that report failed to recommend the endorsement of IFRS or even a timeline.[33] In spite of widespread frustration with this situation among EU policymakers,[34] the SEC is still not sure whether US will move forward with IFRS as it is not even clear whether the two boards will be able to reach convergence on the key aspects of *all* projects.[35]

2.2. Objections to the adoption of IFRS

While the SEC is committed to the goal of a single set of global accounting standards,[36] it seems reluctant to take the next step and set a date for adoption. Recent developments imply that there will be no "big bang approach" and the SEC might come up with "ways that a softer transition or change over time can occur."[37] The following sections explore several reasons that seem to underlie the SEC's ambivalent stance. The first set of concerns address procedural issues relating to the introduction of IFRS. The sheer size of the US economy and the possibly disastrous consequences, both nationally and internationally, of a rushed decision may be one reason (section 2.2.1).[38] Moreover, we discuss the objection that it

[31] Progress Report on IASB-FASB Convergence Work dated April 21, 2011, http://www.fasb.org/cs/BlobServer?blobkey=id&blobwhere=1175822338795&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs.

[32] SEC Staff Paper, "Work Plan for the Consideration of Incorporating International Financial Reporting Standards in the Financial Reporting System for US Issuers: Exploring Possible Method of Incorporation," May 26, 2011, at 1, http://www.sec.gov/spotlight/globalaccountingstandards/ifrs-work-plan-paper-052611.pdf, [hereinafter SEC Staff Paper, May 26, 2011].

[33] *See* SEC Final Staff Paper, July 13, 2012, *supra* note 3.

[34] *See*, Speech from Olivier Guersent at the Conference EFRAG/Trustees: An EU Perspective on the Move Towards Global Accounting Standards, October 11, 2012. *See,* European Financial Reporting Advisory Group (EFRAG) Press Release, An EU Perspective on the Move Towards Global Accounting Standards, October 16, 2012.

[35] SEC Final Staff Paper, July 13, 2012, *supra* note 3. SEC Staff Paper, May 26, 2011, *supra* note 3, at 8.

[36] *See, e.g.*, SEC Press Release: SEC Approves Statement on Global Accounting Standards, Feb. 24, 2010, http://sec.gov/news/press/2010/2010-27.htm. *See also*, SEC Commission Statement in Support of Convergence and Global Accounting Standards (which also includes the Work Plan as an appendix) [hereinafter SEC Work Plan, February 24, 2010], http://sec.gov/rules/other/2010/33-9109.pdf.

[37] Ken Tysiac, *Beswick: "Change Fatigue" a Barrier to the IFRS in U.S.,* J. ACCT., May 2, 2013.

[38] *See* Goldschmid, *supra* note 28. (suggesting that Dodd-Frank Act will not be a reason a delay); *but see* Michael Cohn, *AICPA to Reconsider IASB Recognition, Definition of*

might not be legitimate for the SEC to delegate accounting standard setting to an *international* body (section 2.2.2). The second and more important set of concern relates to the substance of IFRS. US GAAP currently follow a "rules-based" model, while the IFRS model is purportedly "principles-based." Detractors of the IFRS have argued that this and other features of IFRS will make them less useful in the US economic and legal setting. Section 2.2.3 introduces the debate, and section 2.2.4 discusses how it may be linked to peculiar aspects of US legal culture, in particular investor litigation.

2.2.1. Too big to fail: the US economy and the role of the SEC

Most obviously, the SEC appears to be reluctant to abandon American exceptionalism in accounting due to the fact that the US is the largest economy in the world. Given the high stakes, the SEC may reasonably want to be cautious about moving forward without making sure IFRS will not fail in the long run.[39] A premature adoption of a set of underdeveloped accounting standards might have severe consequences around the world, given the role of the well-developed US public equity market in providing external finance to foreign companies.[40] Metaphorically speaking, for a "large vessel" such as the US financial system, it may be simply more difficult to get back on the right course after a wrong (or even disastrous) one has been set.

Moreover, because of the large size of the US capital market possible benefits from adopting IFRS will likely be less substantial than in smaller markets. One of the standard rationales for mandatory financial disclosure of publicly traded firms is that information is a public good whose benefits the issuer does not fully internalize.[41] In part, the reason for this is network effects resulting from investors comparing different

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Asset, and Global Credentials, ACCT. TODAY, May 13, 2013 (noting that the SEC is understaffed and that SEC Chair Mary Jo White has indicated that Dodd-Frank and the JOBS Act are priorities).

[39] *See e.g.*, Cunningham, *supra* note 2 at 64-65. *See also* Ken Tysiac, *Beswick: Rulemaking preventing SEC from deciding on IFRS*, J. ACCT., Dec 9, 2013.

[40] Luzi Hail, Christian Leuz & Peter Wysocki, *Global Accounting Convergence and the Potential Adoption of IFRS by the U.S. (Part I): Conceptual Underpinnings and Economic Analysis*, 24 ACCT. HORIZONS 355, 366-368 (2010) (providing a detailed discussion on costs and benefits of IFRS adoption in the US).

[41] Gerard Hertig, Reinier Kraakman & Edward Rock, *Issuers and Investor Protection*, in ANATOMY, *supra* note 6, at 275, 276-281; Allen Ferrell, *The Case for Mandatory Disclosure in Securities Regulation around the World*, 2 BROOK. J. CORP. FIN. & COM. L. 81 (2007). *Also see* Allen Ferrell, *Mandated Disclosure and Stock Returns: Evidence from the Over the Counter Market*, 36 J. LEGAL STUD. 213 (2007); Holger Daske, Luzi Hail, Christian Leuz, & Rodrigo S. Verdi, *Mandatory IFRS Reporting Around the World: Early Evidence on the Economic Consequences*, 46 J. ACCT. RES. 1085 (2008).

firms.[42] Within the US, these network effects may be large enough because of the sheer market volume.[43] In smaller markets, these benefits may only materialize if investors are capable of diversifying across a set of exchanges, for which a single set of accounting standards may be required as a basis.[44]

It is of course true that the New York Stock Exchange (NYSE) is the largest stock market in the world by market capitalization. As of December 2011, its equity market capitalization was 11.8 billion dollars, followed most closely by the domestic equity markets of Tokyo and London with 3.3 billion dollars each.[45] However, there are a number of objections to this argument. In a globalized world, capital markets are perhaps not best seen in national terms. Collectively, the countries using IFRS constitute a larger economy than the United States, with a market capitalization exceeding that of the US exchanges by more than a quarter.[46] In the US the number of publicly traded firms has decreased since the mid-1990s,[47] and there have been few IPOs since the dot-com bubble burst.[48] Some firms have permanently left the market, and international issuers have increasingly sought listings elsewhere, e.g. in London.[49] Accounting standards may therefore be a competitive factor for the US stock market, and particularly for American firms seeking both domestic and international investment.

Since the formation of FASB in early 1970s, US issuers believed that US GAAP were well-developed and perfectly met the needs of US

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[42] *See* Karthik Ramanna & Ewa Sletten, *Network Effects in Countries' Adoption of IFRS*, HARVARD BUSINESS SCHOOL WORKING PAPER 10-092, at http://ssrn.com/abstract=1590245.

[43] *Id.,* at 5.

[44] *See, e.g.*, Ramanna & Sletten *supra* note 42 at 5, 6 & 30; Hail et.al. *supra* note 40 at 364-366.

[45] World Federation of Exchanges, WFE 2011 Market Highlights, 19 January 2012, http://www.world-exchanges.org/files/file/stats%20and%20charts/2011%20WFE%20Market%20Highlights.pdf.

[46] SEC 2008, Open Meeting Video of [then] SEC Chair Christopher Cox, at http://www.sec.gov/news/press/2008/2008-184.htm (stating that market capitalization in 85 countries requiring IFRS represented approximately 35% of global market capitalization in July 2008, which exceeded the 28% share of US exchanges).

[47] World Federation of Exchanges Statistics, at http://www.world-exchanges.org; David Weild & Edward Kim, *A wake-up call for America*, GRANT THORNTON CAPITAL MARKETS SERIES (November 2009), http://www.gt.com/staticfiles/GTCom/Public%20companies%20and%20capital%20markets/gt_wakeup_call_.pdf; *see also* Alix Stuart, *Missing: Public Companies – Why is the number of publicly traded companies in the U.S. declining?*, CFO.COM US, March 22, 2011.

[48] "U.S. exchanges have captured just 13.8% of the total value of Global IPOs in 2007, compared with an average of 74% in the period from 1996 to 2000." Committee on Capital Markets Regulation, *supra* note 22.

[49] SOX has often been blamed for this. *See e.g*. Langevoort, *supra* note 21, at 195; Newman, *supra* note 6, at 839.

business and its investors and thus provided American firms with a competitive edge.[50] In spite of incidents such as the Enron scandal, the SEC held on to the belief that this system generally works well. The purpose of adopting IFRS would therefore not primarily be to remedy the defects of the existing system, but rather to harmonize US accounting practices with those used in the rest of the world, and thus help the US capital market, and US firms, to regain international competitiveness in addition, adopting IFRS in the US may ease US public companies' access to international capital.[51]

Harmonization may be desirable if the goal for SEC is to protect US investors investing globally and secure a strong position for the US in today's competitive global capital markets.[52] As former SEC Chair Christopher Cox said in 2008, "two thirds of US investors own securities issued by foreign companies."[53] "A common accounting language around the world could give investors greater comparability and greater confidence in the transparency of financial reporting worldwide."[54] In other words, both American investors and issuers should be able to benefit from amplified network effects if the financial reporting landscape of the US were integrated into the developing global one, in which investors are able to compare financial statements of firms worldwide using a single set of standards.

2.2.2. Delegating authority to a private international body

Another concern has been about "ratifying as laws the set of rules created by a small self-appointed private body," which was also debated in the EU.[55] However, it is hard to justify such an argument in the US as the constitutional structures and decision-making processes of FASB and IASB are almost identical.[56] Many name the extent of similarity as IASB being

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[50] For a historical overview *see* Stephen A. Zeff, *The Evolution of U.S. GAAP: The Political Forces Behind Professional Standards*, CPA J., February 2005.
[51] Langevoort, *supra* note 21, at 195; Newman, *id.*, at, 842-861; Ken Tysiac, *IFRS Foundation Report Says SEC's Concerns Can Be Overcome*, J. ACCOUNTANCY, October 23, 2012.
[52] *Id.;* Cunningham, *supra* note 2 at 21; Langevoort, *supra* note 21, at 195 (arguing that companies are already raising capital not just in New York but all around the world such as London, Hong Kong, or Dubai). Newman, *supra* note 6, at 835.
[53] *Id.*
[54] SEC 2008 Press Release, *supra* note 3.
[55] *See* Wiley IFRS 2011, *supra* note 12, at 18; Bratton & Cunningham, *supra* note 25, at 1000-01.
[56] Bratton & Cunningham, *supra* note 25, at 1000-1001; *see* David S. Ruder, Charles T. Canfield, and Hudson T. Hollister, *Creation of World Wide Accounting Standards: Convergence and Independence*, 25 NW. J. INT'L L. & BUS. 513, 526-54 (2005). In fact, the overhaul of IASB's structure in 2000 was motivated by the desire to follow the American model and thus facilitate the adoption of IFRS in the US.

the "carbon copy" of FASB – only on a broader geographic scale.[57] FASB has been the standard setter in the U.S. since 1973, and its predecessors were private bodies as well.[58] Since the 1930s, the Commission has been relied on as an independent private sector organization to establish accounting standards, which apparently never caused debate about the legitimacy of private standard setting.[59] In fact, only the Sarbanes-Oxley Act of 2002 created an explicit authority for the SEC to recognize a private standard-setting body and set up criteria for recognition,[60] but the private character of accounting standards had apparently never even been an issue. Hence, the concern obviously originates not in the fact that the IASB is a *private* standard-setter but it in the fact that it is a *foreign* one.

The US is generally often reluctant to espouse foreign and international standards. The US Supreme Court is divided on "whether it is legitimate to rely on foreign law"[61] – even though foreign and international law are cited only as a secondary (nonbinding) source (i.e., at the same level with law review articles).[62] Justice Scalia, maybe the most outspoken opponent of the practice, argues in one of the decisions "this Court [...] should not impose foreign moods, fads, or fashions on Americans."[63]

From not ratifying even the basic international human rights agreements such as The Convention on the Elimination of All Forms of

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[57] *Id*.; William W. Bratton, *Heedless Globalism: The SEC's Roadmap to Accounting Convergence*, 79 U. CIN. L. REV. 471, 476 (2010).

[58] These include the Committee on Accounting Procedure (CAP) and the Accounting Principles Board (APB). Anne B. Fosbre, Ellen M. Kraft & Paul B. Fosbre, *The Globalization of Accounting Standards IFRS vs. US GAAP*, 3(1) GLOBAL J. BUS. RES 61, 63-64,(2009).

[59] The Financial Accounting Foundation (FAF), founded in 1972, is a private-sector organization overseeing FASB, which was established by the FAF in 1973. *See generally* http://www.fasb.org, at *Facts about FASB*. Accounting Standards codified by FASB are officially recognized as authoritative by SEC (Financial Reporting Release No. 1, Section 101, and reaffirmed in its April 2003 Policy Statement) and the American Institute of Certified Public Accountants; Rule 203, Rules of Professional Conduct, as amended May 1973 and May 1979).

[60] SOX § 108.

[61] Martin Gelter & Mathias M. Siems, *Language, Legal Origins, and Culture before the Courts: Cross-Citations between Supreme Courts in Europe,* forthcoming 21 S. CT. ECON. REV. section A.1 (2013). *See also Roper v. Simmons,* 125 S. Ct. 1183 (2005); *Lawrence v. Texas,* 123 Ct 2472 (2003); *Foster v. Florida*, 537 US 990 (2002); *Atkins v. Virginia* 536 US 304 (2002).

[62] *See* Ruth Bader Ginsburg, *Looking Beyond Our Borders: The Value of a Comparative Perspective in Constitutional Adjudication*, 22 YALE L. & POL'Y REV. 329 (2004). *See also* Jess Bravin, *Looking Global: Ginsburg Speaks Out on Kagan, Comparative Law Issue*, WALL ST. J., July 30, 2010, at LawBlog, http://blogs.wsj.com/law/2010/07/30/looking-global-ginsburg-speaks-out-on-kagan-comparative-law-issue/.

[63] Gelter & Siems, *supra* note 61, section A.1 (citing Justice's Scalia dissent in *Lawrence v. Texas*).

Discrimination Against Women (CEDAW),[64] and the UN Convention on the Rights of the Child,[65] to arguing the legitimacy of citing international or foreign decisions and laws, when it comes to following foreign/international legal developments, "*imposing foreign moods […] on Americans"* [66] seems to be a major concern in the US.[67] Yet, the skepticism US judges and scholars have with regards to foreign law is not the only instance we see US exceptionalism. It is rather part of a larger pattern that includes the refusal to adopt the metric system[68] and using the term "soccer" for the game known to the rest of the world as "football."

Clearly, IASB is not completely foreign in the sense of excluding US representation. Thus, the actual fear in the US may be that the US would be *underrepresented* in the new regime – against which must be balanced the fear of other countries that the US is actually *overrepresented* in the current regime, as a country that has still not adopted the IFRS but is in the position to substantially influence IASB.

The fear of delegating authority over financial reporting to a non-US organization has grown so much by now that some have started to question the authority of the SEC to decide on such delegation.[69] However, the SEC clearly stated that it has the authority and has been delegating its power to FASB since 1970s. Furthermore, should the, SEC decide to adopt IFRS, FASB will remain the body responsible for endorsing interna-

[64] CEDAW is an international agreement that affirms principles of fundamental human rights and equality for women around the world that is adopted by the United Nations General Assembly in 1979. All but seven countries (US, Iran, Sudan, South Sudan, Somalia, Palau, and Tonga) have ratified the treaty.
[65] The United Nations Convention on the Rights of the Child (UNCRC) is a human rights treaty setting out the civil, political, economic, social, health and cultural rights of children. Since its adoption in 1989, the Convention has become the most widely ratified human rights treaty in history. Only three countries, Somalia, South Sudan and the US, have not ratified the treaty.
[66] *Lawrence v. Texas* 123 Ct 2472, 2495 (2003) (Scalia J).
[67] *See, e.g.,* 151 CONG. REC. S3109 (daily ed. March 20, 2005) (statement of Sen. John Cornynarguing that citation of foreign law would imply that the American people would lose "control over the meaning of our laws and of our Constitution"); Martha Minow, *The Controversial Status of International and Comparative Law in the United States, 52* HARV. INT'L L. J. 1, 4 (2010).
[68] Ramanna, *supra* note 6, at 35 (besides the US, only Liberia and Myanmar have eschewed the metric system).
[69] *See, e.g.*, Senator Carl Levin asking Mary Schapiro when she was nominated as the chair of SEC whether SOX allows the "the SEC to delegate the development of US accounting standards to the IASB"; *see also* Cunningham, *supra* note 2 at 28-33; Jacob L. Barney, Note, *Beyond Economics: The U.S. Recognition of International Financial Reporting Standards as an International Subdelegation of the SEC's Rulemaking Authority*, 42 VAND. J. TRANSNAT'L L. 579, (2009) (all questioning the SEC's authority). *But see, infra* note 334, SOX § 108, and section 4.2.1 (discussing the SEC's authority and an endorsement approach as a possible solution).

tional standards, which would be a precondition for their application in the US.[70]

The influence of US in the emergence of IFRS dates back to its roots. The predecessor of the current IFRS Foundation,[71] the International Accounting Standards Committee (IASC)Foundation was formed in 1973 through an agreement among nine national accounting bodies: Australia, Canada, France, Germany, Japan, Mexico, Holland, the United Kingdom, and the United States;[72] arguably, the Anglo-Saxon countries dominated.[73]

The "three-tier governance structure" of IFRS is similar to the US model of FASB. First, IASB consists of 15 independent experts, four of whom are American. Second, five out of the twenty-two Trustees of IFRS Foundation are from the US. Third, the Monitoring Board is made up of five securities regulators including the SEC.[74] In other words, US influence is perceptible at all levels of the institutional structure associated with the IFRS. In addition to all these structural similarities, IASB's standards have gradually been amended in the course of a deliberate process to create convergence with GAAP. The FASB-IASB joint project has resulted in changes both in US GAAP and IFRS to the extent that they are now "far more similar than they are different."[75] In fact, IFRS mirror US GAAP in many respects.[76]

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[70] Nov 2008 SEC Roadmap, *supra* note 26. For a further discussion on who actually adopted IFRS in a way that each standard is effective as soon as it is issued by the IASB, *see* Stephen A. Zeff & Christopher W. Nobes, *Has Australia (or Any Other Jurisdiction) 'Adopted' IFRS?*, 20 AUSTL. ACCT. REV. 178, 178-184 (2010). *See infra* section 4.2.1

[71] On July 1, 2010, the IASC Foundation renamed itself as International Financial Reporting Standards Foundation (IFRS Foundation). IASC Web Announcement 2010, IFRS Foundation Constitution 2010.

[72] *See* CLARE ROBERTS, PAULINE WEETMAN, & PAUL GORDON, INTERNATIONAL FINANCIAL REPORTING A COMPARATIVE APPROACH, (3rd ed. 2005); *see* Mark J. Hanson, *Becoming One: The SEC Should Join the World in Adopting the International Financial Reporting Standards*, 28 LOY. L. A. INT'L & COMP. L. REV. 521 (2006); *see* WILEY IFRS 2011. *supra* note 12.

[73] Leo van der Tas & Peter van der Zanden, *The International Financial Reporting Standards,* in THE INFLUENCE OF IAS/IFRS ON THE CCCTB, TAX ACCOUNTING, DISCLOSURE AND CORPORATE LAW ACCOUNTING CONCEPTS 1, 3 (Peter Essers et al. eds 2009); Alain Burlaud & Bernard Colasse, *Normalisation comptable internationale : le retour du politique,* 16 COMPTABILITE CONTROLE AUDIT 153, 155-156 (2010) (pointing out that four former English colonies – and only one other country – joined in 1974).

[74] Goldschmid, *supra* note 28.

[75] Stuart H. Deming, 84 MICH. B.J. 14, 17 (2005); SEC Comparison of US GAAP and IFRS, *supra* note 3.

[76] SEC Comparison of US GAAP and IFRS, *supra* note 3 (examples of recent changes to FASB and/or IASB standards as a result of joint projects). For example, on May 2011, IASB issued IFRS 10, *Consolidated Financial Statements* which resulted substantial convergence of IFRS with US GAAP on structural investment vehicles and other SPEs as well as related disclosures. However, when it comes to *Consolidation*, differences remain. SEC Comparison of US GAAP and IFRS, *supra* note 3, at 5. For a more detailed discussion on Consolidation and SPEs *see* section 2.2.3. Another example of substantially converged standards is *Business Combinations*. Both IFRS 3 and ASC Topic 805 contain

2.2.3. The rules-principles debate in accounting

While procedural obstacles should normally only be temporary, substantive objections to IFRS should play a role in the debate irrespective of the cost of transition. This kind of objection does not concern specific details, but the nature of this set of standards as a whole, and its purported incompatibility with the US financial reporting environment and the legal system as a whole.[77]

The main critique relates to the level of detail of the two sets of accounting standards.[78] It is often claimed that US GAAP are "rule-based," while IFRS are "principles-based."[79] These two terms used by accountants are more or less analogous to what legal scholars mean when they set up a dichotomy of "rules" and "standards."[80] In the accounting context, a rules-based approach means that a particular statement gives relatively detailed instructions regarding specific accounting treatment to be given to particular transactions.[81] Under a principles-based approach, the applicable accounting standard applies to a more general set of transactions, which consequently requires the accountant to employ greater discretion to comply with a general objective such as fair presentation.[82]

For example, accounting for leases is often used to illustrate the difference between the two systems because the accounting treatment (i.e. operating lease or capital lease) determines whether the corporation should report the lease as an asset or as an expense.[83] US GAAP employ bright line criteria such as requiring "[…] seventy-five percent or more of the leased property's economic life […]" as to when the transaction will be

similar requirements for accounting for business combinations. SEC Comparison of US GAAP and IFRS *supra* note 3, at 6 and 44-45.

[77] Newman, *supra* note 6, at 840-841; s*ee* Shyam Sunder, *IFRS and Accounting Consensus*, 23(1) ACCT. HOR. 101 (2009).

[78] *E.g.,* Newman, *id.*, at 844-845 points US GAAP has a bigger volume of information than IFRS with approximately 4,530 pages while IFRS is 2719 pages. Bratton, *supra* note 57, at 489-490.

[79] SEC Staff Paper, A Comparison of U.S. GAAP and IFRS: Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers (November 16, 2011). *See, e.g.,* Institute of Chartered Accountants Australia, *SEC Progress on US IFRS Adoption.*

[80] *See* Duncan Kennedy, *Form and Substance in Private Law Adjudication,* 89 HARV. L. REV. 1685, 1687-1713 (1976); Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992). Lance J. Phillips, *The Implications of IFRS on the Functioning of the Securities Antifraud Regime in the United States*, 108 MICH. L. REV. 603, 616–618 (2010); William W. Bratton, *Enron, Sarbanes-Oxley and Accounting: Rules Versus Principles Versus Rents,* 48 VILL. L. REV. 1023, 1030 (2003).

[81] Phillips, *id.*, at 616-617; Bratton, *id.*, at 1037.

[82] Phillips, *id.,* at 617; Bratton, *id.*, at 1036-1037.

[83] Newman, *supra* note 6, at 845-850; Bratton & Cunningham, *supra* note 22, at 994; Bratton, *supra* note 57, at 479.

recorded as a capital lease instead of an operating lease.[84] In spite of requiring a similar treatment of accounting for leases, IFRS do not provide quantified measures and state the idea in principled terms. IAS 17 requires capital lease accounting if "[…] the lease term is for the major part of the economic life of the asset […]" IFRS requires preparers to understand the essence of the transaction and report on its substantive reflection, while US GAAP is more prescriptive and tries to be as clear as possible.

Another important example is consolidation,[85] more precisely accounting for Special Purpose Entities (SPEs), and when to report SPEs on a consolidated basis. Debate about this issue erupted shortly after the Enron scandal, where a partnership controlled by Enron's CFO was used to circumvent consolidation requirements and thus effectively shift some corporate debt off the books.[86] Critics argued that a more principles-based approach would have prevented Enron from employing such tactics, since it would not have been possible to claim just to have followed the rules while avoiding compliance with the more general objective of accounting standards to consolidate all entities under the de facto control of the reporting entity.[87] Others objected that Enron did not follow US GAAP to the letter.[88] Yet, the criticism persuaded Congress to (legislatively) commission (in the Sarbanes-Oxley Act of 2002) an SEC report on whether the US should adopt a principles-based accounting system.[89]

Before Enron, the test corporations reporting under US GAAP were required to apply was simply to answer whether they are "holding majority voting control over the affiliate."[90] The standard FASB enacted on that matter in 2003[91] is less specific and it broadened the mere "voting control over SPEs" criterion.[92] It requires a company to consolidate if "a company is exposed to a majority of an entity's expected losses or entitled

[84] Newman, *id.*, at 848-849 citing FASB, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 13-ACCOUNTING FOR LEASES ¶ 7(c) (1976).
[85] Bratton & Cunningham, *supra* note 25, at 994-995; Bratton, *supra* note 57, at 479-480.
[86] JOHN C. COFFEE, JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 22-23 (2006); US v. Arthur Anderson, 374 F.3d 281 (2004).
[87] Coffee, *supra* note 8, at 1416-17 (2002); Bratton, *supra* note 80; *see* Joel S. Demski, *Enron et al. – a comment*, 21 J. ACCT. & PUB. POL'Y 129 (2002); *see* Mark Nelson, John Elliott & Robin Tarpley, *Evidence from Auditors about Managers' and Auditors' Earnings Management Decisions*, 77 ACCT. REV. 175 (Supplement 2002).
[88] *See, e.g.*, David Kershaw, *Evading Enron: Taking Principles Too Seriously In Accounting Regulation,* 68 MODERN L. REV. 594, 616-624 (2005); COFFEE, *supra* note 86, at 24; Bratton, *supra* note 80, at 1041-1043; Cunningham, *supra* note 2, at 17.
[89] SEC Study 2003, *supra* note 9.
[90] COFFEE, *supra* note 86, at 22-24; Newman, *supra* note 6, at 853-858 citing FASB, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 94 – CONSOLIDATION OF ALL MAJORITY OWNED SUBSIDIARIES ¶¶ 6-7 (1976); *see also* Kershaw, *supra* note 88 at 607 (discussing possible ambiguities in a consolidation standard based on voting control).
[91] FIN 46(R). Newman, *id.*, at 853-858.
[92] Newman, *id.,* at 853-858.

to a majority of entity's residual returns."[93] Arguably, the new criterion is more open-textured – and thus more principles-based – than the prior one.[94] Still, the applicable IFRS on consolidation[95] provides even less specific guidance whether to consolidate an SPE:[96] A reporting entity must consolidate an investee when the former controls the latter. Arguably, the reporting entity and its auditor need to exercise a greater degree of judgment under IFRS 10.[97] In order to eliminate inconsistencies, IFRS 10 articulates the principle of control in a way that it can be applied to all investees. Under this standard, control consists of three elements: power, exposure to variable returns, and an investor's ability to use power to affect its amount of variable returns.[98]

If a purportedly "principles-based" approach could solve America's accounting woes, why would anyone object? In spite of these examples, the dichotomy as such is often considered problematic.[99] Clearly, it does not imply that US GAAP do not employ any principles, or that IFRS exclusively consist of principles. To the contrary, US GAAP and IFRS each combine both.[100] It may be true that the IFRS include fewer specific rules because these could create problems in countries with very different economies, while more general prescriptions could be interpreted in ways that would better fit the particular circumstances.[101] For instance, US GAAP include detailed cost and expense guidance for extractive industries (oil and gas), but there is no corresponding guidance under IFRS. While industry-specific standards are an important aspect of the US accounting

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[93] *Id.*; Financial Interpretation 46(R); *see* SEC, OFFICE OF THE CHIEF ACCOUNTANT, REPORT AND RECOMMENDATIONS PURSUANT TO SECTION 401(C) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 91 (2003).

[94] Newman, *supra* note 6, at 854-855.

[95] The applicable standard is IFRS 10. IFRS 10 *Consolidated Financial Statements* supersedes IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation—Special Purpose Entities. See* IFRS Foundation, Effect Analysis: IFRS 10 *Consolidated Financial Statements* and IFRS 12 *Disclosure of Interests in Other Entities*, September 2011 (updated January 2012) [hereinafter Effect Analysis: IFRS 10] (observing several causes of inconsistent application of IAS 27 and SIC-12 that have resulted in diversity in practice and thus IFRS 10 was issued).

[96] Newman, *supra* note 6, at 856.

[97] Effect Analysis: IFRS 10, *id.* at 22, 33, 39, 44; Newman, *id.*, at 855-856.

[98] Effect Analysis: IFRS 10, *id.,* at 8 (explaining the principle of control and its elements in detail).

[99] *See* Phillips, *supra* note 80, at 616 n.100, and Russell B. Korobkin, *Behavioral Analysis and Legal Form: Rules vs. Standards Revisited*, 79 OR. L. REV. 23, 30 (2000) (both questioning the dichotomy between rules and standards).

[100] *See* SEC Study 2003, *supra* note 9; *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, 1413 (2007); Newman, *supra* note 6, at 845; *see also* Bratton, *supra* note 80, at 1026, 1036-1055 (explaining that Enron violated both rules and standards under US GAAP).

[101] *See* October 2012 IFRS Foundation Report, *supra* note 3.

system, IASB has not followed in FASB's footsteps in this respect,[102] and is also not planning to do so.[103] Moreover, even if a system has a larger number of rules than another, this does not make it automatically rules-based, since it always depends on how a specific rule is interpreted and applied against the backdrop of the underlying principles.[104] As we will discuss below, US GAAP and IFRS are both much more similar to each other than they are to Continental European accounting systems, which often had completely different objectives and were – in a certain way – more principles-based than either of them.

Even if we accept the rules-principles dichotomy as typically presented in the debate, one objection is that a principles-based approach could trigger negative reactions by accountants, auditors, and firms in the US, who are accustomed to working with bright line rules rather than principles. IFRS's less detailed guidance is seen as a challenge to their auditability and enforceability. For instance, Sunder strongly argues against the implementation of IFRS for several reasons, including the fact that IFRS favor principles instead of detailed rules and these standards focus on "fairness" which could only be "an *ex post* judgment about a particular instance of valuation," as opposed to an "ex ante judgment" and thus makes it impossible for a standard to "specify the numbers arrived at by the application of a particular method to be 'fair' by definition."[105]

Consequently, IFRS allow for greater discretion compared to U.S. GAAP. This seems to be the major concern raised by accountants in the US, given that discretion increases the risk of opportunistic accounting.[106] The IFRS focus on fair value measurement has been criticized as it "significantly impairs the ability of an auditor to limit opportunistic actions of management and improve financial reporting."[107] Arguably, simply by providing principles rather than bright line rules, IFRS create greater opportunities to engage in "financial engineering" to achieve the desired presentation in the financial statements.[108]

However, a detailed comparison with US GAAP would not necessarily reveal that the latter standards are indeed better at protecting inves-

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[102] *See* SEC Staff Paper, May 26, 2011 and SEC Final Staff Paper, July 13, 2012, *supra* note 3.
[103] October 2012 IFRS Foundation Report, *supra* note 3.
[104] Kershaw, *supra* note 88, at 606-608.
[105] Sunder, *supra* note 77 at 103. *See also* Kaplow, *supra* note 80, at 560 (offering an economic analysis of rules versus standards, suggesting that the distinction "is the extent to which efforts to give content to the law are undertaken before or after individuals act.").
[106] Various comment letters to SEC cited in SEC Work Plan February 24, 2010 *supra* note 3. *E.g.*, comment letters from American Accounting Association, Financial Accounting Standards Committee ("AAA-FASC"), Fund Stockowners Rights, National Association of State Boards of Accountancy ("NASBA"), and Psoras.
[107] *Id.*
[108] WILEY IFRS 2011, *supra* note 12. Regarding the prevalence of financial engineering, *see supra* note 87 and accompanying text.

tors in a public company from managerial misconduct with the help or tacit support of accountants and auditors. Currently, US GAAP are characterized by exceptions to more general rules, and often there are exceptions to these exceptions.[109] After Enron, a common criticism has been that the larger number of rules and exceptions makes it even more complicated and harder to track "financial engineering."[110] As Goldschmid puts it, "principles (with enough specificity to create comparability) can be better applied and enforced than detailed rules with bright lines and multiple exceptions.[111] Arguably, the principle-based approach has been incorporated into FASB's standards in the course of the IFRS-GAAP convergence project. It is much harder to avoid – by financial engineering – a well-crafted principle than a detailed, specific rule. The last two decades have taught us that financial types find it much too easy to manipulate and structure their ways around "hard and fast" rules."[112]

2.2.4. "Vague principles" and their fit with prevalent investor litigation

Scholars such as Newman link the rules-principles dilemma to cultural fit discussion and question whether US issuers have the "proper mindset to apply principles-based standards."[113] IFRS require issuers to capture the "economic substance" of transactions and prepare financial statements accordingly. However, Newman claims that US issuers' intent is "not necessarily to get the numbers 'right' but to present their company's financial position as favorably as possible without running afoul of the accounting guidance in that particular area."[114] Without having clear boundaries of right and wrong, it is not apparent whether US issuers would choose the "fair presentation" over "presenting financial statements

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[109] For a detailed discussion on rules and exceptions *see* Cass R. Sunstein, *Problems with Rules*, 83 CAL. L. REV. 953 (1995) ("It is familiar to find rules that have explicit or implicit exceptions for cases of necessity or emergency. It is unfamiliar to find rules without any such exceptions"); *See also* Lawrence A. Cunningham, *Private Standards in Public Law: Copyright, Lawmaking and the Case of Accounting,* 104 MICH. L. REV. 291, 324 & 324 n.169 (2005) (explaining difficulties in accessing FASB materials).
[110] *E.g.,* Newman, *supra* note 6, at 878 ("a good crook can outsmart a good cop any day of the week."); Bratton & Cunningham, *supra* note 25, at 1004 ("There is no question that GAAP's layers of rules can have perverse effects. […] Worse, there results a dysfunctional, check-the-box approach to compliance that admits transaction structuring and other strategic behavior").
[111] Goldschmid *supra* note 28.
[112] Goldschmid, *id*.
[113] Newman, *supra* note 6, at 859; Bratton & Cunningham, *supra* note 25, at 998-99; *see* William W. Bratton, *Rules, Principles, and the Accounting Crisis in the United States*, 5 EUR. BUS. ORG. L. REV. 7 (2004). Cultural fit discussion was most lively during the acceptance of IAS/IFRS across Europe due to Anglo-American origin of these standards. *See also* Andreas M. Fleckner, *FASB and IASB: Dependence despite Independence*, 3 VA. L. & BUS. REV. 275, 299 (2008).
[114] Newman, *supra* note 6, at 859.

as favorably as possible."[115] Newman's argument lends itself to some obvious criticism. First, other countries have produced their fair share of accounting scandals.[116] European scandals such as Parmalat have prompted the EU to pass a new Audit Directive in 2006,[117] and auditing remains high on the Commission's agenda.[118] It is not clear why issuers and auditors in the US – a country that scores quite well on corruption indices[119] – should be culturally more susceptible to accounting fraud than others. For the argument to persuade, the opportunities and incentives to publicize misleading financial statements would have to be particularly strong in the US.

In fact, another concern seems to point in exactly the opposite direction, namely a particularly strong, possibly excessive incentive structure discouraging accounting fraud. It is sometimes argued that "IFRS's less detailed and prescriptive guidance could expose companies to increased claims by shareholders and others seeking to challenge its application, given the perceived litigious environment in the United States."[120] Preparers and auditors of financial statements are not comfortable with the possibility that even judgments made in good faith that seemed reasonable at that time could be second-guessed in court, in spite of them having asked for assurance from SEC on that matter.[121] IFRS require accountants to use more judgment and, while this may have several advantages, might

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[115] *Id.,* at 866-867; Bratton, *supra* note 113, at 28-30. *See, e.g.* Woo, *supra* note 22, at 121 (citing SEC Commissioner Kathleen L. Casey noting "that one of the lessons of the current financial crisis is that financial stability depends on investor confidence, which in turn depends on the transparency of financial statements").

[116] *E.g.* John C. Coffee, Jr., *A Theory of Corporate Scandals: Why the USA and Europe Differ,* 21 OX. REV. ECON. POL'Y 198 (2005) (comparing US scandals such as Enron and WorldCom with European ones such as Parmalat and Ahold).

[117] Directive 2006/43/EC of the European Parliament and the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC, 2006 O.J. L 157/87.

[118] In November 2011, the commission issued two further proposals: Proposal for a Regulation of the European Parliament and the Council on specific requirements regarding statutory audit of public-interest entities, COM(2011) 779 final; Proposal for a Directive of the European Parliament and the Council amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts, COM(2011) 778 final.

[119] For example, Transparency International lists the US in 19th position on its 2012 corruption index, just behind the UK and ahead of several Western European countries, including Austria, France, Spain, and Italy. *See* http://cpi.transparency.org/cpi2012/results/.

[120] Pöschke, *supra* note 25, at 66-69; Phillips, *supra* note 80, at 608–612; Bushman & Piotroski, *Financial Reporting Incentives for Conservative Accounting: The Influence of Legal and Political Institutions*, WORKING PAPER, UNIVERSITY OF NORTH CAROLINA (2005); Comment letter from FPL Group, Inc. ("FPL") and tw telecom cited in in SEC Work Plan February 24, 2010, *supra* note 3.

[121] SEC Study 2003, *supra* note 9; SEC Work Plan February 24, 2010 *supra* note 3.

also mean a greater exposure to liability for them.[122] Some argue that litigation against auditors based on alleged negligence and defending accountants against such suits might result in increased opportunities for lawyers when IFRS are fully adopted.[123] Given that most jurisdictions using IFRS still lack class actions suits, extensive discovery and contingency fees,[124] litigation risk may simply not be particularly salient outside the United States.

However, class action litigation is extensively used in the United States and, as Woo points out, "in 2004 class action suits cost publicly traded companies in the United States $4.74 billion, compared with $40.48 million in the United Kingdom. The fact that the number in the United States is more than one hundred times that experienced in the United Kingdom is the primary reason the cost of directors' and officers' insurance in the United States is six times greater than in Europe."[125]

Although the number of securities class action settlements has decreased significantly in recent years, total settlement dollars in 2012 alone increased by more than 100 percent from 2011.[126] This mechanism in the US "has enjoyed considerable success both as a deterrent to large-scale corporate securities fraud and as a source of compensatory recovery for investors."[127] According to Warren, its success originates from a "uniquely adversarial legal system in a uniquely litigious culture."[128] From a behavioral law and economics perspective, the concern about excessive litigation risk seems at least plausible.

Hindsight bias compounded with the ex-post judgment of an incident under a less detailed, principles-based IFRS may increase the liability risk of companies, accountants and auditors. According to this concept, defendants are relatively likely to be found liable ex post because "once something happens, people tend to think it was more likely to occur, and

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[122] *See* Bratton, *supra* note 113, at 28-30; Cunningham, *supra* note 100, at 1473; Newman, *supra* note 6, at 873.
[123] Thomas C. Pearson, *Potential Litigation against Auditors for Negligence*, 5 BROOK. J. CORP. FIN. & COM. L. 405 (2011); Sharma, *supra* note 25, at 163.
[124] *E.g.* Manning Gilbert Warren III, *The U.S. Securities Fraud Class Action: An Unlikely Export to the European Union,* 37 BROOK. J. INT'L L. 1076, 1983-1087 (2012) (discussing reasons why securities class actions are unlikely to spread widely in the EU).
[125] Woo, *supra* note 22, at 132.
[126] The number of securities class action settlements reached a 14 year low in 2012 with only 53 court-approved settlements. However, the average settlement amount ($54.7 million) increased more than 150 percent in 2012 from prior year and this amount is well above the historical average ($36.8 million). Mega settlements (settlements over $100 million) accounted for 75% percent of all settlement dollars in 2012. *See* Ellen Ryan & Laura Simmons, *Securities Class Action Settlements: 2012 Review and Analysis*, Cornerstone Research (2013). *See also* Renzo Comolli et al., *Recent Trends in Securities Class Action Litigation: 2012 Mid-Year Review: Settlement bigger, but fewer*, NERA, 24 July 2012.
[127] Warren, *supra* note 124, at 1080-1083.
[128] *Id.,* at 1081-1082.

easier to foresee, than it really was."[129] For example, jurors of a car accident case are more likely to think that the car accident was foreseeable and the driver could have prevented it had she been more careful. However, participants in behavioral experiments intended to mimic a jury trial were more reluctant to find a driver negligent because the accident was supposedly foreseeable if conditions (e.g. weather, road) were explained without being informed about the outcome (i.e. the accident).[130] This is simply because, after the incident, it is often hard to imagine that it may not have been foreseeable.[131] Hindsight bias is said to "blur the distinction between fraud and mistake."[132] Looking at the securities-fraud cases, scholars found that judges do identify the influence of hindsight on jury.[133] However; a remedy to correct this real problem is yet to be seen and they may be punishing fraud and mistake equally.[134]

In stark contrast to these concerns, others have greater discretion accorded to managers by principles-based standards would "significantly weaken a plaintiff's chances to prove a corporate misstatement and scienter and thereby significantly weaken the effectiveness of securities law in general."[135] From a theoretical perspective, it seems more plausible that a less clearly defined standard will lead to a higher, possibly excessive level of deterrence. The law and economics literature on liability suggests that less predictability in the imposition of liability will increase incentives for risk-averse (or even risk-neutral) individuals to avoid possibly harmful actions.[136] The contrary argument seems to assume that compliance with the applicable accounting and auditing standards provides a safe harbor from liability; less clearly defined accounting standards would thus increase the discretion of the defendant and not that of the court. US courts have consistently refused to grant such a safe harbor to auditors, and have often largely disregarded GAAP. The US Supreme Court has long recognized that GAAP "are far from ... a canonical set of rules that will ensure

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[129] WARD FARNSWORTH, THE LEGAL ANALYST 218 (2007).

[130] *Id.*, at 218-223. *See, e.g.,* Kim A. Kamin & Jeffrey J. Rachlinski, *Ex Post ≠ Ex Ante: Determining Liability in Hindsight*, 19 L. & HUM. BEHAV. 89 (1995).

[131] FARNSWORTH, supra note 129, at 220; *see* Donald Langevoort, *The Epistemology of Corporate-Securities Lawyering: Beliefs, Biases and Organizational Behavior,* 63 BROOK. L. REV. 629, (1997).

[132] Mitu Gulati, Jeffrey Rachlinski & Donald Langevoort, *Fraud by Hindsight*, 98 NW. U. L. REV. 773 (2003) at 774.

[133] *Id*. at 775 (finding that one-third of published opinions in securities class action cases mention concerns with hindsight).

[134] *Id*. at 774; s*ee also* Jeffrey Rachlinski, *A positive Psychological Theory of Judging in Hindsight*, 65 U. CHI. L. REV. 571 (1998).

[135] *See, e.g.*, Phillips *supra* note 80, at 608–614; Newman *supra* note 6, at 860-861.

[136] John E. Calfee & Richard Craswell, *Some Effects of Uncertainty on Compliance with Legal Standards,* 70 VA. L. REV. 965, 966 (1984); Richard Craswell & John E. Calfee, *Deterrence and Uncertain Legal Standards,* 2 J. L. ECON. & ORG. 279,, 279-280 (1986); STEVEN SHAVELL, ECONOMIC ANALYSIS OF ACCIDENT LAW 97 (1987); Steven Shavell, *Liability for Accidents,* in 1 HANDBOOK OF LAW AND ECONOMICS 139, 159-160 (2007) (all suggesting that less certain legal standards will result in a higher level of deterrence).

identical accounting treatment of identical transactions. [GAAP], rather, tolerate a range of 'reasonable' treatments, leaving the choice among alternatives to management."[137] In the view of the courts, compliance with US GAAP does not necessarily provide users of financial statements with a transparent or fairly presented information, and thus protection from litigation. Generally, the courts did not permit a defense of formal *compliance* with accounting standards.[138] In the 1969 case of *U.S. v. Simon,* the defendant auditors had induced the audit client to relegate the explanation of one account receivable (which was especially a vehicle for the CEO to borrow money from the company without shareholders knowing about it) to one footnote. During the trial, eight leaders of the accounting profession testified on their behalf that, with the exception of minor technicalities, the accounting treatment was consistent with the applicable standards; seven of these prominent accountants testified that a more revealing disclosure actually would have been improper under GAAP.[139] Nevertheless, the Court of Appeals for the Second Circuit upheld the trial judge's decision that compliance with GAAP did not provide a defense but that the critical test was whether the financial statements as a whole fairly presented the financial situation of the firm. If they did not (as was apparently the case), the question on trial would have to be whether the accountants had been acting in good faith.[140] In light of the courts' lack of deference to GAAP, it appears unlikely that more principles-based accounting standards would have more than a marginal effect on the incidence of litigation.

The experience of foreign issuers with US GAAP until 2007 supports this argument, given that many of them faced the consolidation requirement and had to bear significant compliance costs.[141] These costs were not to eliminate the risk of litigation in the US[142] – they accepted the fear of litigation as an inevitable part of "the deal" of being listed in the US and thus signaling their good quality. There is no evidence that foreign issuers listed in the US would consider increased litigation risk to be a disadvantage, in fact, they already report under IFRS, are and by virtue of a US listing, they and their auditors are already exposed to exactly the same litigation risk of which US issuers and their auditors are supposedly afraid. Moreover, it is often suggested that foreign issuers often seek a

[137] Thor Power Tool Co. v. C.I.R., 439 U.S. 522, 544 (1979) *see also* Ezra Charitable Trust, 466 F.3d at 12 ("GAAP can tolerate a range of reasonable approaches")

[138] In its Regulation S-X, the SEC requires the financial statements must be audited by an independent accountant in accordance with generally accepted auditing standards. 17 C.F.R 210.1-02(d).

[139] Fred Kuhar, *The Criminal Liability of Public Accountants: A Study of United States v. Simon,* 46 NOTRE DAME L. REV. 564, 593-594 (1971).

[140] U.S. v. Simon, 425 F.2d 796, 805 (1969).

[141] U.S. CHAMBER OF COMMERCE COMM'N ON THE REGULATION OF U.S. CAPITAL MARKETS IN THE 21ST CENTURY. REPORT AND RECOMMENDATIONS 39 (Mar. 2007).

[142] *See, e.g.* Woo, *supra* note 22, at 130-134 (citing survey data showing that CEOs preferred ligation in the UK to the US).

listing in the US *because* of strong enforcement of securities law, which sends a positive signal to potential investors.[143] In other words, litigation risk is high in the US, and a switch to IFRS will most likely neither lower nor substantially increase such a risk.

Some claim that IFRS simply have not yet evolved to a similar level as US GAAP and will eventually develop into a rules-based set of standards.[144] In this view, US GAAP were originally principles-based, but gradually took their contemporary rules-based shape because of litigation risk. The US is therefore bound to end up with rules-based accounting standards one way or the other. Bratton and Cunningham suggest that IFRS in the US will over time become as rules-based as US GAAP by gradually adopting an increasing number of rules.[145] In their view, Americans will likely grow disenchanted with the IASB, which, as a globally oriented standard setter, will not be responsive to "particular demands from a single national interest group or regulator," which is why "new domestic politics of accounting standard setting will emerge."[146] Others argue that US GAAP are "too complex and proscriptive and result in a system in which entities tend to follow form over substance while violating the underlying spirit of transparency."[147] They expect that "convergence of US GAAP and IFRS will take the best practices of rules-based and principles-based accounting standards […]. Under such a setting, it is claimed that transparency would be greatly enhanced."[148] In spite of all that, FASB has still not succeeded in reducing the "complexity" of its standards more than ten years after Enron.[149] The "big four" convergence

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[143] *See e.g.*, Edward Rock, *Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure,* 23 CARDOZO L. REV. 675 (2002); Yuliya Guseva, *Cross-Listings and the New World of International Capital: Another Look at the Efficiency and Extraterritoriality of Securities Law*, 44 GEO. J. INT'L L. 411 (2013); René M. Stulz, *Securities Laws, Disclosure, and National Capital Markets in the Age of Financial Globalization*, 47 J. ACCT. RES. 349 (2009).

[144] SEC Work Plan February 24, 2010, *supra* note 3, (citing comment letters from Air Products and Chemicals, Inc. ("Air Products"), Community Health Systems, Inc. ("Community Health"), JPMorgan Chase ("JP Morgan"), The London Centre for International Corporate Governance Law ("London Ctr Int'l Corp Gov Law"), and Edward Randle).

[145] Bratton & Cunningham, *supra* note 25, at 1008.

[146] *Id.* at 1005-1008.

[147] RUTH ANN MCEWEN, TRANSPARENCY IN FINANCIAL REPORTING: A CONCISE COMPARISON OF IFRS AND US GAAP (2009).

[148] *Id*.

[149] *See, e.g.,* Remarks of Russell G. Golden, Chairman, Financial Accounting Standards Board, AICPA Conference on Current SEC and PCAOB Developments, Washington, DC, December 10, 2013, available at http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176163675405 (explaining future steps of FASB and how they are working towards their mission in order to "promote transparency, reduce complexity, and ensure continued progress toward the convergence of international accounting standards"). *See also Updates from FASB and the SEC: Standars Setting, Outreach and the Convergence Projects,* CPA J., July 2013 at 14-19.

initiatives namely, revenue recognition, leases, insurance contracts and financial instruments have been seen as massive barriers in this endeavor. For instance, for lessor accounting many argued it is "not broken, so don't fix it."[150] Revenue recognition on the other hand, has seen the most agreement between IASB and FASB leaders. The two boards are expected to publish an almost identical standard on revenue recognition.[151]

3. The Internationalization of European Accounting

While in the US, IFRS is sometimes seen as an expansionist project of a European accounting or corporate governance model, the perception is different in Europe, where the introduction of IAS/IFRS continues to be seen as an expansion of Anglo-Saxon capital market tradition that brought fundamental changes to the various Continental accounting styles. Section 3.1 describes the background history of Continental European, specifically German and French, accounting before the introduction of IFRS. Section 3.2 discusses the introduction of IFRS in Continental Europe and the resistance it faced, again focusing on Germany and France. Section 3.4 describes the *modus vivendi* that accounting seems to have reached for the time being.

3.1. European accounting before IAS/IFRS

3.1.1. The institutional framework

The legal framework of accounting within the European (Economic) Community that later morphed into the EU needs to be understood against the backdrop of harmonization in the company law area in general. With the creation of the common market and the free movement of capital during the 1960s, policymakers thought it to be important to harmonize important areas of corporate law in order to facilitate the free movement of capital and the establishment of businesses across borders, foster legal certainty, and to avoid a race to laxity.[152] Accounting came on the EEC's

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[150] Christopher Westfall, *Convergence 2014 the Tip of the Iceberg*, FIN. EXECUTIVE, Dec 1, 2013.
[151] Hoogervorst, *supra* note 19, at 3.
[152] *E.g.* Jan Wouters, *European Company Law: Quo Vadis?* 37 COMMON MKT. L. REV. 257, 269 (2000) (explaining the EC Commission's rationale for company law harmonization in the 1960s); Luca Enriques, *Company Law Harmonization Reconsidered: What Role for the EC?* in EUROPEAN COMPANY LAW IN ACCELERATED PROGRESS 59, 61 (Steef M. Bartman ed. 2006) (describing the prevention of a race to the bottom as the main original goal in light of the incipient debate about a possible "race to the bottom" in the US). *See also* Friedrich Kübler, *A Shifting Paradigm in European Company Law,* 11 COLUM. J. EUR. L. 219, 220-221 (2005) (providing a number of references from the 1970s that the purported "race to laxity" in the US was a major factor influencing harmonization); Claus Luttermann, *Accounting as the Documentary Proof of Good Corporate Gov-*

harmonization agenda early, a requirement for all limited-liability entities to disclose a set of financial statements was introduced as an amendment to First Company Law Directive in 1972.[153] The enactment of substantive accounting standards, which had been on the EC's agenda already longer, followed with the 1978 enactment of the so-called 4th Directive or Accounting Directive.[154] The United Kingdom had joined the Community in 1973 alongside Ireland and Denmark, which made agreement on a number of issues considerably more difficult and ultimately resulted in a greater need to compromise.[155] In 1983 the EC passed the Directive on Consolidated Accounts,[156] which supplemented the Accounting Directive's regime for corporate groups (since the Fourth Directive applies to the accounts of the individual business entity). Only in 2013 the two directives, which had been amended numerous times, were recodified in a single new accounting directive.[157]

At first glance, the two directives in combination seemed to set forth a comprehensive regime of accounting standards. The Fourth Directive provides that limited liability entities,[158] irrespective of whether

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ernance, in GERMAN CORPORATE GOVERNANCE IN INTERNATIONAL AND EUROPEAN CONTEXT 275, 281 (2nd. ed. Jean J. du Plessis et al. 2011) (noting the connection between EC Treaty's freedoms of establishment and freedom of movement of capital on the one hand and accounting harmonization on the other hand).

[153] First Council Directive of 9 March 1968 on co-ordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, with a view to making such safeguards equivalent throughout the Community, 68/151/EEC, OJ L 65/8, March 14, 1968, art. 2(1)(f). Art. 2(1)(f) was introduced by amendment OJ L 73/89, March 27, 1972. The directive has recently been recodified as Directive 2009/101/EC, OJ L 258/11, October 1, 2009.

[154] Fourth Council Directive of 25 July 1978 based on Article 54(3)(g) of the Treaty on the annual accounts of certain types of companies (78/660/EEC), OJ L 222/11, 14.8.1978. Regarding the relationship between the First and Fourth Directive, *see also* VANESSA EDWARDS, EC COMPANY LAW 118 (1999) ("The Fourth Directive has its roots in the discussions leading up to the First Directive…").

[155] *See e.g.* Lisa Evans & Christopher Nobes, *Some mysteries relating to the prudence principle in the Fourth Directive and in German and British law,* 5 EUR. ACCT. REV. 361, 363-365 (1996) (discussing changes to the original, German-inspired draft as a result of UK influence); EDWARDS, *supra* note 154, at 120-121 (discussing UK influence in the 1970s).

[156] Seventh Council Directive of 13 June 1983 based on the Article 54 (3) (g) of the Treaty on consolidated accounts (83/349/EEC), OJ L 193/1,July 18, 1983.

[157] Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC, O.J. L182/19, June 29, 2013. According to its art. 53, the Member States will have to implement the new directive by July 20, 2015.

[158] This includes stock corporations (e.g. the public company in the UK, the *société anonyme* in France, and the *Aktiengesellschaft* in Germany) and limited liability companies (i.e. the private company in the UK, the *société à responsabilité limitée* in France and the *Gesellschaft mit beschränkter Haftung* in Germany). In addition, it applies to partnerships

they are publicly traded or not, have to set up and disclose financial statements (consisting of a balance sheet, a profit and loss account, and the notes).[159] More importantly, and maybe more unusually from a US perspective, the Fourth Directive includes sections on the presentation of financial statements (i.e. on the format of the balance sheet and the income statement),[160] and a plethora of rules for the recognition of assets and liabilities, expenses and revenue, as well as rules on valuations.[161] These rules – at least in their original form – are far less casuistic than IFRS or US-GAAP. For example, art. 35-38 provide valuation rules for fixed assets in general (i.e. at what value they are to be recognized, when they have to written down), and art. 39-42 do the same for current assets.[162] By contrast, IFRS or US GAAP are more strongly case-based and have lengthy standards that apply in specific business contexts, such as real estate, property, plant and equipment, leases, or inventories.[163] The greatest influence on the directives came from the French and German accounting law in place at that time,[164] although the directives added an additional layer of complexity that required all Member States to recodify their accounting laws.[165] British accounting tradition also had a considerable influence, leading e.g. to the inclusion of the "true and fair view" standard originally derived from the Companies Act of 1948.[166] Correspondingly,

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where all unlimited partners are companies of the types just mentioned. Fourth Directive, art. 1(1).

[159] Art. 2(1).

[160] Art. 9, 23.

[161] Art. 31 through 42f.

[162] Art. 42a-42f on the use of fair value for financial assets were only introduced in 2001, when the influence of "Anglo-Saxon" accounting concepts oriented toward the capital market was about to reach its peak, and even then remained largely optional.

[163] One could object that the reason may be that the Directive is only a general framework and still needs to be implemented in the respective member state, where standards on specific business situations can be passed. Indeed, this is what happened in the UK, where the Accounting Standards Board (ASB) issues Financial Reporting Standards (FRS). However, in line with diverging legislative traditions, e.g. the German accounting law largely retains the level of generality of the directives.

[164] EDWARDS, *supra* note 154, at 118-121 (discussing the Elemendorff report of 1966, the first proposal of 1969, and the subsequent of the UK and other new Member States); Brigitte Eierle, *Differential Reporting in Germany – A Historical Analysis,* 15 ACCT., FIN. & BUS. HIST. 279, 290 (2005) (noting strong German influence on the 4th Directive).

[165] Gesetz zur Durchführung der Vierten, Siebenten und Achten Richtlinie des Rates der Europäischen Gemeinschaften zur Koordinierung des Gesellschaftsrechts (Bilanzrichtlinien-Gesetz – BiRiLiG) vom 19. Dezember 1985, BGBl. I S. 2355; *e.g.* Eierle, *id.,* at 289-291 (discussing implementation of the directive in Germany).

[166] Fourth Directive, art. 2(3)-(6). Regarding the historical origin in the Companies Act 1948, *see* Lawrence E. Cunningham, *Semiotics, Hermeneutics, and Cash: An Essay on True and Fair View,* 28 N.C. INT'L J. L. & COM. REG. 893, 904 (2003); *see also* Dieter Ordelheide, *True and fair view: A European and German Perspective,* 2 EUR. ACCT. REV. 81, 82 (1993) ("Great Britain, which argued for bringing the true and fair view principle into Art. 2 of the Fourth Directive"); Jonathan Rickford, *Legal Approaches to Restricting Distributions to Shareholders: Balance Sheet Tests and Solvency Tests,* 7 EUR.

the Seventh Directive included requirements how the companies heading corporate groups need to represent consolidated financial statements, and specific rules on the consolidation process.

The Fourth and Seventh Directives were often criticized for including dozens of options, including some leaving the choice to the respective Member State in the national implementation of the directive, and some leaving the choice to the reporting firm.[167] The large number of options, which were often the result of compromises between different accounting traditions, have often been given as a reason why the EU never achieved true accounting harmonization: Member States were able to maintain their traditional accounting cultures, and financial statements never became truly comparable.[168]

The directives, however, had to be implemented into the Member States' legal systems as formally enacted laws.[169] The content of financial statements were thus more strongly characterized by formal laws in European countries than they ever were in the United States, where – like in the UK – the tradition has been private standard setting.[170] For example, while

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BUS. ORG. L. REV. 135, 147 (2006). This presumably overarching goal of accounting subsequently caused considerable problems for two reasons. Several Member States, including Germany, Austria, Denmark, Sweden and Finland refused to implement art. 2(5), according to which the reporting firm must, "in exceptional cases" depart from specific accounting rules where they would be incompatible with a "true and fair view" (the so-called "overriding principle") *See* David Alexander & Eva Eberhartinger, *The True and Fair View in the European Union,* 18 EUR. ACCT. REV. 571 (2009); Cunningham, *id.*, at 910-911; David Alexander & Eva Jermakowicz, *A True and Fair View of the Principles/Rules Debate,* 42 ABACUS 132, 139 (2006) (reporting that Germany, Austria and Sweden refused to implement the overriding principle). Moreover, in Continental Europe, particularly Germany, traditional goals of accounting such as prudence were considered to predominate true and fair view. *E.g.* Evans & Nobes, *supra* note 155 (discussing discrepancies between different linguistic versions of the directive as a possible reason). The interpretation of the overriding principle in French law has remained rather unclear. C. Com. (France) art. L 123-14 al. 3. *See* CHRISTIAN DE LAUZAINGHEIN, JEAN-LOUIS NAVARRO & DOMINIQUE NECHELIS, DROIT COMPTABLE ¶ 361 (3rd ed. 2004) (noting that after 20 years the notion is still unclear).

167 *E.g.* RICHARD M. BUXBAUM & KLAUS J. HOPT, LEGAL HARMONIZATION AND THE BUSINESS ENTERPRISE 235 (1988); Luca Enriques, *EC Company Law Directives and Regulations: How Trivial are they?* 27 U. PA. J. INT'L ECON. L. 1, 26-27 (2006).

168 *E.g.* Werner F. Ebke, *Accounting, Auditing and Global Capital Markets*, in CORPORATIONS, CAPITAL MARKETS AND THE BUSINESS IN THE LAW: LIBER AMICORUM RICHARD M. BUXBAUM 113, 119-120 (Theodor Baums et al. eds., 2000) (discussing the consequence of different laws and languages in maintaining different accounting cultures). The 2013 recodification of the EU Accounting Directives did not significantly reduce the number of options. *See, e.g.,* Georg Lanfermann, *EU-Rechnungslegungsrichtlinie: Zum Handlungsbedarf des deutschen Gesetzgebers,* 2013 DIE WIRTSCHAFTSPRÜFUNG 849, 849-850.

169 *E.g.* EDWARDS, *supra* note 154, at 119 ("Like France …, Germany regarded accounting regulation as a matter for the statute book rather than for guidelines issued by the accountancy profession, as was the tradition in the United Kingdom").

170 *See* C.W. Nobes, *The Evolution of the Harmonising Provisions of the 1980 and 1981 Companies Acts,* ACCT. & BUS. RES., Winter 1983, at 43, 52 (concluding that the 4th Di-

in Germany recommendations and standards set by the German Institute of Chartered Accountants were and are influential, it had no official mandate, and its pronouncements had no binding legal force. Germany thus did not have a formally recognized standard setting body until 1999, and even the one created then has a very limited scope of tasks relating mainly to the use of IFRS in consolidated accounts in the specific German context.[171] The situation was somewhat different in France. While the French commercial code includes provisions on accounting,[172] a committee was set up under the aegis of the ministry of the economy (and composed of representatives of a large number of interest groups) and had the mandate to amend the General Accounting Plan (*Plan comptable général* or PCG), which effectively provided accounting standards.[173] These standards were, of course, subordinate to the applicable law and had to be promulgated by the ministry of the economy until 2009.[174] Only after a 2007 reform, these were replaced with an independent regulatory agency, which, however, is still subject to considerable government influence.[175]

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rective will lead to revolutionary changes in British accounting "because their inspiration comes from outside the Anglo-Saxon world; the most obvious source being the German *Aktiengesetz* of 1965").

[171] *See* GESETZ ZUR KONTROLLE UND TRANSPARENZ IM UNTERNEHMENSBEREICH (KonTraG), March 3, 1998, BGBl I Nr.24 S. 786, April 30, 1998 (adding § 342 to the German Commercial Code, which permits the Ministry of Justice to recognize a private standard setter). On the activities of the *Deutsches Rechnungslegungs Standards Committee* (the standard setting body). *see* Christian Leuz & Jens Wüstemann, *The Role of Accounting in the German Financial System,* in THE GERMAN FINANCIAL SYSTEM 450, 458-459 (Jan Pieter Krahnen & Reinhard H. Schmidt eds. 2004); Matthias Schmidt, *On the Legitimacy of Accounting Standard Setting by Privately Organised Institutions in Germany and Europe,* 54 SCHMALENBACH BUS. REV. 171, 173 (2002).

[172] CODE DE COMMERCE (FRANCE) art. L. 123-12 to L. 123-28, L. 233-16 to L. 233-28.

[173] *See* Christian Hoarau, *The Reform of the French Standard-Setting System: Its Peculiarities, Limits and Political Context,* 6 ACCT. IN EUR. 127, 129-132 (2009); CHRISTOPHER NOBES & ROBERT PARKER, COMPARATIVE INTERNATIONAL ACCOUNTING 331 (12th ed. 2012). Between 1998 and 2009, the National Accounting Counsil (*Conseil national de la comptabilité* or CNC) and the Accounting Regulation Committee (*Comité de Réglementation Comptable* or CRC) shared the standard-setting role, but their pronouncements had be approved by the ministry of the economy. *See* DE LAUZAINGHEIN ET AL., *supra* note 166, ¶ 24.

[174] *See also* Christian Hoarau, *International accounting harmonization. American hegemony or mutual recognition with benchmarks,* 4 EUR. ACCT. REV. 217, 224 (1995) (discussion state and private-sector influence on accounting standard setting in France).

[175] A 2007 law creating the Accounting Standards Authority (Autorité des normes comptables or ANC) came into force in 2009. Bernard Colasse & Christine Pochet, *De la genèse du nouveau Conseil National de la Comptabilité (2007) : un case d'isomorphisme institutionnel?* 15 COMPTABILITE CONTROLE AUDIT 7 (2009) (arguing that the AMC rather resembles the SEC than FASB); Rouba Chantiri-Chaudemanche & Christine Pochet, *La normalisation comptable : l'expert, le politique et la mondialisation,* in COMPTABILITE, SOCIETE, POLITIQUE. MELANGES EN L'HONNEUR DU PROFESSEUR BERNARD COLASSE 143, 145 (Marc Nikitin & Chrystelle Richard eds. 2012) ; Hoarau, *supra* note 173, at 136-139.

Financial statements had to be set up following the rules according to the accounting law included in the respective Commercial Code.[176] The implementation of the directive led to a considerable growth of the body of accounting *law*.[177] Like the directives, these accounting rules always had a higher level of generality than US GAAP or IAS/IFRS. German accounting law refers to "principles of proper bookkeeping,"[178] which one might – taken literally – understand as a reference to professional opinion and good accounting practice to fill gaps. In practice, these principles have since the 1950s been understood as the set of rules deductively developed from the principles underlying accounting law and codified in it.[179] As Leuz and Wüstemann put it, "accounting principles are considered to be legal rules ('Rechtsnormen') and not professional standards ('Fachnormen')."[180] Consequently, accounting principles have been shaped by similar forces as other laws where the guidance provided by the general legal rules was insufficient. Besides recommendations of the German Institute of Chartered Accountants and the still relatively new "officially recognized" accounting standards committee[181] (whose standards have only been provided with a presumption of compatibility with the principle of proper bookkeeping that was widely considered problematic when it was introduced in 1999[182]), substantive requirements for accounting are therefore in practice often determined by judicial decisions, typically on tax law issues, given the high degree of book-tax conformity.[183] Like in other

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[176] HANDELSGESETZBUCH (HGB) (GERMANY) §§ 238-342e; Loi no 83-353 du 30 avril 1983 (introducing art. L.123-12 to L.123-28 into the CODE DE COMMERCE [FRANCE]).

[177] For France, *see* Hoarau, *supra* note 174, at 224 (stating that there were relatively few legal rules in France before the Accounting Act of 1983, which implemented the directives).

[178] According to HGB § 238(1), "every merchant is obligated to keep books and to show his commercial transactions and to show his net asset position in these *according to the principles of proper bookkeeping´*" (own translation, emphasis added"). Specifically for corporations and other limited liability entities, § 264(2) provides that "the financial statements must provide, *in compliance with the principles of proper bookkeeping,* a view of the company's assets, liabilities, financial position and profit and losses" corresponding to the actual circumstances" (own translation, emphasis added). *See* Ordelheide, *supra* note 166, at 85 (discussing the relationship between German "principles of proper bookkeeping" and the "true and fair view" principle); Alexander & Eberhartinger, *supra* note 166, at 579 (addressing the question whether the "true and fair view" trumps the principles of proper bookkeeping).

[179] Lisa Evans, *Language, translation and the problem of international accounting communication,* 17 ACCT. AUD. & ACCOUNTABILITY J. 210, 227-228 (2003); Leuz & Wüstemann, *supra* note 171, at 456-457; David Alexander, *Legal Certainty, Europeanness and Realpolitik,* 3 ACCT. IN EUR. 65, 71-72 (2006).

[180] Leuz & Wüstemann, *id.* 457.

[181] As noted above in footnote 171, it remains limited to standards for accounting consolidation.

[182] HGB (GERMANY) § 342(2). *See* Schmidt, *supra* note 171, at 180 (discussion problems of the presumption raised under German constitutional law).

[183] *Infra* notes 211-220 and accompanying text.

fields of law, academic (and professional) writing had a certain influence on the practice of legal interpretation.[184]

Thus, in sharp contrast to the US, accounting standards were basically enacted as laws. In both France and Germany, the term "accounting law" (*droit comptable* or *Bilanzrecht*) is often used in reference to the respective legal field. As explained above, that should not be understood to imply that there was no sub-legal standard setting. Nevertheless, accounting was not seen merely as a technical matter best left to the accounting profession, but to a large part as an issue of legislation.[185] Given the legal consequences of accounting standards, a legislature abdicating its rule-making power, as has been the case in the US since the early days of securities law in the 1930s, would have been seen as problematic from a constitutional perspective.[186]

3.1.2. Continental European objectives of accounting

In the United States, there is no doubt about the objective of financial reporting: Financial statements are intended to provide timely, useful, and material information to investors in the capital markets. The disclosure of financial information is required by the Securities Act of 1933 (in the context of the registration statement),[187] and, maybe more importantly, as part of the periodical reporting requirements for publicly traded firms under the Securities Exchange Act of 1934.[188] The administrative competence to pass regulations on accounting – including recognition of balance sheet items and valuation – therefore lies with the SEC, which has passed Regu-

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[184] Generally, German law is often analyzed by academics and leading practitioners in academic writing, specifically so-called "commentaries," which are treatises, are exposing a field of law organized by section. *E.g.* Carl Baudenbacher, *Some Remarks on the Method of Civil Law,* 34 TEX. INT'L L. J. 333, 354-355 (1999). Regarding the significance of academic writing in civil law systems, *see generally* Bruce W. Frier, *Interpreting Codes,* 89 MICH. L. REV. 2201, 2205 (1991); MARTIJN W. HESSELINK, THE NEW EUROPEAN LEGAL CULTURE 14-17 (2001). These tend to be more detailed than American legal treatises, with the better ones providing guidance even on issues that have not yet arisen in court by establishing a scholarly interpretation of the law. Baudenbacher, *id.*Specifically in the context of accounting, *see* Stuart McLeay, Dieter Ordelheide & Steven Young, *Constituent lobbying and its impact on the development of financial reporting regulations: evidence from Germany*, 25 ACCT. ORG. & SOC. 79, 84 (2000); Rolf Uwe Fülbier & Malte Klein, *Financial Accounting and Reporting in Germany: A Case Study on German Accounting Tradition and Experiences with the IFRS Adoption,* http://ssrn.com/abstract=2200805 (2012), at 22-24 (discussing the role of traditional German accounting scholarship).

[185] *E.g.* for France RICHARD ET AL., *supra* note 1, at 428 (stressing the influence of legislation in France compared to the US).

[186] Functionally, US GAAP could also be seen as law, since their violation may lead to civil and criminal penalties. *See* Cunningham, *supra* note 109, at 292, 323-324.

[187] § 230.610a Schedule A [17 CFR 230.610a]; [15 USC 77s] (giving authority to SEC to regulate the information or document specified in Schedule A).

[188] § 13(a), (b) of the Exchange Act [15 USC §78m].

lation S-X[189] and other accounting series releases. However, the SEC has overwhelmingly deferred to private standard setting, and has in fact been explicitly permitted to recognize a standard setting body that conforms to certain legal requirements since Sarbanes-Oxley.[190] In any event, within the framework of US Securities Law, financial reporting has always had only one objective, namely the provision of information to capital markets.

This stands in contrast to the (Continental) European tradition encapsulated in the original accounting directives, under which not only publicly traded firms, but all limited liability entities have to follow the national implementation of the Fourth Directive's accounting rules, and disclose the information to the public by filing it to the commercial register.[191] The directives thus implement a wide-ranging scheme of mandatory disclosure, which was seen as the "price" for limited liability, an idea originating in the UK[192] that met considerable resistance on the Continent.[193] It also connects accounting to the protection of creditors, who are, for private firms, the primary presumed beneficiaries of accounting and manda-

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[189] Accounting Series Release Nr. 12 (1940). Rule 4-01(a)(3) [17 CFR §210.4-01(a)(3)]; Regulation S-X art.13 [17 CFR § 210.13].

[190] Sarbanes-Oxley Act § 108 (inserting § 19(b) into the Securities Act permitting the SEC to recognize a standard setting body that complies with certain criteria).

[191] *See* First Directive, art. 1 and Fourth Directive, art. 1 (list of corporate types to which the Directive applies), First Directive art. 2(f) and Fourth Directive, art. 47 (requiring disclosure of at least a limited set of financial statements for all firms). To be precise, all stock corporations and private limited companies are required to make these disclosures, as well as partnerships whose only personally liable members are such limited liability entities.

[192] *See* Fourth Directive, 2nd recital (suggestion that limited liability companies' "activities frequently extend beyond the frontiers of their national territories and,on the other, they offer no safeguards to third parties beyond the amounts of their net assets"); EDWARDS, *supra* note 154, at 123 n. 41 ("The latter rationale has a familiar ring for lawyers in the UK, where it has long been the accepted view that extensive disclosure is the price for limited liability); Jonathan Rickford, *Fundamentals, Developments and Trends in British Company Law – Some Wider Reflections,* 1 EUR. COMPANY & FIN. L. REV. 391, 408 (2004) (describing publicity as the main protection for creditors and tracing the UK legislative development); *see also* Wolfgang Schön, *Corporate Disclosure in a Competitive Environment – The Quest for a European Framework on Mandatory Disclosure,* 6 J. CORP. L. STUD. 259, 264 (2006) ("Evidently, the First Directive (and this approach has been confirmed in the Fourth Directive […]) dwells upon the hypothesis that "disclosure" has to be regarded as a collateral to "limited liability").

[193] *See e.g.* EDWARDS, *supra* note 154, at 22-23 (discussing German and French resistance to disclosure of accounting information for small firms during the drafting process for the directives). The resistance was particularly fierce in the German *Mittelstand*. Until at least the early 2000s, reportedly about 30% of French SARLs and around 90% of German GmbHs failed to disclose their accounts. Enriques, *supra* note 167, at 14; Armour et al., *supra* note 6, at 125 n.46. The ECJ repeatedly found that sanctions were not strong enough. Daihatsu Deutschland v. Verband deutscher Daihatsu-Händler, Case C-97/96, December 4, 1997; Commission v. Germany, Case C–191/95, September 29, 1998. The court also had to deal with the question whether mandatory disclosure was a violation of fundamental rights. *Axel Springer AG v Zeitungsverlag Niederrhein*, Case C-435/02, September 23, 2004; *see* Schön, *supra* note 192, at 260-262.

tory disclosure.[194] Even a recent reform intended to eliminate bureaucratic burdens for very small business ("micro entities") did not completely eliminate the disclosure requirement.[195]

However, the accounting rules of the Fourth Directive are also linked with the regulation of legal capital under the Second Directive.[196] While this directive has also recently been recodified,[197] its original version passed in 1976 it provides (among others) rules on capital contributions and distributions to shareholders of stock corporations. Distributions to shareholders through dividends, repurchases of shares, or otherwise, are only permitted as far as equity exceeds stated capital.[198] This does not seem too unusual from an American perspective, given that many US cor-

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[194] *See* Armour et al, *id.* at 124-125. In practice, however, it is doubtful whether creditors ever avail themselves of the possibility of inspecting financial statements submitted to the company register: Sophisticated creditors with the capability of using the financial information contained therein (such as banks) will typically have the bargaining power to ask the company to disclose the information voluntarily. *See* Luca Enriques & Martin Gelter, *How the Old World Encountered the New One: Regulatory Competition and Cooperation in European Corporate and Bankruptcy Law,* 81 TUL. L. REV. 577, 610-611 (2007). Moreover, the directives do not say *when* financial information has to be disclosed, which is why deadlines vary widely between Member States. *See* Enriques & Gelter, *id.* at 610 (citing a deadline of 9 months after the balance sheet date for the UK and Austria, seven months for Italy and Spain, and 12 months for Germany).

[195] *See* Directive 2012/6/EU of the European Parliament and the Council of 14 March 2012 amending Council Directive 78/660/EEC on the annual accounts of certain types of companies as regards micro-entities, 2012 O.J. L 81/3, amended art. 1a(2)(e) (exempting entities not meeting two out of three thresholds [balance sheet total of € 350,000, net turnover of € 700,000, 10 employees] from the disclosure requirement "provided that the balance sheet information contained therein is duly filed, in accordance with national law, with at least one competent authority designated by the Member State concerned"). In the new, consolidated Accounting Directive, *supra* note 157), the corresponding section is art. 36(d). "Micro entities" thus still have to file an abbreviated balance sheet, but it may be more difficult for outsiders to inspect it. For example, in Germany "micro entities" instead of filing electronically will be allowed to deposit a simplified balance sheet with the commercial register, which can be looked up on location and will not be accessible over the internet. Karlheinz Küting & Raphael Eichenlaub, *Verabschiedung des MicroBilG – Der vereinfachte Jahresabschluss für Kleinstkapitalgesellschaften,* 2012 DEUTSCHES STEUERRECHT 2615, 2618.

[196] Second Council Directive of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent (77/91/EEC).

[197] Directive 2012/30/EU of the European Parliament and of the Council of 25 October 2012 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 54 of the Treaty on the Functioning of the European Union, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent, 2012 O.J. L 315/74.

[198] Second Directive, art. 15(1)(a) (limiting distributions), art. 19(1)(c) (limiting repurchases).

porate laws still have similar distribution constraints, including Delaware.[199] However, these rules have usually not been taken very seriously in the US, partly because it was not clear under which accounting principles the "surplus" available for distribution was to be computed.[200] Accounting can therefore be manipulated to generate profits if a distribution is desired.[201] In Europe, however, with the Directives' comprehensive system of accounting principles in place, the accounting rules of the Fourth Directive were intended to be the basis of profit distribution as well, even if the Second Directive only applies to public companies (stock corporations) and not to Private Limited Liability Companies.[202] Member States typically applied largely the same principles of legal capital to the latter type of firm. Accounting standards (or more precisely accounting laws) therefore were directly relevant to the amount firms were allowed to distribute, and possibly to the amount shareholders could claim[203]; measuring the proper amount of distributions was therefore a central purpose of accounting[204] and sometimes even thought to be more important than providing accurate information.[205]

In combination, mandatory disclosure for all firms and the capital maintenance objective underlying accounting rules helped to infuse and solidify a greater degree of creditor protection spirit into accounting standards and how they were usually interpreted: Reporting entities were supposed to make sure that they did not show more profits than they had actually made.[206] Thus, under the system of the Fourth Directive, financial accounts had to conform strictly with the historical cost principle in order to avoid distributions to shareholders based on profits that were not real-

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[199] DGCL § 170. The RMBCA did away with these rules, but many States still have them. *See* BAYLESS MANNING & JAMES J. HANKS, JR., LEGAL CAPITAL 182-189 (3rd ed. 1990); James J. Hanks, Jr., *Legal Capital and the Model Business Corporation Act: An Essay for Bayless Manning,* 74 L. & CONT. PROBS. 211 (2011).

[200] The only exception seems to be California, which requires at least publicly traded firms to use GAAP. *Infra* note 350.

[201] ROBERT CHARLES CLARK, CORPORATE LAW 618-623 (1986) (showing how a distributable surplus can be created by writing assets up to "fair value" and other accounting changes).

[202] Second Directive, art. 1.

[203] Schmidt, *supra* note 171, at 176 (discussing minimum dividends).

[204] Leuz & Wüstemann, *supra* note 171, at 459; *see also* Axel Haller, *International Accounting Harmonization,* 4 EUR. ACCT. REV. 235, 236 (1995) (describing the computation of the distributable income as one of the two major purposes of financial accounting in Germany); Eilís Ferran, *The Place for Creditor Protection on the Agenda of Company Law in the European Union,* 3 EUR. COMPANY & FIN. L. REV. 178, 200-201 (2006) (stating that UK companies have been operating on this basis); Ferran, *id.* at 208-209 (describing the interplay between the Second and Fourth Directives).

[205] Schmidt, *supra* note 171, at 176 (describing the secondary importance of this goal).

[206] *E.g.* Rickford, *supra* note 166, at 146-155; Wolfgang Schön, *Balance Sheet Tests or Solvency Tests – or Both?* 7 EUR. BUS. ORG. L. REV. 181, 186-187 (2006) (both discussing the role of accounting in limiting the distribution of "unrealized" gains").

ized.[207] For the same reason, the definition of “assets” that could be capitalized remained relatively narrow.[208] On the credit side of the balance sheet, losses had to be recognized as soon as they arose (e.g. through provisions for future losses and contingent liabilities).[209] Hidden reserves were an element of the creditor protection objective that led to an understanding of accounting law permeated by an asymmetric understanding of the prudence principle.[210]

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[207] Leuz & Wüstemann, *supra* note 171, at 459 (giving the example of long-term construction contracts, from which profits could only be realized after completion); Ferran, *supra* note 204, at 209-210 (describing the “prudent” position of the Fourth Directive). Note that art. 33 of the Fourth Directive always permitted the Member States to allow some degree of revaluation above historical cost under some circumstances, but at the same time required the creation of a non-distributable revaluation reserve in the balance sheet’s equity section. *See* Ferran, *id.,* at 209-210; Rickford, *supra* note 166, at 152. While “replacement valuation” was originally only permitted for “tangible fixed assets with limited useful economic lives and for stocks” (art. 33(1)(a)) and for valuation methods taking inflation into account (art. 33(1)(a)), two directives passed in the early 2000s expanded these possibilities to bring the Fourth Directive more in line with IFRS. Directive 2001/65/EC of the European Parliament and of the Council of 27 September 2001 amending Directives 78/660/EEC, 83/349/EEC and 86/635/EEC as regards the valuation rules for the annual and consolidated accounts of certain types of companies as well as of banks and other financial institutions, 2001 O.J. L 283/28 (“fair value directive” introducing art. 42a-42d on the “fair valuation” of financial instruments); Directive 2003/51/EC of the European Parliament and of the Council of 18 June 2003 amending Directives 78/660/EEC, 83/349/EEC, 86/635/EEC and 91/674/EEC on the annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings, 2003 O.J. L 178/16 (“modernization directive” introducing, among other things, art. 33(1)(c) permitting the “fair valuation” of fixed assets). In the case of “fair valuation” of financial instruments, no revaluation reserve is required. *See* Rickford, *id.* at 156-157.

[208] Bernhard Pellens & Thorsten Sellhorn, *Improving Creditor Protection through IFRS Reporting and Solvency Tests,* in LEGAL CAPITAL IN EUROPE 365, 372 (Marcus Lutter ed. 2006) (comparing the definition of assets under German law and under IFRS); Christian Nowotny, *Taxation, Accounting and Transparency: The Missing Trinity of Corporate Life,* in TAX AND CORPORATE GOVERNANCE 101, 104-105 (Wolfang Schön ed. 2008); *see also* RICHARD ET AL, *supra* note 1, at 260-261, 362 (comparing the French and IASB understanding of assets, the latter being rooted in “neoclassic theory”). Where the directive in its original permitted the capitalization of cost that could be problematic under a narrowly understood asset definition, it prohibited the distribution of the profits resulting from capitalization. *See* Fourth Directive, art. 34(1)(b) (formation cost), art. 37(1) (expenses for research and development).

[209] Leuz & Wüstemann, *supra* note 171, at 459-460, 460 (stating that accounting for liabilities and contingent liabilities can be characterized as more prudent than in the US).

[210] Art. 31(1)(c) of the 4th Directive provides that “valuation must be made on a prudent basis, and in particular: (aa) only profits made at the balance sheet date may be included, (bb) account must be taken of all liabilities arising in the course of the financial year concerned or of a previous one, even if such liabilities become apparent only between the date of the balance sheet and the date on which it is drawn up, (cc) account must be taken of all depreciation, whether the result of the financial year is a loss or a profit.” The prudence principle is asymmetric because profits must already have been “made” at the balance sheet date, whereas liabilities must be taken into account if they “arose” during the balance sheet year. *See also* Karel van Hulle, *Prudence: a principle or an attitude?* 5

The third big difference to the US lies in the role of accounting for taxation. While the Internal Revenue Code provides that "taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books,"[211] the degree of book tax-conformity in the US is actually quite low.[212] The courts have long recognized that the objectives of taxation and financial reporting are too different to allow a close connection.[213] By contrast, book-tax conformity is much stronger in the majority of European countries.[214] In Germany, according to the legal principle of "authoritativeness" (*Maßgeblichkeitsprinzip*), the financial statements of business entities required to draw up financial statements (including corporations and LLCs) drawn up under the Commercial Code also form the basis of taxation.[215] Similarly, in France the tax authorities have traditionally insisted on a "principle of unity," according to which financial statements form the basis also for tax accounting.[216]

This means that e.g. an accounting option that has been used in a certain way for purposes of disclosure under the applicable financial accounting principles applies also under tax purposes, unless mandatory tax law overrides this particular option.[217] Given the financial incentives set

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EUR. ACCT. REV. 375, 376 (1996) (explaining that prudence was introduced "with a view to protecting the interests of creditors"); Schön, *supra* note 206, at 196 (2006) ("the 'asymmetry' between shareholders and creditors leads to a 'conservative' framework of accounting law"); Giovanni E. Colombo, *International Accounting Principles (IAS/IFRS), Share Capital and Net Worth,* 5 EUR. COMPANY L. & FIN. L. REV. 553, 555 (2007) (comparing this approach with the IFRS where "[t]he ban on the inclusion of non-realized capital gains – characteristic of traditional historic cost balance sheets – is not considered any more").

[211] INTERNAL REVENUE CODE § 446(a).

[212] Henry J. Lischer & Peter N. Märkl, *Conformity Between Financial Accounting and Tax Accounting in the United States and Germany,* in WPK-MITTEILUNGEN, SPECIAL ISSUE JUNE 1997, at 91, 97-98 (describing "general nonconformity"); Ebke, *supra* note 168, at 124 (comparing book-tax conformity in the US and Germany); Wolfgang Schön, *The Odd Couple: A Common Future for Financial and Tax Accounting?*.58 TAX L. REV. 111, 119-122 (describing the history of increasing divergence between tax and financial accounting).

[213] *Thor Power Tool Co. v Commissioner*, 439 U.S. 522 (1979) (finding that a corporation's method of accounting of inventories in alignment with GAAP did not meet the "clear reflection of income" standard).

[214] Peter Essers & Ronald Russo, *The Precious Relationship between IAS/IFRS, National Tax Accounting and the CCCTB,* in INFLUENCE OF IAS/IFRS, *supra* note 73, at 29, 33 (listing EU Member States by strength of book-tax conformity).

[215] EINKOMMENSTEUERGESETZ [ESTG] (GERMANY) § 5(1) (requiring "merchants" to use their bookkeeping under the commercial law requirements as the basis of their tax returns). *See* Nowotny, *supra* note 208, at 105 (noting the German theory that the government could be seen as a "dormant partner").

[216] A. Frydlander & D. Pham, *Relationship between accounting and taxation in France,* 4 EUR. ACCT. REV. Supplement 845, 845-846 (1996).

[217] For Germany, *see* Dieter Pfaff & Thomas Schröer, *The relationship between financial and tax accounting in Germany – the authoritativeness and reverse authoritativeness*

by corporate taxes, the practical consequence has usually been the dominance of tax law: Firms use accounting options in order to minimize taxes and therefore had a strong interest not to show excessive profits in their financial statements.[218] Taxation depends on the profits shown by an individual reporting entity, and not the consolidated accounts that also includes profits made by subsidiaries.[219] However, since in principle the same accounting rules applied to both sets of financial statements (with the addition of consolidation rules applicable only to group accounts), accounting standards for both purposes developed largely uniformly, since any legislative change to accounting standards was always also discussed in terms of its tax consequences. Furthermore, empirical evidence up to the 1990s showed that firms typically used accounting options in similar ways both in individual and group accounts, thus creating an indirect link between group accounts (which only serve information purposes) and individual accounts, which also serve tax and capital maintenance purposes. Tax dependence of consolidated accounts only decreased in the 2000s with the introduction of IFRS on the consolidated level.[220]

All in all, these non-disclosure purposes of financial reporting had two consequences relevant to the debate about IFRS. First, the objective of limiting distributions to residual claimants (shareholders and the tax authorities) created incentives for firms to deflate their reported earnings, quite in contrast to the capital-markets driven tendency to inflate earnings that is common in the US and elsewhere today. Arguably, tax goals in particular distracted from the goal of providing a true and fair view.[221] Second, the high degree of book-tax conformity strengthened state involvement in financial accounting, given the legal and fiscal consequences

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principle, 5 EUR. ACCT. REV. supplement 963, 967-969 (1996); for France, *see* DE LAUZAINGHEIN ET AL., *supra* note 173, ¶ 29.

[218] *E.g.* Pfaff & Schröer, *id.* at 970-972. Arguably, directors may even be required to minimize the firm's tax burden under their duty of care, which creates some obvious tension with truthfulness in accounting. Wolfgang Schön, *Tax and Corporate Governance: A Legal Approach,* in TAX AND CORPORATE GOVERNANCE 31, 46-47 (Wolfgang Schön ed. 2008). For France, *see* Frydlander & D. Pham, *supra* note 216, at 856; *see also* Reginald Hansen, *Assessing and Tax Accounting Principles in the German Civil and Commercial Code and the Impact on Tax Compliance,* 7 EUR. J. L. & ECON. 15, 34 (1998) ("This being so led to the consequence, that most commercial balance sheets in the FRG are totally deformed, at least compared with what they should normally be expected to show").

[219] *E.g.* Ebke, *supra* note 168, at 124.

[220] Maria Gee, Axel Haller & Christopher Nobes, *The Influence of Tax on IFRS Consolidated Statements: The Convergence of Germany and the UK*, 7 ACCT. IN EUR. 97, 100-106 (2010) (describing the reduction of "tax pollution" in German consolidated accounts in the 2000s); *but see* Giovanna Gavana, Gabriele Guggiola & Anna Marenzi, *Evolving Connections Between Tax and Financial Reporting in Italy,* 10 ACCT. IN EUR. 43 (2013) (finding that in Italy, where publicly traded firms use IFRS also for entity-level account, book-tax conformity has decreased in recent years, while it has increased in firms that still use Italian GAAP).

[221] DE LAUZAINGHEIN ET AL., *supra* note 173, ¶ 377.

of the numbers computed with the applicable accounting standards.[222] In particular, private standard-setting would have been considered problematic from a constitutional law perspective because of the tax consequences.[223]

3.2. The growth of capital markets and the decline of traditional accounting during the 1990s

IFRS entered the European picture described so far only at a relatively late point in time. IASB's predecessor body, IASC (International Accounting Standards Committee) was founded in 1973 upon the initiative of prominent British accountant with the participation of accountants from Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the UK and the US.[224] While there is no way to prove the participating individuals' true motivation, it is often believed that it was a reaction to the accounting harmonization ambitions of the European Commission, which were seen as a threat to British accounting tradition in the United Kingdom emanating from the Continental European statutory approach.[225] At that point, IASC – as a private, relatively informally constituted association – had no power whatsoever to set accounting standards and acted primarily as a coordinating and consultative body between its members.[226] While in countries following the Anglo-Saxon model, representatives at IASC were generally sent by the respective accounting standard setter, in countries with an accounting *law* model representatives at IFRS generally had no standard setting power at home.[227] Even though IASC's membership cut across the fault lines between different accounting cultures, there is consensus that it followed an Anglo-American approach.[228] The influence of Continental Europe members with little influence on the national standard setting process remained as limited as the influence of IAS on these jurisdictions. As one commentator put it, the IASC at that time began to be seen in Europe as a "Trojan horse which conceals the Anglo-American

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[222] DE LAUZAINGHEIN ET AL., *supra* note 173, ¶ 377 (explaining the strong influence of tax law on the standard setting process in France).
[223] Schmidt, *supra* note 171, at 172, 180.
[224] John Flower, *The future of harmonization: the EU versus the IASC versus the SEC,* 6 EUR. ACCT. REV. 281, 288 (1997); Stephen A. Zeff, *The Evolution of the IASC into the IASB, and the Challenges it Faces,* 87 ACCT. REV. 807, 809 (2012).
[225] Anthony G. Hopwood, *Some reflections on "The harmonization of accounting within the EU',* 3 EUR. ACCT. REV. 241, 243 (1994); *see also* Flower, *supra* note 224, at 288; Zeff*, supra* note 224, at 809-810.
[226] *E.g.* Per Thorell & Geoffrey Whittington, *The harmonization of accounting within the EU,* 3 EUR. ACCT. REV. 215, 223 (1994) (describing the "voluntary nature" of the IASC's standards); Zeff*, supra* note 224, at 810 (members committed to using "their 'best endeavors'" to implement IAS).
[227] Colasse, *supra* note 7, at 78.
[228] Flower, *supra* note 224, at 288-289.

accounting enemy inside a more respectable international façade."[229] French accounting scholar Bernard Colasse goes even further by suggesting that IASC remained true to a "Friedmanian conception of corporate responsibility," which focuses only on the needs of investors, in contrast to Continental European models of corporate governance in which corporations serve broader goals.[230]

While IASC was thus initially a bulwark erected to protect the Anglosphere against an onslaught from a regulatory European accounting model, the tide began to change in the 1990s, which the Anglo-Saxon accounting tradition began to become attractive for at least some large Continental European firms. Capital markets began to grow in Europe, and firms increasingly sought to cross-list in New York or London in order to tap new sources of capital.[231] At the same time, Continental European governments became increasingly interested in shoring up their capital markets to attract international investors. In retrospect, scholars identified a convergence in corporate governance practices in that period, most of all during the late 1990s.[232] Before accounting law could follow, some pioneering firms spearheaded the trend by adopting accounting standards from the English speaking world. In most cases these were initially US

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[229] Flower, *supra* note 224, at 289 (quoting CHRISTOPHER NOBES, A STUDY OF THE INTERNATIONAL ACCOUNTING STANDARDS COMMITTEE 21 (1994)); Haller, *supra* note 204, at 238 ("international harmonization is very much perceived as the introduction of the American accounting model"); Gordon L. Clark, Daniel Mansfield & Adam Tickell, *Emergent Frameworks in Global Finance: Accounting Standards and German Supplementary Pensions,* 77 ECON. GEO. 250, 255 (2001) ("For some, the IASC is an extension of FASB because the IASC is an agent of the SEC, which represents U.S. nation-state interests in extending the geographic reach of U.S. capital markets"); Jane Fuller, *The Continent's Largest Companies are Gearing Up for Change That Should Reduce the Need to Reconcile Accounts to Different Rules. But the Relevance and Reliability of the Measures is Open to Question*, FIN'L TIMES, Nov 23, 2004 ("most of the 7,000 companies concerned do not have securities listed in the US and so are less motivated by convergence. […] Convergence has heightened fears within Europe that this will lead to the import of prescriptive US standards).

[230] Colasse, *supra* note 7, at 80. Even without providing a citation, it is clear that Colasse is referring Milton Friedman, *The Social Responsibility of Business is to Increase its Profits,* N.Y. TIMES MAGAZINE, September 13, 1970.

[231] *E.g.* Flower, *supra* note 224, at 282-286 (discussing the motivation for European firms to tap international capital markets in the 1990s from a contemporary perspective); Fülbier & Klein, *supra* note *184,* at 13-14 (discussing the role of "pioneering" German firms that went on international capital markets); Zeff, *supra* note 224, at 817-818.

[232] *See* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law,* 89 GEO. L. J. 440-443 (2001); from the accounting literature, *see* Yuan Ding, Jacques Richard & Hervé Stolowy, *Towards an understanding of the phases of goodwill accounting in four Western capitalist countries: From stakeholder model to shareholder model,* 33 ACCT. ORG. & SOC. 718 (2008) (arguing that the accounting treatment of goodwill is connected to the respective orientation of capitalism, and suggesting that there has been a trend from stakeholder to shareholder capitalism reflected in accounting); Yuri Biondi, *What do Shareholders Do? Accounting, Ownership and the Theory of the Firm: Implications for Corporate Governance and Reporting,* ACCT. ECON & L., vol 2, iss. 2, art. 5.

GAAP, as in the case of Daimler Benz' 1993 stock issue in New York, and in some cases UK GAAP for firms that sought a listing in London.[233] None of these firms had a legal mandate to "internationalize" their accounting systems, which in those days was often a term used for applying US GAAP. Instead, in addition to setting up entity-level and consolidated accounts under their respective national law, these large firms put together an additional set of financial statements or reconciliation statements applying the standards required in the respective capital market where they sought a listing.[234] The Daimler-Benz case was a watershed for this development, particularly in Germany, since it allowed a direct comparison between German Accounting and US GAAP. While its consolidated financial statements under the German commercial code showed profits of DM 602 Mio., its financial statements under US GAAP actually showed a loss of DM 1,839 Mio.[235] Unsurprisingly, this undermined German confidence in the capability of the traditional accounting law to protect creditors through prudent Financial Accounting.[236] Pressure to internationalize accounting grew, until the German parliament passed a law in 1998 that permitted publicly traded firms to draw up consolidated financial statements under "internationally recognized accounting principles" as long as they were still in accordance with EU accounting directives, instead of applying the rules of the German commercial code.[237] Public firms quickly jumped the bandwagon; in 1999, more than half of German publicly traded firms already used either US GAAP or IAS for their consolidated financial statements.[238] However, as required by the law, they continued to use the standards of the German commercial code for entity-level financial statements, thus maintaining the previous standard for creditor protection and taxation purposes.[239] Concurrently, in 1999 Germany created the legal basis for a private standard setter in the form of a not-for-profit organization, which was charged with the task of setting "principles for the implementation of consolidated financial statements."[240]

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[233] Zeff, *supra* note 224, at 817.
[234] Eierle, *supra* note 164, at 291
[235] Interestingly, its equity leapt from 17,584 million DM to 28,281 million DM. *See* Flower, *supra* note 224, at 285.
[236] *See also* Eierle, *id.* (noting a loss of confidence among international investors).
[237] HGB (Germany) § 292a (1998), as introduced by the GESETZ ZUR VERBESSERUNG DER WETTBEWERBSFÄHIGKEIT DEUTSCHER KONZERNE AN KAPITALMÄRKTEN UND ZUR ERLEICHTERUNG DER AUFNAHME VON GESELLSCHAFTERDARLEHEN (KAPITALAUFNAHME-ERLEICHTERUNGSGESETZ - KAPAEG) [Law on the Improvement of the Competiveness of German Groups in Capital Markets and the Facilitation of Raising Shareholder Loans (Capital Raising Facilitation Act], April 20, 1998, BGBL I S. 707. *See* Eierle, *id.,* at 291-292.
[238] Holger Daske, *Economic Benefits of Adopting IFRS or US-GAAP – Have the Expected Cost of Equity Capital Really Decreased?* 33 J. BUS. FIN. & ACCT. 329, 336 (2006).
[239] Eierle, *supra* note 164, at 291-292.
[240] Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (KonTraG – Law on Control and Transparency in Business), April 27, 1998) BGBl I, S. 786 (introducing,

France first permitted the use of IFRS in consolidated financial statements in 1998.[241] Scholars noted a change in French accounting culture, as financial markets became more important and the function of providing financial information to shareholders began to gain ground.[242] Besides a number of reforms that better aligned French accounting with IFRS, the most conspicuous change has been the evolution of the French standard setter. In the 1990s the CNC still had more than a hundred members, which were supposed to represent various interest groups, including labor.[243] The 1996 reform reduced the number of members in the CNC to 58, the emphasis among whom shifted from representation of interest groups to "technical" competence, which resulted in increasing role for representatives of international accounting firms.[244] The body's newest incarnation, the ANC, has a board of a handful of full-time members[245], among who the large accounting firms and large publicly traded corporations dominate.[246]

Besides Germany, Austria, Belgium, France, and Italy passed laws permitting firms to use IAS.[247] The EU commission acquiesced, as it began to see that the tide was turning against the traditional accounting systems and therefore did not bother to clarify whether laws permitting the use of "internationally recognized financial accounting principles" were compatible with a correct implementation of EU law. Ultimately, the EU solved this untenable situation by passing the IFRS Regulation in 2002,

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among others, a § 342 into the commercial code that permits the Ministry of Justice to recognize a private standard setter for purposes of principles of consolidated accounts). *See* Fülbier & Klein, *supra* note 184, at 19-21 (discussing the role of the German Accounting Standards Board).

[241] Loi no 98-261 du 6 avril 1998 portant réforme de la réglementation comptable et adaptation du régime de la publicité foncière, J.O. no 82 du 7 avril 1998, p. 5384, art. 6 (permitting publicly traded firms to apply "international rules translated into French" instead of national French accounting laws and standards, provided that they also conform to community law). *See also* Hoarau, *supra* note 173, at 133 (noting that this law allowed firms to choose either IAS or US GAAP).

[242] *E.g.* René Ricol, *Vers une normalisation comptable internationale, condition de la transparence de l'information financière,* in LE JUGE ET LE DROIT DE L'ÉCONOMIE. MELANGES EN L'HONNEUR DE PIERRE BEZARD 137, 137 (Marie-Charlotte Piniot, Jean-Pierre Dumas & Paul Le Cannu eds. 2002) (noting that "practice has evolved; the rules most follow").

[243] Hoarau, *supra* note 173, at 129-131; Colasse & Pochet, *supra* note 175, at 10-11.

[244] Colasse & Pochet, *id.*, at 11-12, 30; *see also* Hoarau, *id.,* at 133, 136 (noting that the state no longer had the dominant role).

[245] Hoarau, *id.,* at 136.

[246] Hoarau, *id.,* at 139 (noting the influence of large companies and accounting firms); Colasse & Pochet, *id.*, at 13-14 (noting that, while the leadership of the organization is still appointed by various government bodies, the actual standard-setting committee is dominated by the accounting profession).

[247] Axel Haller, *Financial accounting developments in the European Union: past events and future prospects,* 11 EUR. ACCT. REV. 153, 169 (2002). For the French law passed in April 1998, *see infra* note 241. Of course, in all cases entity-level accounts still had to be drawn up under the respective national law.

which explicitly required firms to use IAS (now IFRS) that had been endorsed by a new EU body for their consolidated accounts, thus reducing the sphere of application of the directives.[248]

The regulation gives EU and EEA Member States the option to require or permit firms to use IFRS also in the entity-level financial statements and also grants the same option to Member States with respect to the entity-level and consolidated accounts of non-listed corporations.[249] The states used this option in a variety of ways:

[248] IAS Regulation, art. 4; *see also* van der Tas & van der Zanden, *supra* note 73, at 8 (noting that the was forced to accept IAS).

[249] IAS Regulation, art. 5.

Country	Entity-level accounts of listed firms	Consolidated accounts of non-listed firms	Entity-level accounts of non-listed firms
Austria	IFRS not permitted	IFRS optional	IFRS not permitted
Belgium	IFRS not permitted	IFRS optional	IFRS not permitted
Bulgaria	IFRS required	IFRS optional for SMEs, required for all others except entities in liquidation and insolvency	IFRS optional for SMEs; required for all others except entities in liquidation and insolvency
Cyprus	IFRS required	IFRS required	IFRS required
Czech Republic	IFRS required	IFRS optional	IFRS not permitted
Denmark	IFRS optional for listed companies which do prepare consolidated accounts; required for listed companies which do not prepare consolidated accounts	IFRS optional	IFRS optional
Estonia	IFRS required	IFRS optional	IFRS optional
Finland	IFRS optional	IFRS optional for companies audited by certified auditors	IFRS optional for companies audited by certified auditors
France	IFRS not permitted	IFRS optional	IFRS not permitted
Germany	IFRS optional, but additional balance sheet under German law required	IFRS optional; required if filed for listing	IFRS optional, but additional balance sheet under German law required
Greece	IFRS required	IFRS optional for companies audited by certified auditors	IFRS optional for companies audited by certified auditors
Hungary	IFRS optional, but additional balance sheet under Hungarian law required	IFRS optional	IFRS optional, but additional balance sheet under Hungarian law required
Iceland	IFRS optional for the years 2005 and 2006; required from 2007	IFRS optional only for medium sized and big companies	IFRS optional only for medium sized and big companies; required for the annual accounts of each subsidiary from 2007 if consolidated groups are permitted to use IAS
Ireland	IFRS optional	IFRS optional	IFRS permitted
Italy	IFRS required	IFRS permitted except for SMEs	IFRS permitted except for SMEs
Latvia	IFRS required	IFRS optional	IFRS not permitted
Liechtenstein	IFRS optional	IFRS optional	IFRS optional
Lithuania	IFRS required	IFRS optional	IFRS optional
Luxemburg	IFRS optional	IFRS optional	IFRS optional

Malta	IFRS required	IFRS required for larger companies deemed significant in the local economy; optional for all others	IFRS required for larger companies deemed significant in the local economy; optional for all others
Netherlands	IFRS optional	IFRS optional	IFRS optional
Norway	IFRS required for listed companies that do not prepare consolidated accounts starting from 2011; optional for others	IFRS optional	IFRS optional
Poland	IFRS optional	IFRS optional for companies filed for admission to public trading, optional for parent company being subsidiary of parent company preparing consolidated accounts in line with IAS	IFRS optional for companies filed for admission to public trading and for companies whose parent company prepares its consolidated accounts in line with IAS
Portugal	IFRS required if the statutory accounts are the only accounts that they published to the market; otherwise optional	IFRS optional	IFRS permitted for companies within the scope of consolidation of an entity who applies IAS/IFRS
Romania	IFRS permitted for purposes of information only	IFRS optional for companies which have obligation to draw up consolidated financial statements	IFRS permitted for purposes of information only.
Slovakia	IFRS permitted	IFRS required	IFRS optional for listed companies
Slovenia	IFRS optional	IFRS optional	IFRS optional
Spain	IFRS not permitted	IFRS required for groups in which there is a listed company; optional for all others	IFRS not permitted
Sweden	IFRS not permitted	IFRS optional	IFRS not permitted
UK	IFRS optional	IFRS optional	IFRS optional

Table 1: Implementation of options under the IAS Regulation in EU and EEA countries (2010)[250]

[250] Source: EU Commission, Implementation of the IAS Regulation (1606/2002) in the EU and EEA, at http://ec.europa.eu/internal_market/accounting/docs/ias/ias-use-of-

Table 1 demonstrates that IFRS are not as ubiquitous in Europe as a casual American observer might think. Several important Member States, including Germany and France, continue to adhere to their respective traditional accounting standards for non-listed firms and the entity-level accounts even of listed firms. The reason is that IFRS, being drawn up only for the purpose of providing information for capital markets, are not considered suitable for calculating distributable profits under the legal capital system[251] or computing the basis of corporate tax.[252] While EU law now permits Member States to use IFRS by giving firms the option to use IFRS in individual accounts, a number of Member States have not decided to do so.

In Germany, for example, after some adjustments the law now permits all firms to use IFRS in their entity-level accounts, but they additionally have to draw up financial statements under the traditional rules for purposes of distribution of profits and taxation (and to submit it to the commercial register).[253] This rule not only fails to provide firms with any cost savings, it basically does not permit them to do anything that they could not have done without the law, since there was clearly never a prohibition against drawing up IFRS statements in addition to the required ones drawn up under German accounting law. Another option would have been to require reconciliation from IFRS to traditional financial statements. Because of the cost of these two options for firms, Italy opted for a third option, namely to require the creation of restricted reserves to prevent unrealized gains (resulting e.g. from write-ups to fair value) from showing up as distributable profits or reserves in the balance sheet.[254] France also does not permit the use of IFRS in entity-level accounts.

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options2010_en.pdf. Special rules and/or exceptions for banks, other credit and financial institutions, investment companies, insurance companies as well as charities are disregarded.

[251] *E.g.* Colombo, *supra* note 210, at 554; Schön, *supra* note 206, at 197; Giovanni Strampelli, *The IAS/IFRS after the crisis: limiting the impact of fair value accounting on companies' capital,* 9 EUR. COMPANY & FIN. L. REV. 1, 7 (2011).

[252] *E.g.* Eve Chiapello & Karim Medjad, *Une privatisation inédite de la norme : le cas de la politique comptable européenne,* 49 SOCIOLOGIE DU TRAVAIL 46, 54 (2007) (pointing out that in the Anglo-Saxon countries, other than in French law, financial and tax accounting are separate).

[253] HGB (GERMANY) § 325(2a) (permitting firms to submit financial statements drawn up under IFRS to the commercial register for purposes of disclosure without eliminating the duty to draw up regular financial statements under the rules of the commercial code); *see, e.g.* Eierle, *supra* note 164, at 295-296; Luttermann, *supra* note 152, at 284-285; *see also* HGB (GERMANY) § 315a(3) (permitting unlisted firms to draw up financial statements under IFRS endorsed by the EU).

[254] Colombo, *supra* note 210, at 556; Strampelli, *supra* note 277, at 19-20; *but see* Schön, *supra* note 206, at 198 (pointing out that in this case "the company will virtually be obliged to draw up a second set of accounts," thus eliminating any cost savings). Note, however, that the Italian legislator chose to permit the offsetting of revaluation reserves with losses, which may result in the permission of distributions when the firm reentered the profit zone earlier than under "traditional" accounting. Strampelli, *id.,* at 25.

The European institutional structure of accounting continues to diverge from the US. Unlike FASB in the US, the IASB has by no means been given a blank check to develop accounting standards for Europe. Both on the national and the EU level, it has sometimes been questioned whether it is permissible for the respective legislature can delegate its core function of law-making to private body that is neither elected nor politically accountable.[255] On the EU level, the IAS Regulation applies the "comitology" technique, under which the Accounting Regulatory Committee (ARC) of the EU level endorses a standard promulgated by the IFRS and recommended by the European Financial Reporting Advisory Group (EFRAG) and the Commission.[256] Unless the European Parliament or Council of the European Union opposes a standard within three months, the Commission adopts a regulation enforcing the standard as a regulation of the European Union and published in the official journal, thus binding firms in the Member States.[257] While critics continue to occasionally voice doubts,[258] at least the constitutional conundrum seems to have been resolved. EFRAG has so far taken its task very seriously, and in some cases refused to "rubber-stamp" new standards proposed by the IFRS because they were, in EFRAG's view, not compatible with the objective of providing a true and fair view to investors.[259]

3.3. Continental criticism of IFRS

In the past years, the IFRS and the Anglo-Saxon accounting tradition they stand for have been subject to increasing criticism in Europe. A French textbook (comparing French and IFRS accounting), for example, criticizes IFRS as "dangerous and obsolete."[260] In the author's view, IASB "pretends to be neutral and independent from any political pressure," while fundamental flaws in their approach to fair value accounting have been exposed.[261] Some have criticized IASB's (as well as FASB's) self-congratulatory use of terms such as "high quality accounting standards." The German comparative law scholar Bernhard Grossfeld, for example,

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[255] *Infra* note 268 and accompanying text.

[256] *E.g.* van der Tas & van der Zanden, *supra* note 73, at 9 (describing the endorsement process).

[257] *See* http://ec.europa.eu/internal_market/accounting/docs/ias/endorsement_process.pdf.

[258] For example, there has been some debate whether IFRS 3, which does not require amortization of goodwill, is compatible with the European "true and fair view" and thus should not have been endorsed. *See* Jens Wüstemann & Sonja Kierzek, *True and Fair View Revisited – A Reply to Alexander and Nobes,* 3 ACCT. IN EUR. 91, 100 (2006).

[259] IAS Regulation, art. 3(3) requires that standards "meet the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management."

[260] RICHARD ET AL., *supra* note 1, at 2.

[261] RICHARD ET AL., *id.,* at 1; *see also* Colasse, *supra* note 7 at 81 (criticizing that IASB developed a rhetoric of competence, independency, and impartiality to enhance its perceived legitimacy).

argues that this kind of language obscures the fact that there is no single measure of quality, and that accounting policy choices (very much like choices of legal policy) inevitably involve value judgments.[262]

A considerable part of the critique seems to be directed against fair value accounting,[263] which is sometimes blamed for exacerbating some effects of the financial crisis: As financial assets are required to be shown at their current market value, they arguably gained value quickly during the period leading up to the financial crisis, thus inflating the amount of assets held by financial institutions, and falling equally quickly after the bust, thus undermining financial institutions' capital base and pushing them out of compliance with regulatory requirements.[264] The critique in the context of accounting is broader. Fair value accounting, as opposed to historical cost accounting, allows profits to be shown that have not been realized yet, which, as discussed above, may allow firms to distribute profits that are not certain yet and might easily be reversed by subsequent losses. This might lead to pressure from shareholders to distribute these (arguably fictional) profits, which in turn might lead to a reduction in liquidity, particularly when fair value arguably renders net assets more volatile. Just before the onset of the financial crisis, a German group of accounting professors and professionals christened "Saarbrücken Initiative against Fair Value" expressed concern that the term fair value is too vague, leaves too much discretion to firms and their auditors, enhances opportunities to manipulate earnings and equity, and thus makes it generally more difficult to analyze financial statements objectively.[265] Similarly, French scholars have criticized that IFRS have deemphasized the principle of prudence in accounting, and thus reduced the protection of creditors compared to the previous national law.[266]

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[262] *E.g.* Bernhard Grossfeld, *Global Accounting: Where Internet Meets Geography,* 48 AM. J. COMP. L. 261, 294-300 (2000) (criticizing FASB's and IASB's use of the term "high quality" accounting standards as "magical words" tantamount to "self-flattery" intended to put down other accounting systems); Yuri Biondi, *The Pure Logic of Accounting: A Critique of the Fair Value Revolution,* ACCT. ECON. & L., vol. 1, iss. 1, art. 7, at 3, 6, 21, 25 (comparing the language used by the Anglo-Saxon accounting standard setters to "Newspeak" in George Orwell's "1984").

[263] *E.g.* Bernard Raffournier, *Les oppositions françaises à l'adoption des IFRS : examen critique et tentative d'explication,* 13 COMPTABILITE – CONTROLE – AUDIT 21, 24-25 (2007) (summarizing French criticism of fair value and defending IFRS).

[264] *E.g.* Christian Laux & Christian Leuz, *The crisis of fair-value accounting: Making sense of the recent debate,* 34 ACCT. ORG. & SOC. 826, 831-832 (2009) (discussing problems of banks with fair value accounting during the financial crisis); Bernard Colasse, *La normalisation comptable face à la crise*, 95 REVUE D'ECONOMIE FINANCIERE 387, 389 (2009).

[265] Hartmut Bieg, Peter Bofinger, Karlheinz Küting, Heinz Kußmaul, Gerd Waschbusch & Claus-Peter Weber, *Die Saarbrücker Initiative gegen den Fair Value,* 61 DER BETRIEB 2549-2552 (2008); *see also* Burlaud & Colasse, *supra* note 73, at 165 (criticizing that fair value is based on internal computations in many areas).

[266] *See* Raffournier, *supra* note 263, at 28-29 (summarizing the criticism and arguing that IFRS are merely ending an abnormal privilege for creditors).

Others have criticized IASB's lack of accountability and political legitimacy, as well as a perceived absence of a transparent process. Even the European parliament, while committing to IASB as a standard setter, has criticized it as lacking "transparency and accountability as a consequence for not being under the control of any democratically elected parliament."[267] Similarly, French scholars have criticized IASB for its lack of political legitimacy and accountability to a government, given that it grew out of a professional organization dominated by accounting firms.[268] Some of the critique in the French literature ties differences between accounting systems to different models of corporate governance: IFRS, based on fair value accounting, are more strongly based on the needs of financial markets because they reflect short-term developments; they are based on the agency theory view of the corporation and the efficient capital markets hypothesis.[269] Thus, in this view IFRS provide a fit for a corporate governance system characterized by small, short-term investors with little to no long-term interaction with the firm.[270] Traditional historical cost accounting standards are said to be, by contrast, more relevant for large, long-term shareholders, creditors, and employees, who are interested in the long-term viability of the firm.[271] The IFRS framework indeed professes to privilege the interests of investors, given that these are the residual risk-bearers of the firm; critics have sometimes argued that it is doubtful that financial investors bear greater risks than, e.g., employees.[272]

Colasse also criticizes the composition of IFRS, whose independence, in his view, "is a myth resulting from the false idea that an organization is independent if its members are."[273] He argues that IASB's members, by and large, went through the same cultural experience and education emphasizing the same vision of economics; moreover, the majority of them are from English-speaking countries, and most of them were socialized in large international accounting firms; hence, a true debate that integrates different views is not possible.[274] As to *due process,* he suggests

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[267] Luttermann, *supra* note 152, at 283 (quoting from a report and a non-legislative resolution of the parliament).
[268] Burlaud & Colasse, *supra* note 73, at 155-156; *see also* Raffournier, *supra* note 263, at 30-33 (summarizing the criticism).
[269] Colasse, *supra* note 264, at 392; Céline Michaïlesco & Véronique Rougés, *Le reporting financier : Enjeux actuels,* in COMPTABILITE, SOCIETE POLITIQUE, *supra* note 175, at 75, 79; *see also* RICHARD ET AL., *supra* note 1, at 363 (suggesting that IFRS are based on neoclassical economic theory) .
[270] Colasse, *id.,* at 392 ("Implicitement, à la suite du FASB, l'IASB adhère à la conception Friedmanienne de la responsabilité de l'entreprise").
[271] RICHARD ET AL., *id.,* at 691-692 (suggesting that IFRS prioritize the interests of shareholders desiring dividend payments); Michaïlesco & Rougés, *id.,* at 92-93 (arguing that IFRS privilege investors, while undermining the relationship with groups interacting with the firm in the long run, such as employees).
[272] Burlaud & Colasse, *supra* note 73, at 161.
[273] Colasse, *supra* note 264, at 393.
[274] Colasse, *id.,* at 394; Burlaud & Colasse, *supra* note 73, at 159.

that only users of financial statements with *financial* interests – but not other stakeholders – can make their voice heard at IASB.[275]

While this criticism originates even before the financial crisis, its advocates certainly tend to argue their view has been vindicated. While IASB has resiliently defended fair value against the post-financial crisis critique, its long-term viability may well depend on the long-term path of European corporate governance systems; if we will indeed see convergence toward shareholder capitalism, IASB is certainly in line with the development. In light of all of this criticism in the apparent ill fit with Continental European financial systems, why did the EU even adopt IFRS? First, there was clearly a growing dissatisfaction with the limited success of the harmonization process and the EU's inability to adopt national accounting standards that would lead to comparable financial statements. Given that the Member States could not agree on a transnational standard setting process within the framework of the EU – which would have required further compromise – it was likely easier to adopt the only existing external international standard, namely IAS/IFRS.[276] Given the pressures from and the then prevailing political enthusiasm for capital markets, the moment for IFRS seemed to have come; arguably, IASC/IASB used financial analysts to create pressure for publicly traded firms apply to IAS/IFRS.[277] Second, the important role (even though it is no longer a one-sided dominance) of the large (now Big 4) accounting firms in IASB may have played a role.[278] While the Big 4 are by no means internally homogenous across borders, complex, international standards whose application requires substantial training favors firms with international networks. The local incarnations of the Big 4 may have seen an opportunity to capture a larger slice of the respective national market.

3.4. The road ahead for Europe

The discussion above has shown that the problems of IFRS in Continental Europe were considerably greater than in the US. However, at least for now, the need for a stronger integration of accounting standards into the legal system in light of their consequences for corporate and tax law seems to have been met. Still, the current situation does not seem entirely satisfactory. Firms applying IFRS still often must have a "dual" accounting system, since they are forced to use IFRS by the IAS Regulation and in-

[275] Colasse, *supra* note 7, at 81; Burlaud & Colasse, *supra* note 73, at 160 (mentioning specifically states, representatives of employees, financial analysts, the majority of small and medium-sized enterprises, and academics, and also noting that third-world countries are underrepresented, as well as that changes to IAS 1 were introduced in spite of the opposition of most commentators during the process).
[276] Chiapello & Medjad, *supra* note 252, at 58-59.
[277] Michaïlesco & Rougés, *supra* note 269, at 85.
[278] *See, e.g.* Colasse, *supra* note 264, at 394; Chiapello & Medjad, *supra* note 252, at 49, 57.

ternational capital markets on the one hand, and often to use national accounting laws by their respective national legislatures on the other hand. Having two sets of accounting standards – even within a single country – undermines the core benefit of accounting standards setting, namely a relatively large degree of comparability of different firms' financial statements. EU accounting harmonization and IFRS in part came about because financial statements were considered to be insufficiently comparable between countries. However, at this point IFRS have undermined comparability between different groups of firms within countries, and possibly also within single corporate groups, namely where consolidated statements are drawn up under IFRS and entity-level statements under national accounting laws.

Europe will have to find a more persuasive solution. Obviously, the IFRS pose certain challenges if the computation of the distributable and taxable amounts of profits is to be retained as a function of financial accounting. With respect to taxation, policy makers may eventually have to decide whether to integrate financial and tax accounting, or whether to separate them completely. Whereas book-tax conformity has a preparation cost advantage for firms, governments are understandably reluctant to delegate the authority to manipulate their corporate tax base to private actors. The EU has been discussing a possible "common consolidated tax base" (without harmonizing rates) for business in recent years. The EU Commission's 2011 proposal seeks to establish autonomous tax accounting rules that "will not interfere with financial accounts."[279] The debate, however, is far from over.[280]

With respect to legal limitations to the distribution of profits, one possible long-term solution could be the abandonment of the capital-based creditor protection system implemented by the 2nd Directive. While legal capital was never taken quite seriously as a creditor protection mechanism in the United States,[281] it also had to take enormous heat in the European literature and policy debate in the early and mid-2000s.[282] Given the heavy criticism, the EU and national governments might eventually abandon the

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[279] Proposal for a Council Directive on a Common Consolidated Tax Base (CCCTB), COM (2011) 121/4, at 5.

[280] For a comprehensive analysis, *see* Essers & Russa, *supra* note 214.

[281] *E.g.* Marcel Kahan, *Legal Capital Rules and the Structure of Company Law: Some Observations on the Differences Between European and U.S. Approaches,* in CAPITAL MARKETS AND COMPANY LAW 145, 146 (Klaus J. Hopt & Eddy Wymeersch eds. 2003) ("To oversimplify, the U.S. rules are lax, while the European rules impose some meaningful constraints").

[282] John Armour, *Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law,* 63 MODERN L. REV. 355 (2000); Luca Enriques & Johnathan R. Macey, *Creditors versus Capital Formation: The Case against the European Legal Capital Rules,* 86 CORNELL L. REV. 1165 (2001); Peter O. Mülbert & Max Birke, *Legal Capital – Is There a Case against the European Legal Capital Rules?* 3 EUR. BUS. ORG. L. REV. 695 (2002); John Armour, *Legal Capital: An Outdated Concept?* 7 EUR. BUS. ORG. L. REV. 5 (2006).

system and replace it with something else, most likely along the lines of the "Solvency Test" proposed in the Rickford report and would thus not rest on accounting.[283] At the moment, however, the debate seems to be stalled. An abandonment of the legal capital system would at least make the problem of how to reconcile prudent, creditor-oriented accounting with capital-market oriented accounting moot.

Another possibility would be to gradually decouple distributions constraints from financial statements. Where profits under IFRS seem "too optimistic" from the creditor protection perspective, firms would have to be required revaluation reserves in their equity showing the amount by which they diverge from "prudent," creditor-protection oriented accounting.[284] Most importantly, firms applying fair value accounting would have to create revaluation reserves for the amount exceeding historical cost (net of depreciation), which would then have to be excluded from distribution to shareholders.[285] The recodified Accounting Directive of 2013 is going in this direction when it allows Member States to revalue assets above historical cost: Firms choosing revaluation must create revaluation reserves that may only be distributed if they represent gains that have been "actually realized."[286] UK law already limited distributions to "realized" profits in the Companies Act of 1985,[287] and Italian law now requires it for firms applying IFRS in the individual accounts.[288] Nevertheless, it is to some extent questionable whether this approach is practical. Given the speed of developments in business life, legislatures (possibly even on the EU level) would have to closely follow the development of the IFRS and ponder where additional distribution constraints are necessary in order to pursue such a strategy consistently.

Finally, it is not yet completely clear whether IFRS should be expanded to non-listed firms, where creditor protection and book-tax conformity are most relevant. The IFRS has launched a project "IFRS for SMEs," whose basic approach it is to by and large apply recognition of the IFRS, but with relaxed provisions on disclosure.[289] However, in light of

[283] Jonathan Rickford, *Reforming Capital. Report of the Interdisciplinary Group on Capital Maintenance* 2004 EUR. BUS. L. REV. 919, 967-982; for a defense of the current regime, *see, e.g.,* David Kershaw, *Involuntary creditors and the case for accounting-based distribution regulation*, 2009 J. BUS. L. 140.

[284] *See also supra* note 207.

[285] Pellens & Sellhorn, *supra* note 208, at 377-379

[286] Accounting Directive of 2013, *supra* note 157, art. 7.

[287] COMPANIES ACT 1985 (UK), s. 263, 264. This has now been superseded by COMPANIES ACT 2006 (UK), s. 830. *See* Schön, *supra* note 206, at 198; Strampelli, *supra* note 251, at 19.

[288] Strampelli, *id.*, at 19-20.

[289] *See* the IFRS Foundation's main "IFRS for SMEs" page at http://go.ifrs.org/SMEsHome and at http://www.ifrs.org/IFRS-for-SMEs/Pages/IFRS-for-SMEs.aspx; *see also* van der Tas & van der Zanden, *supra* note 73, at 21-22.

heavy criticism, it is questionable whether the project will ever receive the endorsement of the EU.[290]

4. Lessons for the US debate

As we have seen, the changes in accounting culture brought about by IFRS in Continental Europe countries were much more radical than a shift from GAAP to IFRS would be in the United States, both of which are firmly established in Anglo-Saxon accounting culture. There are, however, a number of remaining hurdles and implementation issues, which we address in this section. First, we address the question whether the US should require firms to use IFRS, or whether it should give them the option. Do we want a monopoly or competition in the setting of financial reporting standards? Section 4.1.1 analyzes the possibility of mandatory adaption of IFRS for US issuers, while section 4.1.2 looks at the possibility of giving an option to US issuers to adopt IFRS if they desire to do so. Second, we look at the possible institutional integration of IASB into the US legal system. Does it matter how IASB is funded? What will the fate of FASB be in this case? Section 4.2.1 seeks alternative setups for FASB. Section 4.2.2 discusses the controversial issue of funding.

4.1. IFRS or US GAAP?

4.1.1. Should US firms be required to apply IFRS?

As we have seen in section 2.2, the substantive arguments against IFRS per se are rather weak: The criticism relates primarily to their purported principles-orientation, which could also be seen as the strong point of IFRS against the backdrop of accounting scandals. A more rules-based accounting system may to some extent be the consequence of preferences of the US accounting profession for the, whose desire to avoid litigation may have encouraged them to seek liability-minimizing bright-line rules.[291] Given the problems to which bright-lines rules' propensity to encourage circumvention seems to have contributed, IFRS's supposed lack of specification, which arguably makes circumvention more difficult, may well be an advantage. Even if capture by the accounting profession inevi-

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[290] IFRS for SMEs is not endorsed in the EU and there is no plan for such an adoption in a foreseeable future as IFRS for SMEs was assessed to be incompatible with the EU Accounting Directive. *See* EFRAG COMPATIBILITY ANALYSIS: IFRS FOR SMES AND THE EU ACCOUNTING DIRECTIVES consisting of available at http://www.efrag.org/Front/p172-4-272/Compatibility-Analysis-IFRS-for-SMEs-and-the-Council-Directives.aspx; *see* Françoise Flores, EFRAG Chair, *Advice on compatibility of the IFRS for SMEs and the EU Accounting Directives (Letter to European Commission), 28 May 2010, available at* www.efrag.org.

[291] *See supra* notes 87 and 108 with the accompanying text; *see also* Goldschmid, *supra* note 28.

table results in the coalescence of general principles into rules over time,[292] it may at least temporarily be beneficial to "reboot" the system and focus on principles.

The most fundamental argument in favor of IFRS, however, is comparability. In globalizing capital markets, it seems to make little sense for some firms to apply one accounting system while others use another, which will obviously make comparisons by investors and analysts more difficult on the margin. Arguably, if one believes that financial markets should be global, global accounting standards must follow.[293]

Other objections to IFRS in the US, as we have seen, relate to their institutional integration into the US financial system, namely the sheer size of the US economy and problems of delegating a quasi-legislative function to an international body. As to market size, any problems arising from it clearly can only be transitory, as adjustment to IFRS may take time for firms and investors. However, this problem seems to pale in comparison to the Continental European transition to IFRS, which, contrary to popular belief, is far from complete. While it may be difficult to set a new course for a large, inert ship such as the US economy, as we have seen in section 0, the smaller vessels of the Continental European financial systems were to break with the past much more radically and set a completely new course that diverges much more from their previous traditions than that of the IFRS diverges from US GAAP, who developed within the same tradition of investor orientation. If comparability is a virtue, then there seems to be no reason to stick to GAAP.

The SEC is unlikely to rush towards mandatory adoption in part because of the ongoing recession. For all the economic, regulatory, and political difficulties, the real fear seems to be the high first-time adoption costs, which would excessively burden firms in difficult economic times.[294] Many US companies are already concerned about a possible mandatory adoption and have stated that its high costs make such a switch undesirable, at least in the short term.[295]

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[292] Bratton & Cunningham, *supra* note 25, at 1008.
[293] *See supra* note 25.
[294] *E.g.* Mary Schapiro, Speech by SEC Chairman: Statement at SEC Open Meeting – Global Accounting Standards, February 24, 2010; SEC Staff Papers, *supra* note 3 explaining that the transition period will be relatively long and SEC will give enough time – 4 years or so before mandatory adoption. Hans Hoogervorst, *Speech from the Chair of the International Accounting Standards Board*, IFRS Foundation/AICPA Conference, Boston October 2011; Luzi Hail, Christian Leuz & Peter Wysocki, *Global Accounting Convergence and the Potential Adoption of IFRS by the U.S. (Part I): Conceptual Underpinnings and Economic Analysis*, 24 ACCT. HORIZONS 355 (2010); Luzi Hail, Christian Leuz & Peter Wysocki, *Global Accounting Convergence and the Potential Adoption of IFRS by the U.S. (Part II): Political Factors and Future Scenarios for U.S. Accounting Standards*, 24 ACCT. HORIZONS 567 (2010); Cunningham, *supra* note 2 at 2-4, 11-14.
[295] *See* Black et al., *supra* note 28, at 23 ("Many corporations, such as Exxon Mobil and Citigroup, believe the costs of IFRS adoption are too high, potentially higher than any benefit received from the conversion. Other companies such as Walmart, think that im-

Again, this argument does not seem entirely persuasive in light of the European experience. True, the EU "switched" to the IFRS in better economic times, namely the mid-2000s, when enthusiasm for capital markets was still running high. Given the greater distance between the accounting cultures of many European countries from the IFRS. arguably, one would expect the switching cost in the US to be lower. Counterintuitively, an SEC study published in 2008 estimates the switching cost in the United States as likely higher than in comparable European companies, namely between 0.125% to 0.13% of revenue for U.S. issuers compared to 0.05% for EU companies.[296] This translates into a switching cost of $32 million per US issuer.[297] Yet, these numbers are at the very least questionable. For instance, in Canada, where IFRS have been mandatory since 2011, a survey of 146 companies showed that Canadian companies budgeted less than $500,000 in Canadian dollars for the changeover.[298] The SEC roadmap did not explain how these estimates were calculated, while another study, conducted after the SEC report by academics, provides an estimated switching of $420,000 for small firms and $3.24 million for large ones, thus corresponding to almost one tenth of the SEC estimates.[299] Since the publication of the SEC study preceded the actual measurement of switching costs in Canada in 2011, the SEC probably should update, if not completely reassess its estimate. Finally, publicly traded firms in several European countries, notably France and Germany, effectively required to maintain two parallel accounting systems since these jurisdictions were not ready to abandon traditional accounting for purposes of dividend distributions and taxation. US firms would not have this ongoing additional cost since IFRS would simply replace GAAP.

4.1.2. Should US firms be permitted to voluntarily adopt IFRS?

One may, however, argue, that there is no need to require US issuers to apply IFRS, and that one could, at least for the time being, allow IFRS as an alternative to US GAAP. Since 2007, foreign companies cross-listed in the US do not face a "reconciliation to US GAAP" requirement[300] as long

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plementing changes to financial accounting during a depressed economic climate does not seem wise").

[296] Nov 2008 SEC Roadmap *supra* note 3 at 116-117 citing ICAEW, EU IMPLEMENTATION OF IFRS AND THE FAIR VALUE DIRECTIVE: A REPORT FOR THE EUROPEAN COMMISSION, October 2007 available at, http://ec.europa.eu/internal_market/accounting/docs/studies/2007-eu_implementation_of_ifrs.pdf.

[297] *Id*. at 130-131

[298] October 2012 IFRS Foundation Report *supra* note 3, at 18.

[299] Hail et al., *supra* note 40 at 373.

[300] "In a reconciliation, a foreign private issuer that files its financial statements prepared in accordance with a basis of accounting other than U.S. GAAP must identify and quantify the material differences from the requirements of U.S. GAAP and Regulation S-X." SEC, Acceptance from Foreign Private Issuers of Financial Statements Prepared in Ac-

as they are reporting under IFRS.[301] This option for foreign companies has led to a discussion on whether the SEC should allow US companies to report under IFRS if they prefer to do so. If mandatory adoption is politically not feasible, voluntary adoption might be the best alternative. Voluntary adoption is favored, among others, by some multinationals,[302] the American Institute of Certified Public Accountants (AICPA)[303] and the Big Four[304].[305] While the AICPA sees an option for US firms as a way of providing equal treatment to US companies and their competitors, namely foreign companies that report under IFRS, [306] multinationals tend to see it as a cost-saving opportunity. Many of them have non-US subsidiaries reporting under IFRS and seek to avoid a costly conversion to US GAAP for consolidation purposes.[307] At least for those firms, the long term cost savings would likely be larger than the initial costs of adoption.

An option for publicly traded US companies to report under IFRS would permit these firms to engage a cost-benefit analysis before they switch. Firms likely better positioned to make an assessment about which standards are superior from a business perspective. Individual firms will not weigh all social benefits arising from world-wide standardization of accounting standards and increased comparability. Because of these network benefits, financial disclosure is often thought to have a public good

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cordance with International Financial Reporting Standards without Reconciliation to U.S. GAAP, 17 CFR Parts 210, 230, 239 and 249, p.9
http://www.sec.gov/rules/proposed/2007/33-8818.pdf.

[301] A "foreign private issuer" as defined in Rule 3b-4 under the Exchange Act that files on Form 20-F will be eligible to report under IFRS without having to reconcile with the US GAAP.

Foreign issuers based in the EU that are unable to assert compliance with IFRS as issued by IASB only because of the "EU carve-out" for IAS 39 were permitted to reconcile those financial statements to IFRS as issued by the IASB. Also see footnote 13.

[302] *See, e.g.,* Hoogervorst, *supra* note 294 (listing a number of firms, including Ford, Archer-Daniels-Midland, the Bank of New York Mellon, Kellogg, Chrysler and United Continental Holdings); *See* Wall Street Journal, *US Firms Clash over Cost of Implementation of IFRS*, July 7, 2011. Also *see* various speeches from IFRS Foundation/AICPA Conference in Boston, 5-7 October, 2011.

[303] *See* AICPA Press Release, AICPA Recommends SEC Allow Optional Adoption of IFRS by US Public Companies, August 17, 2011. http://www.aicpa.org/press/pressreleases/2011/pages/aicparecommendssecallowoptionaladoptionofifrsbyuspubliccompanies.aspx.

[304] *See* for example, PwC, Point of View - The path forward for international standards in the United States: Considering possible alternatives, October 2011 stating "the SEC should target the beginning of 2015 to allow US companies to optionally adopt international standards."

[305] Financier Worldwide, *supra* note 338 (noting that if IFRS are good enough for foreign issuers trading in the US, they should suffice for US companies as well).

[306] *See* AICPA Press Release, *supra* note 303.

[307] *See, e.g.,* Accountants Give International Rules Short Shift, Wall Street Journal, August 17, 2011. Also see Hoogervorst, *supra* note 294 (noting that "Ford Motor Company sees IFRSs as an important element of its 'One Ford' strategy" and pointing out the advantages of standardization in a multinational firm).

component, which is why firms would not produce the socially optimal amount in the absence of regulation.[308] Surveys reveal that few firms are likely to switch immediately to IFRS, even if they are given the option to do so.[309] If this is indeed the case, allowing the small number of potential first time adopters to switch voluntarily to IFRS might offer exactly the stress test the SEC needs to assess the next steps.[310] The data from voluntary adoption would likely help the SEC to engage in discussions with US issuers whether IFRS should be mandated for all publicly traded companies.

4.1.3. Should there be regulatory competition between standard setters?

A possible choice of two different sets of accounting standards raises the question whether regulatory competition is desirable in this area, or whether one accounting standard setter should have a monopoly, irrespective of the content of accounting standards. There are of course similar debates in many other fields, possibly most prominently – and most closely relevant – in corporate law. To keep it short, proponents of a "race to the bottom" argue that choice between different sets of laws allows firms to select a regime that benefits managers, while shareholders are inadequately protected.[311] Adherents of the "race to the top" school, by contrast,

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[308] *See*, *e.g.*, Harry I. Wolk, James L. Dodd & John J. Rozycki, ACCOUNTING THEORY: CONCEPTUAL ISSUES IN A POLITICAL AND ECONOMIC ENVIRONMENT 107-138 (8th ed. 2012); Richard G. Schroeder, Myrtle W. Clark, Jack M. Cathey, FINANCIAL ACCOUNTING THEORY AND ANALYSIS 139 (11th ed. 2013); John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 723-27 (1984) (especially *see* 725 n.23); Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 791-792 n.76 (1985); Cunningham, *supra* note 2 at 26-28, 63. *See also, supra* note 41.

[309] *See* Marie Loeone, *Ready but Not Eager for IFRS*, CFO.com, November 2, 2010 (quoting a survey among accounting and financial-reporting executives revealing that most companies are ready to move to IFRS but are not likely make a switch until SEC requires them to do so). *See also* PwC, *2011 US GAAP convergence & IFRS survey: How companies are preparing for convergence between US GAAP and IFRS* in which PwC surveyed 1,400 executives.

[310] *See AICPA: Allow US Companies the IFRS Option Now*, Journal of Accountancy, October 6, 2011. http://www.journalofaccountancy.com/Web/20114658.htm?action=print Also *see* David Katz, Investors Defend FASB Role on IFRS, CFO.com, July 8, 2011 (citing a managing director at Morgan Stanley saying he prefers "a gradual adoption of IFRS that hedges against risk of IFRS failure"); *see also* Financier Worldwide*, infra note* 338 (stating that iIt makes sense to level the playing field with foreign private issuers that already have been granted the privilege of using IFRS"); Hoogervorst, *supra* note 294 (arguing that a transitional period would be appropriate for the changeover given the cost).

[311] S*ee e.g.*, Slutz, *supra* note 143; *see* Lucian Bebchuk, Alma Cohen & Allen Ferrell, *Does the Evidence Favor State Competition in Corporate Law?,* 90 CAL. L. REV. 1775 (2002); Lucian Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1440 (1992); William Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 Yale L. J. 663, 705

suggest that firms need to attract investment, which creates an incentive for managers to choose a value-maximizing corporate law.[312] Various intermediate views have developed in the context of the US;[313] the role of Delaware as a quasi-monopolist and its relationship to the federal government have drawn particular attention.[314] And in the European context, scholars have argued that different ownership structures might lead to different outcomes in regulatory competition.[315] Generally, views on where actually regulatory competition leads on the top-bottom continuum depend on what one believes about how well markets work: The more efficient they are, the more likely is a movement to the top; the more they are distorted by information asymmetries, irrational behavior and cognitive distortions on the part of investors, the more likely managers may be able to exploit these disadvantages.

The debate in the accounting literature parallels the one in corporate law. The two competing views are either to "let the market forces determine how much and what kind of information firms should produce" or "to turn to regulation to protect investors, on the grounds that information is such a complex and important commodity that market forces alone would fail."[316]

(1974); Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching,* 150 U. PA. L. REV.1795, 1872 (2002).

[312] Roberta Romano, *Is Regulatory Competition a Problem or Irrelevant for Corporate Governance?,* 21 OXFORD REV. ECON. POL'Y 212, 229 (2005); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2427-2428 (1998); ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW, 14-24 (1993); Robert Daines, *Does Delaware Law Improve Firm Value?,* 62 J. FIN. ECON. 525, 533 (2001); Ralph Winter, *The Race for the Top Revisited: A Comment on Eisenberg*, 89 COLUM. L. REV. 1526, 1529 (1989); Ralph Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEG. STUD. 251, 289-92 & 251-52 (1977).

[313] *See e.g.*, Ray Ball, *Market and Political/Regulatory Perspectives on the Recent Accounting Scandals*, 47 J. Acct Research 277, 317 (2009); William W. Bratton, *Corporate Law's Race to Nowhere in Particular,* 44 U. TORONTO L. J. 401, 419 (1994); Melvin Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1512 (1989).

[314] *See e.g.*, Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 590 & 644-646 (2004); Mark J. Roe, *Delaware and Washington As Corporate Lawmakers*, 34 DEL. J. CORP. L. 1, 32-33 (2009).

[315] *See* Tobias H. Tröger, *Choice of Jurisdiction in European Company Law – Perspectives on European Corporate Governance,* 6 EUR. BUS. ORG. L. REV. 3, 28-29 (2005); Martin Gelter, *The Structure of Regulatory Competition in European Corporate Law,* 5 J. CORP. L. STUD. 247, 273-275 (2005); Hanne Søndergaard Birkmose, *A 'Race to the Bottom' in the EU?* 13 MAASTRICHT J. EUR. & COMP. L. 35, 51-52 (2006); Luca Enriques & Matteo Gatti, *The Uneasy Case for Top-Down Corporate Law Harmonization in the European Union*, 27 U. PA. J. INT'L ECON. L. 939, 950 (2006); Federico M. Mucciarelli, *The Function of Corporate Law and the Effects of Reincorporations in the US and the EU*, 20 TULANE J. INT'L & COMP. LAW 421, 445 (2012) (all discussing the possibility that reincorporations will be driven rather by large shareholders than management in a concentrated ownership system).

[316] WILLIAM R. SCOTT, FINANCIAL ACCOUNTING THEORY (5th ed., 2009) at 15.

The second view is based on the premise that market forces are not well-suited to incentivize firms to produce the optimal amount of information, given that managers and investors have diverging interests and will eventually try to capture standard-setting processes to pursue them,[317] and that information asymmetry that investors face while trading in the market will result in an adverse selection problem.[318] Whether the existence of multiple standard setters is a vice or a virtue is thus a matter of perspective: Proponents of uniform regulation argue that letting standard setters compete would force each of them to lower its standards as to attract firms and their managers away from the other, thus resulting in a race to bottom.[319]

Both in the markets for corporate law and accounting standards, network externalities may play a role:[320] Delaware, by virtue of its developed law and its specialized courts, creates an advantage for firms to incorporate there that is independent from which group its corporate law actually favors. Managers and shareholders, whose interests seem to play the greatest role in the debate, therefore have an additional advantage when choosing Delaware over other states. However, accounting differs in a crucial way from corporate law in that the network effect is not an aspect of norm creation, but their substantive content and the extent of disclosure. An important aspect of it is investors' ability to compare: An individual firm may actually lose because comparability might shed an unfavorable light on it, but on the aggregate, capital market participants will gain. Moreover, financial accounting information is considered a public good (since it can be shared with those who did not "pay for it"), which is why it arguably will be underproduced under purely voluntary market conditions.[321] In some cases, particularly when a firm issues capital, firms may be inclined to overproduce information in order to attract investment;

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317 SCOTT, *supra* note 316 at 466; *see e.g.*, William U. Parfet, *Accounting Subjectivity and Earnings Management: A Preparer Perspective*, 14 ACCT. HORIZONS 481 (2000).

318 *E.g.* Christian Leuz & Peter Wysocki, *Economic Consequences of Financial Reporting and Disclosure Regulation: A Review and Suggestions for Future Research*, WORKING PAPER, UNIVERSITY OF CHICAGO AND MIT SLOAN SCHOOL OF MANAGEMENT 6 (2008).

319 *See e.g.*, Ronald Dye & Shyam Sunder, *Why Not Allow the FASB and IASB Standards to Compete in the U.S.?*, 15 ACCT. HORIZONS 257 (2001) (discussing "arguments for and against introducing competition into the accounting standard-setting process in the US by allowing individual corporations to issue financial reports prepared in accordance with either FASB or IASB rules"); Karmel & Kelly, *supra* note 21 at 950-51 (arguing that "regulatory competition will lead to a race to the bottom and the absence of meaningful standards").

320 Regarding accounting, *see e.g.*, Karthik Ramanna & Ewa Sletten, *supra* note 42.

321 *See supra* notes 41 & 308; Christian Leuz, *Different Approaches to Corporate Reporting*, 40 ACCT. & BUS. RES. 229, 231 (2010); *but see* Christian Leuz & Peter Wysocki, *Economic Consequences of Financial Reporting and Disclosure Regulation: A Review and Suggestions for Future Research*, WORKING PAPER, UNIVERSITY OF CHICAGO AND MIT SLOAN SCHOOL OF MANAGEMENT 16 (2008) (discussing the argument and criticism of it).

however, it is not clear that this argument persists after an IPO.[322] It is therefore often argued that in a purely market-based system, where firms freely decide on the extent of disclosure (when there is no regulation), firms would not disclose the right level of information.[323] A regulatory solution, as opposed to one where firms privately choose the level of disclosure, may also achieves better outcomes and be cheaper, which may be why it is today widespread around the world.[324] Regulation, among other advantages, makes it easier to process the information and compare across firms while eliminating the cost of negotiating disclosures with various parties such as shareholders and creditors.[325]

One could therefore argue with some justification that the very idea of allowing two sets of accounting standards to compete is incompatible with accounting standard setting as such.[326] If there are multiple standard setters, comparability between the financial statements of firms using different standards would likely suffer.[327] Advocates of competition suggest that the latter is necessary for the evolution of accounting standards, while a monopoly of one standard setter would eliminate the possibility of comparing alternative methods in the pursuit of identifying the best ones.[328] In

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[322] Leuz & Wysocki, *id.,* at 17.

[323] Leuz, *supra* note 321, at 231-232.

[324] Leuz, *id.,* at 232.

[325] Leuz, *id.,* at 231.

[326] Pöschke, *supra* note 25, at 65; Cunningham, *supra* note 2, at 4.

[327] Pöschke, *supra* note 25, at 64; Cunningham, *supra* note 2 at 4. *But see*, Hans B. Christensen, Luzi Hail, Christian Leuz, *Mandatory IFRS Reporting and Changes in Enforcement*, 56 J. ACCT & ECON 147 (2013).

[328] *See e.g.*, Shyam Sunder, *Uniform Financial Reporting Standards: Reconsidering the Top-Down Push*, 77 CPA J. 6, 6 (2007) (arguing that a system of supervised competition among multiple sets of standards would allow investors, companies and auditors to choose from a set of competing standards); Shyam Sunder, *IFRS and the Accounting Consensus*, *23* ACCT HORIZONS 101, 101, 105-106, & 109 (2009) (arguing that a monopoly of IFRS will "discourage discovery of better methods of financial reporting and make it difficult if not impossible to conduct comparative studies of the consequences methods of using alternative methods of accounting."); Shyam Sunder, *Adverse Effects of Uniform Written Reporting Standards on Accounting Practice, Education, and Research*, 29 J. ACCT. PUBLIC POLICY 99, 100 (2010), (arguing that "[t]he pursuit of uniform written standards at the expense of social norms diminishes the effectiveness of financial reporting in stewardship and governance, and in keeping the security markets informed"); SCOTT, *supra* note 316 at 503 (arguing that "complete integration of accounting standards will take some time if, indeed, it is desirable at all. In the meantime, some ability of firms to choose between competing sets of accounting standards should not be ruled out"); Jeremy Bertomeu & Edwige Cheynel, *Toward a Positive Theory of Disclosure Regulation: In Search of Institutional Foundations*, 88 THE ACCT REV. 789, 792-793 (2013) (arguing that "competition also disciplines standard-setters to cater to different groups and thus encourages the revelation of information through standard adoptions"); Shyam Sunder, *Regulatory Competition Among Accounting Standards Within and Across International Boundaries*, 21 J. ACCT & PUB. POL'Y 219 (2002); *see* S.P. Kothari, Karthik Ramanna, Douglas J. Skinner, *Implications for GAAP from an Analysis of Positive Research in Accounting*, 50 J. ACCT & ECON 246 (2010) (arguing that "competition between the FASB and the IASB would allow GAAP to better respond to market forces"); Rob-

this view, competition would lead to a race-to-the-top by pushing standard-setters toward the direction of passing better standards and be selected by firms. In fact, a recent study found that "allowing choice between competing standards increases market value over a single uniform standard."[329]

Allowing GAAP and IFRS to compete in the US capital market would therefore require at least two conditions to work. First, investors must be able to assess which accounting standards provide them with the better information. Second, overall market conditions must not make it impossible for two sets of standards to compete on fair terms. Among other things, this means that the choice of accounting standards should not be inherently linked to other institutional factors so that competition on quality is impossible. For example, as discussed above in section 3.2, in the 1990s European firms began to use IAS, but also US GAAP in addition to domestic accounting laws and standards.[330] At that time, firms seeking a listing at European exchanges generally chose IAS, while those traded in New York had to comply with US GAAP.[331] Clearly, the strategic choice of a capital market determined the choice more than the quality of accounting standards. Moreover, since comparability is so essential to financial accounting, there would have to be a significant number of firms for each set of standards to achieve a critical mass. With FASB starting as the market-dominant standard setter, this would clearly not be a problem for GAAP. US firms switching to IFRS would have a comparative frame primarily in the form of foreign firms, which differ from their US competitors in a variety of other ways and may thus not provide the best comparison.

However, arguably, for over a decade the IFRS and US GAAP convergence process has brought those two sets of standards so close to each other that there is no competition on the merits anyway and thus comparison between firms applying either standard is not excessively difficult. Competition between two standard setters would therefore primarily only be about which of the two entities sets the agenda in accounting, and which one follows. Yet, the study on the advantages of competition men-

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erta Romano, *The Need for Competition in International Securities Regulation*, 2 THEORETICAL INQUIRIES L. 387, 391 (2001) (counting the international regulatory organizations associated with securities law as IOSCO (the International Organization of Securities Commissions) and IASC (the International Accounting Standards Committee) [today's IASB] and arguing for greater regulatory competition in international securities regulation).

[329] Bertomeu & Cheynel, *supra* note 328, at 789, 793.

[330] *See* 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, 301-305 (1994); *see also* Eierle, *supra* note 164 (discussing "differential reporting" with different standards within European countries, but also New Zealand, Canada, and Hong Kong).

[331] Eric M. Sherbet, *Bridging the GAAP: Accounting Standards for Foreign SEC Registrants*, 29 INT'L LAW. 875, 875-877 (1995).

tioned above also suggests that these benefits could disappear if competing standard-setters effectively begin to collude by substantively setting the same standards (as FASB and IASB have been doing in their convergence projects).[332]

At present, the SEC is still considering whether permitting voluntary adoption would complicate the process, or whether it would be a welcome experiment. Judging by SEC Staff Papers and Progress Reports, the Commission is currently focusing on the future of the FASB and on how exactly to adopt IFRS. From a practical point of view, it may be better to resolve these issues first. For instance, if the SEC allowed US companies to voluntarily adopt IFRS but then, when making it mandatory for all US publicly traded companies, decided to move forward with some "carve-outs" (*infra* section 4.2.1), this would complicate the process, as the early adaptors would end up having to switch once again, this time to a US version of IFRS. Alternatively, they would be allowed to use IFRS as issued by IASB for the sake of consistency and comparability of their financial statements over the years and forego comparability at the national level. Of course, if the SEC ever decides to adopt IFRS, the ultimate goal should be to adopt them as issued by the IASB, without any carve-outs. For the time being, it may make sense to allow voluntary "early" adoption.

4.2. Changing institutions

4.2.1. The future of FASB if IFRS are adopted in the US

If it is inevitable for the US to fall in line with the rest of the world and adopt IFRS, this raises questions of institutional transition that are to some extent comparable to those encountered in the EU. As we discussed above in section 2, there are some questions how IASB, as a private self-regulatory body on the international level, would be integrated into the US legal system.[333] The more practical question is how to transition from the old to the new status quo on the factual level. It may be problematic to empower an international organization while undercutting a very powerful national one. The SEC has statutory authority to establish financial reporting standards for publicly held companies.[334] With the Sarbanes-Oxley Act of 2002, SEC may recognize "any accounting principles established by a standard setting body" as US GAAP.[335] If the SEC decides to adopt IFRS, IASB will in effect take over the current role of FASB as the stand-

[332] Bertomeu & Cheynel, *supra* note 328, at 808-809.
[333] *See supra* notes 55 to 60 and accompanying text at section 2.2.2.
[334] *See e.g.*, Securities Exchange Act of 1934 §13(b)(1), http://www.sec.gov/about/laws/sea34.pdf; 15 USC 78m(b)(1); SEC, Historical Background of the 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, http://www.sec.gov/news/studies/principlesbasedstand.htm.
[335] 15 U.S.C. § 77s(b).

ard-setting body.[336] Setting aside concerns about delegating power to an international private organization, there has also been some discussion on the future role of FASB.[337]

The SEC has been mapping out the new roles of FASB depending on various possibilities of IFRS adoption and making it clear – via staff papers and press releases – that there will be a need for FASB even after the adoption of IFRS.[338] For instance, in 2011 the then SEC Chair Mary Schapiro expressed her view that FASB would "continue to play a substantive role not only in achieving the promise of high-quality global accounting standards but also — should the Commission decide to move forward with incorporation — in helping to maintain those standards, as well."[339]

In light of the plans published by the SEC so far, it seems likely that it will not directly designate IASB as standard setter. The 2008 Roadmap outlines an "endorsement" mechanism as a possible option that would keep FASB as the "designated standard setter" that would then be expected to incorporate all provisions under the IFRS, and all future changes to the IFRS directly into US GAAP.[340] For example, Pöschke argues that the most reasonable way of incorporating IFRS could be "by using U.S. GAAP as the mechanism of implementation, i.e. by amending and substantially replacing U.S. GAAP."[341] This way, he claims, the risk of having a dual system of IFRS and U.S. GAAP would be eliminated.[342] Most recently, the SEC has been discussing another alternative called "condorsement"[343] (a neologism combining "convergence" and "endorse-

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[336] *See e.g.*, Bratton, *supra* note 57 *,* at 472.

[337] *See e.g.*, *id.* at 495-496; Nov 2008 SEC Roadmap, *supra* note 26, at 9-10, 10 n.31; *SEC Staff Paper, May 26, 2011, supra* note 3 at 2-3, *see* Mary-Jo Kranacher, *FASB Looks to the Future: Standards Setting in the Post-Convergence World*, 81(12) CPA J. 17 (2011).

[338] Until recently, all discussions were focusing on three main alternatives of allowing IFRS use in the US: adoption, conversion and endorsement. *Adoption* is a switch from US GAAP to IFRS, without converging them first while *convergence* is a gradual movement from US GAAP to full or near-IFRS. Finally, *endorsement* is used for the new or amended IFRS before they are formally enacted. *See, e.g.*, http://FinancierWorldwide.com, Talking Point: Accounting Standards in the US – Convergence with IFRS, November 2011; International Accounting Seminars, http://www.iaseminars.com/en/condorsement.html.

[339] SEC Chair Mary L. Schapiro, SEC Speech: Remarks before the Financial Accounting Foundation's 2011 Annual Board of Trustees Dinner, May 24, 2011, http://www.sec.gov/news/speech/2011/spch052411mls.htm.

[340] Nov 2008 SEC Roadmap *supra* note 26.

[341] Pöschke, *supra* note 25, at 58-65; *see* Hail et.al. *supra* note 11.

[342] Pöschke, *id*.

[343] *See* SEC Staff Paper, May 26, 2011, *supra* note 3 for an explanation of condorsement. *Also see* Financier Worldwide, *supra* note 338 (describing 'condersement' as a fourth option first suggested in late 2010 that is now favored by the SEC). *See* Paul A. Beswick*,* Remarks before the 2010 AICPA National Conference on Current SEC and PCAOB Developments, Dec. 6, 2010, http://www.sec.gov/news/speech/2010/spch120610pab.htm.

ment”), which seems to be similar to EU endorsement process except the fact the endorsed standards will be called US GAAP (or part of US GAAP) rather than IFRS. Arguably, the strongest reason for advocating a condorsement approach could be that it would maintain the US GAAP system and thus save on administrative costs.[344] The trouble with this is that altering international standards to suit an individual economy defeats the very purpose of seeking such standards in the first place. Carve-outs would jeopardize precisely the *comparability* of financial statements that was the initial motivation for considering the adoption of a single set of financial reporting standards.[345] Moreover, allowing carve-outs would open the door to pressure from politics or local interest groups.[346]

Moreover, a special US version of IFRS could be seen as indicating a basic lack of commitment to the idea of an international standard in financial reporting and this, given the clout of US financial markets, could damage the whole international harmonization project worldwide.[347] For example, the American Institute of Certified Public Accountants (AICPA) has warned the SEC about the practical challenges that could limit the effectiveness of the proposed methodology in achieving the SEC’s objective.[348]

No matter how the SEC decides to proceed, it is clear that FASB will have to change and take up a fundamentally different role. With IASB becoming the standard-setting body, FASB will serve as a “facilitator” at best. Most strikingly, the AICPA recommends that FASB’s authority should be limited even further. In a comment letter, the AICPA suggests that FASB should focus on publicly traded companies and the incorpora-

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See also Wing Poon, *Incorporating IFRS into the U.S. Financial Reporting System*, 10 J. BUS. & ECON. RES. 303, 307-308, (2012),

[344] *See, e.g.*, Financier Worldwide *supra* note 338, Ehrlich argues that it “would help companies save on non-value added conversion costs. For instance, they wouldn’t have to amend debt covenants to reference IFRS instead of US GAAP.”

[345] This problem has emerged in the EU, where e.g. IAS 39 (which deals with fair value and hedge accounting), was endorsed with a carve-out. *See* Alan D. Jagolinzer & Christopher Armstrong, *The IAS 39 “Carve-Out”: How the European Union Hedged its Exposure to the International Standard on Derivatives and Hedging*, HARVARD BUSINESS SCHOOL CASE NO. A-191 (2005). *See also* Colasse, *supra* note 264, at 388 (noting that French banks were responsible for the EU resistance to IAS 32 and 39). *Id., at* 390 (discussing the amendment to allow firms to stay within Basel II); Colasse, *supra* note 7, at 78, 85-86 (quoting President Chirac).

[346] Naomi S. Soderstrom and Kevin Jialin Sun, *IFRS Adoption and Accounting Quality: A Review,* 16(4) EUR. ACCT. REV. 675 (2007).

[347] *See* PwC, IFRS Perspectives: An Executive Survey, Dec. 2009, http://www.pwc.com/us/en/issues/ifrs-reporting/publications/ifrs-perspectives.jhtml.

[348] *See* AICPA Press Release, AICPA Recommends SEC Allow Optional Adoption of IFRS by US Public Companies, August 17, 2011 [hereinafter AICPA Press Release, August 2011], http://www.aicpa.org/press/pressreleases/2011/pages/aicparecommendssecallowoptionaladoptionofifrsbyuspubliccompanies.aspx. *See also* Goldschmid, *supra* note 28, at 11, for a similar warning.

tion of IFRS in the US, while a separate board should be established to develop GAAP for private companies.[349] While privately held firms in the US are not legally required to comply with GAAP, some do so voluntarily in practice to satisfy their creditors and other stakeholders.[350] However, applying the complex standards of US GAAP created primarily for public companies is often too costly for other private companies, for which these efforts would be futile because the advantages for the ultimate users of their financial statements are minimal.[351] Still, a "duality" of FASB and a new board would create a need for yet another mechanism to ensure coordination and cooperation between the two bodies, since having public and private companies reporting under substantially different standards in the same country would not seem to be beneficial. On the other hand, mandating the use of IFRS by *all* companies would place a heavy burden on pri-

[349] The idea of creating a separate body developing US GAAP for private and small businesses has recently gained traction with the possibility of adopting IFRS for US publicly traded companies. A Blue-Ribbon Panel on Private Company reporting was formed to provide recommendations on the future of standard setting for 28 million private companies and small businesses in the US. The emphasis of this panel was to address how accounting standards could best meet the needs of the users of private company financial statements. *See e.g.* Elaine Henry & Oscar Holzmann, *Costly Compliance with US GAAP: The Private-Company Dilemma*, J. CORP. ACCT. & FIN. 87, 87 (2012); Video: AICPA President and CEO, Barry Melancon, *Private Company Financial Reporting: The Time for Change is Now*, May 23, 2011, at http://www.aicpa.org/News/AICPATV/Pages/home.aspx?bctid=955338624001&Ca=PCFR&Type=VideoCat; Report to the Board of Trustees of the Financial Accounting Foundation, Blue-Ribbon Panel on Standard Setting for Private Companies, Jan. 2011 [hereinafter Blue-Ribbon Panel Report, Jan. 2011], at http://www.aicpa.org/interestareas/frc/accountingfinancialreporting/pcfr/downloadabledocuments/blue_ribbon_panel_report.pdf; Floyd Norris, *Proposal Would Create New Accounting Standard-Setter for Private Companies*, N.Y. TIMES, Oct. 4, 2011.

[350] The only state corporate law requiring the use of GAAP is that of California, but even there is an exemption for firms with less than 100 shareholders. CAL. CORP. C. §§ 114, 1501(3); Blue-Ribbon Panel Report, Jan. 2011, *id*; Robert Tie, *The Case for Private Company GAAP*, 199 J. ACCOUNTANCY 27 (2005); Gary John Previts, A HISTORY OF ACCOUNTANCY IN THE UNITED STATES: THE CULTURAL SIGNIFICANCE OF ACCOUNTING (1998); American Law Institute, Vincent J. Love & John H. Eickemeyer, *Accountants' Liability: Litigation and Issues in the Wake of the Financial Crisis - GAAP v. IFRS; Public v. Private Company Accounting; PCAOB AS and GAAS v. ISA*, ST004 ALI-ABA 251 (2011); Norris, *id*.; *See* FINANCIAL ACCOUNTING FOUNDATION BOARD OF TRUSTEES, ESTABLISHMENT OF THE PRIVATE COMPANY COUNCIL, FINAL REPORT, May 2012, available at www.accountingfoundation.org [hereinafter FAF Final Report]; s*ee* Pöschke, *supra* note 25, at 60 (noting that GAAP, are not "law" in a technical sense except for certain SEC regulations, and that their authority is based only on recognition by the SEC); *see* Armour et al., *supra* note 6, at 124.

[351] FAF Final Report, *id.* at 35; Stuart Moss & Timothy Kolber, *Private Matters, Proposed Council to Improve Standard Setting for Private Companies*,18(28) DELOITTE: HEADS UP 1, 2 (2011), available at http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/AERS/ASC/us_aers_headsup_101011.pdf.

vate and small companies.[352] Alternatively, it seems more practical to create a more efficient subcommittee under FASB to work specifically on financial reporting standards for private companies. In the end, the Financial Accounting Foundation (FAF) Board of Trustees found this approach more effective and established a new body, the Private Company Council (PCC), in May 2012. PCC is intended to improve the process of setting accounting standards for private companies but the proposed changes will be subject to endorsement by the FASB before becoming part of US GAAP.[353]

Finally, a transnational harmonization of accounting standards may have benefits on the level of private firms, which is why the IFRS Foundation has already created a subcommittee to prepare a version of IFRS for SMEs.[354]

4.2.2. Funding the IFRS Foundation from US sources

The funding of the IFRS Foundation, an international private non-governmental organization (NGO), has so far been a big impediment for the adoption of IFRS in the US. The reason is twofold. First, the SEC is already funding a standard setting body, FASB, and has not yet decided about the future of the FASB. If IFRS are adopted, the SEC wil have to decide which institution will received the funds. Second, it is not clear whether the has the power to directly transfer funds to IASB, even if IFRS is adopted for US issuers.[355]

Currently, the SEC funds FASB through an annual levy of accounting support fees from issuers of US securities; however, it is not clear whether these funds could be transferred to an international body

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[352] For example, both IASB and FASB have been shifting toward a fair-value-based accounting approach. Thus, compliance with these financial reporting standards requires companies to report assets and liabilities at fair value rather than historical cost. The fair value standard increases the cost of compliance as it demands periodic valuations of many financial statement items. While having the information according to fair value is important for public company investors, private companies seem to see it as a costly burden without much benefit because, creditors and other users of private company financial statements are interested in cash flow and a company's ability to pay its debts.

[353] *See* FAF Final Report, *supra* note 350, at 10.

[354] *See, e.g.* GRANT THORNTON, WHO SHOULD SET FINANCIAL REPORTING STANDARDS FOR PRIVATE COMPANIES?, 1-3 (2011), at http://www.gt.com/staticfiles/GTCom/Audit/Assurancepublications/PSG_Standards-For-Private-Companies-WP_FINAL.pdf (noting the heated debate about private company financial reporting, and that 73 countries are considering the adoption of IFRS for SMEs) *See* Andy Thrower, *Should it Be a 'Big GAAP' or 'Little GAAP' For Private Companies?*, FINANCIAL EXECUTIVE INTERNATIONAL, March 2010; Bruce Pounder, *The Big Risks of Little GAAP*, CFO.COM, December 2010; Glenn Alan Cheney, *Private Company Standards – New Road or Same Old Path?*, FINANCIAL EXECUTIVE INTERNATIONAL, March 2012.

[355] SEC Final Staff Paper, July 13, 2012, *supra* note 3 at 56.

such as IASB.[356] The Sarbanes-Oxley Act of 2002 requires SEC "to pay for the budget and provide for the expenses of [the] standard setting body, and to provide for an independent, stable source of funding for such body."[357] The annual funding of the FASB is provided only after the SEC annual review of additional sources of revenue and the budgets of the FAF[358] and the FASB as well as the annual review of the FASB's proposed accounting support fee.[359]

Not accepting contributions from the accounting industry is essential in this "review and fund transfer" process of the SEC because independent source of funding is believed to ensure the independence of a standard setting body.[360] Up until Sarbanes-Oxley, FASB and its predecessors heavily relied on contributions from the large accounting firms, which affected at least the outside perception of independence.[361] IASB faces the same issue because the IFRS Foundation relies heavily on contributions from the large accounting firms, which contributed approximately 25% of its 2012 revenue.[362] Needless to say, the SEC is concerned that the adoption of IFRS might take capital markets back to pre-SOX days in terms of the standard setter's financial dependence.[363]

Dependence on large accounting firms looks like a hurdle that could be easily overcome if US funds the IFRS Foundation's budget in proportion to the size of its economy.[364] According to the IFRS Foundation Report, the present US contribution corresponds to less than one third of what it would pay if the amount were proportionately based on GDP.[365] Considering the fact that around 25% of the total seats in the Foundation's governing bodies are held by US individuals (while US contribution accounting only for 8% of national government contributions), this criticism is understandable. The EU currently provides core funding to the Foundation.[366] Given the questionable authority of the SEC to fund an international body,[367] the strong American representation at IASB and the IFRS

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[356] *Id.* at 52-58; October 2012 IFRS Foundation Report, *supra* note 3, at 56, citing 31 U.S.C. § 1341(a)(1)(B) (Antideficiency Act): An officer or employee of the United States Government or of the District of Columbia government may not [..] involve either government in a contract or obligation for the payment of money before an appropriation is made unless authorized by law.

[357] 15 U.S.C. § 7219.

[358] *See supra* note 59.

[359] SEC Final Staff Paper, July 13, 2012, *supra* note 3, at 55.

[360] *Id. See also* Huw Jones, *US Urged to Bridge Accounting Body Cash Gap*, REUTERS, April 11, 2013.

[361] Bratton, *supra* note 55 at 476; Foesbre *et. al*,. *supra* note 56, at 63-64.

[362] SEC Final Staff Paper, July 13, 2012, *supra* note 3, at 57-58 (noting that international accounting firms contributed 26% of the 2011 budget of the IRS Foundation).

[363] *Id.*, at 6 and 58.

[364] October 2012 IFRS Foundation Report, *supra* note 3, at 8, 24-25.

[365] *Id.* (noting that GDP is the primary indicator used by the IFRS Foundation to assess the funding expectations of a country).

[366] *See, e.g.,* Speech by Olivier Guersent at the Conference EFRAG, *supra* note 34, at 5.

[367] *Supra* note 356 and accompanying text.

Foundation may be in jeopardy.[368] The SEC, seeing what is at stake, recently made a $3 million special contribution to support the completion of the convergence project.[369] While this is a clear sign of continued commitment by the SEC,[370] its current strategic plan for the next four years sends mixed signals.[371] The draft plan does not mention IFRS, but cryptically says that the SEC will "consider […]whether a single set of high-quality global accounting standards is achievable."[372]

5. Conclusion

In this article, we have surveyed the debate about the introduction of IFRS in the US and compared it to the one in Europe. Contrary to what a casual outside observer might believe, IFRS have not completely taken over European accounting, even though this set of standards has considerably pushed back traditional national accounting systems during the past decade. Nevertheless, national accounting traditions largely persist in parallel, in part because they are very different from IFRS in content on purpose. The debates about IFRS, which were hotly waged in the years leading up to their mandatory introduction for the consolidated accounts in publicly traded firms, have not ceased and even surged to some extent after the financial crisis. In the US, whose GAAP are firmly within the capital-market-oriented Anglo-Saxon tradition, differences to their younger sibling IFRS are much smaller, which is why hurdles to introduction should be so as well. Nevertheless, the US, which originally pushed IFRS internationally, is still hesitating. While the SEC sidelined the issue, we have

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[368] *See, e.g.,* Speech from Olivier Guersent at the Conference EFRAG, *supra* note 34 (describing the growing frustration in the US given continued hesitance in the US in light its strong influence on the IFRS standard setting process). *See also Parliament to Challenge International Accounting Standards,* EurActiv, May 8, 2013 ("Lawmakers are also annoyed that the US, which retains a strong influence on the IASB, has not itself adopted the IFRS").

[369] FAF News Release, *Financial Accounting Foundation To Provide Up To $3 Million To IFRS Foundation to Aid Completion of Joint IASB Projects*, January 28, 2014, available at www.accountingfoundation.org.

[370] Hoogervorst, *supra* note 19 at 3; *Is SEC On the (IFRS) Road(map) Again? FAF Contributes $3 Million to IFRS Foundation – Update 2*, FEI, Jan 29, 2014, at http://www.financialexecutives.org. *But see* Carlos Johnson & Ken Bishop, *Letter to the FAF from National Association of State Boards of Accountancy regarding FAF Contribution to IFRS Foundation*, Feb 14, 2014 (criticizing and questioning the contribution) available at http://www.accountingfoundation.org/cs/ContentServer?c=Document_C&pagename=Foundation%2FDocument_C%2FFAFDocumentPage&cid=1176163831522.

[371] Draft SEC Strategic Plan for 2014-2018, Feb 3, 2014, available at http://www.sec.gov/about/sec-strategic-plan-2014-2018-draft.pdf.

[372] *Id.*, at 8; *see also SEC's New Strategic Plan Backs Away From IFRS*, WALL ST. J. - CFO J., Feb 4, 2014; Ken Tysiac, *SEC Plans to Consider Whether Global Standards are Achievable*, J. OF ACCT, Feb 3, 2014.

suggested that introducing IFRS, even on the mandatory level, should not pose insurmountable hurdles.

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