Accounting and Convergence in Corporate Governance: Doctrinal or Economic Path Dependence?

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Martin Gelter
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For helpful comments, I thank Afra Afsharipour, Marco Corradi, Aurelio Gurrea-Martínez, Sean Griffith, Zehra Kavame Eroglu, Uriel Procaccia, Richard Squire, Andrew Tuch, Umakanth Varottil, and Cynthia Williams, as well as attendees of a presentation at WU Vienna University of Economics (January 2018), participants of a Fordham 10-10 Workshop (March 2018), of the SASE Annual Meeting at Doshisha University (Kyoto, Japan, June 2018), and of the Research Handbook conference at Fordham Law School (September 2019).

Abstract

Convergence in corporate governance has been debated for more than 20 years. This paper seeks to explain convergence – and the lack thereof – in accounting laws and standards, within the context of this debate. One could argue about whether accounting has undergone international convergence. One the one hand, the two major accounting systems, IFRS and US GAAP, share the same goal of providing timely and useful information to investors. On the other hand, differences between the two sets of standards remain, and the SEC still does not permit domestic issuers to use IFRS. Moreover, while EU publicly-traded firms are required to use IFRS for their consolidated financial statements, many Member States, continue to require or permit the use of domestic accounting standards for private firms and for entity-level accounting.

This paper seeks to explain this persistent divergence with path dependence. Path dependence is often driven by interest groups. However, there is also the possibility of doctrinal path dependence, which can be explained with the difficulty of making fundamental changes given that legal professionals aim for certain and seek to preserve the value of their specialized human capital. A major factor in accounting reform are the interests of accounting professionals, particularly in large international firms (the "Big 4"). Divergence may in part be because the interests of this key constituency differ between the US and Continental European countries. In Europe, the internationalization of accounting has generally been favored by large firms because of the possibility of increasing their market share at the expense of purely domestic firms. This explains the compromise implemented in the Member state options of the IFRS Regulation. By contrast, the US already had a fully developed set of accounting standards focused on capital markets when IFRS became an option, which means there were no rents to capture for large firms as a result of changes in the audit market. In addition, a key feature of US corporate governance distinguishes it from other systems, including the UK, namely the prevalence of investor litigation. Consequently, a rules-based system serves the interest of the accounting profession better than the arguably more standards-based IFRS.

Keywords: IFRS, IASB, GAAP, SEC, international accounting, EU Company Law Directives, comparative corporate governance

JEL Classifications: K22, M41

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Contents

1. Introduction

Convergence in corporate governance has been debated for the past 20 years, particularly in the legal and the law and economics literature. Broadly speaking, proponents argue that laws and practices in corporate governance have been converging to a single standard that emphasizes the interests of shareholders, including outside investors (as opposed to prioritizing, for example, employees, other stakeholders, controlling shareholders, or the "public interest"). In their famous polemic "The End of History for Corporate Law", Hansmann and Kraakman suggested that the end point for convergence was efficiency.[1] In this view, more open markets and increased competition have forced firms and legislators to converge to the efficient best practice of shareholder primacy in corporate governance. This chapter seeks to explain convergence – and the lack thereof – in accounting standards and laws, within the context of the debate in comparative

[1] Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L. J. 440, 450-53 (2001).

corporate law, focusing mainly on the continuing divergence between US GAAP (Generally Accepted Accounting Principles) and IFRS (International Financial Reporting Standards).

One can plausibly argue that accounting has undergone international convergence, but the contrary view is equally tenable. On the one hand, at least on a superficial level, the objective of the dominant accounting standards – i.e., both IFRS and US GAAP – is to provide timely and useful information to investors in capital markets. On the other hand, in spite of the convergence project formerly pursued by FASB (Financial Accounting Standard Board), which is primarily responsible for developing GAAP, and IASB (International Accounting Standards Board), which promulgates IFRS, differences between the two sets of standards remain (and may reduce comparability of financial statements).[2] While the SEC has permitted foreign private issuers to use IFRS since 2008,[3] it still requires domestic issuers to use GAAP. Moreover, while publicly traded firms in the EU are required to use IFRS for their consolidated financial statements under the IFRS (or IAS) Regulation,[4] many countries, including some of the major Member States, persist in requiring or permitting the use of traditional domestic accounting standards for private firms, and/or for entity-level accounting.[5]

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[2] The "convergence project" between FASB and IASB began with the 2002 Norwalk Agreement and came to an end in 2014 with the declaration that the two standard setters would continue to differ on lease accounting. *See* Robert H. Herz & Kimberley R. Petrone, *International Convergence of Accounting Standards – Perspectives from the FASB on Challenges and Opportunities*, 25 NW. J. INT'L L. & BUS. 631, 642-43 (2005); Zehra G. Kavame Eroglu, *The Political Economy of International Standard Setting in Financial Reporting: How the United States Led the Adoption of IFRS Across the World*, 37 NW. J. INT'L L. & BUS. 459, 496-97, 512 (2017).

[3] Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards Without Reconciliation to U.S. GAAP, 73 Fed. Reg. 986 (Jan. 4, 2008) (codified in 17 CFR § 230.701(e)(4)). *See also* Roberta S. Karmel, *The EU Challenge to the SEC,* 31 FORDHAM INT'L L.J. 1692, 1704-05 (2008).

[4] Regulation (EC) 1606/2002 of 19 July 2002, 2002 O.J. (L 243) 1 [hereinafter IAS Regulation].

[5] *Infra* note 93 and accompanying text.

Path dependence is often an explanation why corporate governance systems continue to diverge, or why they converge only superficially. It is often thought to be driven by vested interests.[6] Coordinated interest groups such as controlling shareholders or unions might resist efficient corporate governance reform to preserve their own rents. However, path dependence can also be driven by transition costs inherent in the legal system. Transitioning to a possibly more efficient system may entail a transition cost, not just resulting from writing new rules, but also from learning by legal intermediaries such as lawyers, who may have to familiarize themselves with new laws. Legal professionals may resist change to avoid losing the competitive advantage from their human capital investment.

This chapter suggests that the accounting industry is an important interest group that helps to explain patterns in the adoption of accounting standards. While in Continental Europe, the internationalization of accounting has benefited large international firms such as the Big 4[7], in the US, the accounting industry would not have been served well by the adoption of IFRS. Unlike most other jurisdictions, including the UK, corporate governance in the US is characterized by a strong prevalence of investor litigation. A rules-based system, as opposed to introducing the arguably more principles-based IFRS,[8] may help to reduce the cost of liability for accounting

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[6] *E.g.*, Lucian Arye Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127, 142-53 (1999).

[7] The "Big 4" are the largest accounting firms that audit most publicly traded firms. *See* Hannah L. Buxbaum, *The Viability of Enterprise Jurisdiction: A Case Study of the Big Four Accounting Firms*, 48 U.C. DAVIS L. REV. 1769, 1791-801 (2015).

[8] On the US debate on IFRS, *see generally* Peter White, *It's Greek to Me: The Case for Creating an International Agency to Enforce International Accounting Standards to Promote Harmonization and International Business Transactions*, 27 WIS. INT'L L.J. 195 (2009). On the parallel rules-standards debate in legal theory, *see* Louis Kaplow, *Rules versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992).

firms. While we cannot clearly say that lobbying by accounting firms shaped patterns of adoption of IFRS, the emerging patterns benefit the strongest interest groups.

This chapter proceeds as follows. Section 2 surveys convergence debates in corporate law and governance, as well as factors hindering convergence, and situates accounting within them. Section 3 discusses two cases – the US and Continental Europe – where different positions of key forces within the accounting industry lead to different outcomes for convergence. Section 4 summarizes and concludes, suggesting that divergent interests of the industry can help to explain why accounting standards have not converged.

2. Convergence, Path Dependence, and Accounting

2.1. Convergence and the transplant phenomenon

"Convergence" in corporate governance refers to the idea that corporate and securities laws across countries are evolving toward a single model — namely one favoring the interest of shareholders, including outside investors — over those of other groups. Advocates of convergence expected the shareholder model to displace other, presumably less efficient models over time, including managerialist, employee-oriented, state-oriented and stakeholder models of corporate governance: With international competition in product and financial markets, efficient firms will outcompete less efficient ones, and laws will eventually adjust to the pressure.[9]

[9] Hansmann & Kraakman, *supra* note 1, at 450-51; *see also* Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063 (2001) (suggesting that divergences from shareholder primacy are more sustainable in smaller, closed economies).

As an actual phenomenon and a subject of scholarly interest, convergence emerged mainly during the late 1990s and early 2000s.[10] In Asia and the developing world, corporate governance reforms were spearheaded by organizations such as the World Bank, the OECD, and the G-20.[11] In Continental Europe, besides a number of corporate law reforms,[12] the best example may be the spread of the concept of corporate governance throughout the region during the late 1990s, as well as the subsequent proliferation of "corporate governance codes" inspired by the UK model.[13] The 2000s also saw the reinvigoration of EU Company Law harmonization, which had reached an impasse during the "eurosclerotic" period of the 1990s.[14] The EU Commission's 1999 Financial Services Action Plan and 2003 Company Action Plan laid the groundwork for a period of vigorous lawmaking, of which the Takeover Directive of 2004[15] and the (original) Shareholder Rights Directive of 2007 are prime consequences.[16] Changes in Germany's corporate governance system

[10] *See, e.g.* JEFFREY N. GORDON & MARK J. ROE, CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE (2004).

[11] Jeffrey N. Gordon, *Convergence and Persistence in Corporate Governance*, *in* OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 28, 30 (Jeffrey N. Gordon & Georg Ringe eds. 2018).

[12] *See, e.g.*, Mariana Pargendler, *State Ownership and Corporate Governance*, 80 FORDHAM L. REV. 2917, 2952 (2012); PIERRE-YVES GOMEZ & HARRY KORINE, ENTREPRENEURS AND DEMOCRACY 192 (2008); Ben Clift, *French Corporate Governance in the New Global Economy: Mechanisms of Change and Hybridisation within Models of Capitalism*, 55 POL. STUD. 546, 553–57 (2007); Luca Enriques & Paolo Volpin, *Corporate Governance Reforms in Continental Europe*, 21 J. ECON. PERSP. 117, 127–37 (2007).

[13] *See, e.g.*, Ruth V. Aguilera & Alvaro Cuervo-Cazurra, *Codes of Good Governance*, 17 CORP. GOV. 376, 377-79 (2009) (describing the spread of codes from their English origins).

[14] *See* Martin Gelter, *EU company law harmonization between convergence and varieties of capitalism*, in RESEARCH HANDBOOK ON THE HISTORY OF CORPORATE AND COMPANY LAW 323, 338-42 (Harwell Wells ed., 2018).

[15] Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids, 2004 O.J. L 142/12. Arguably, the CJEU's case law on "Golden Shares" was a major motivating factor reinvigorating the Takeover Directive. *See* Klaus J. Hopt, *Takeover regulation in Europe — The battle for the 13th directive on takeovers*, 15 AUSTL. J. CORP. L. 1, 14 (2002).

[16] Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies, 2007 O.J. (L 184) 17, revised by Directive 2017/828/EU of 17 May 2017, 2017 O.J. (L 132) 1.

and the withdrawal of German banks from significant share ownership, which has often been identified as a change in the structure of "Germany, Inc." from the late 1990s onwards,[17] provide an extralegal example of a corporate governance change.

However, corporate governance systems will often converge only formally, or superficially.[18] The "legal transplant" effect may be one reason:[19] a rule may be adopted superficially, but operate quite differently within the context of a different legal system.[20] This phenomenon applies even more strongly in the context of supranational harmonization. EU Directives – including those governing accounting[21] – often exhibit gaps, member state options and compromises to accommodate interest groups across national borders, thus reducing their harmonizing effects.[22] Likewise, the adoption of an international or foreign accounting system, such as IFRS or US GAAP, constitutes a form of legal transplant.[23] Empirical evidence suggests that national accounting practices continue to affect the application of IFRS after they have been formally implemented.[24]

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[17] *E.g.*, Wolf-Georg Ringe, *Changing Law and Ownership Patterns in Germany: Corporate Governance and the Erosion of Deutschland AG*, 63 AM. J. COMP. L. 493, 518–19 (2015).

[18] *E.g.*, Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function,* 49 AM. J. COMP. L. 329 (2001); Martin Gelter & Geneviève Helleringer, *Opportunity Makes a Thief: Corporate Opportunities as Legal Transplant and Convergence in Corporate Law,* 18 BERKELEY BUS. L.J. 92, 102 (2018).

[19] *See generally* ALAN WATSON, LEGAL TRANSPLANTS: AN APPROACH TO COMPARATIVE LAW 21 (1974).

[20] Hideki Kanda & Curtis Milhaupt, *Re-examining Legal Transplants: The Director's Fiduciary Duty in Japanese Corporate Law*, 51 AM. J. COMP. L. 887, 889-91 (2003).

[21] *Infra* notes 77-76 and accompanying text.

[22] *See* RICHARD M. BUXBAUM & KLAUS J. HOPT, LEGAL HARMONIZATION AND THE BUSINESS ENTERPRISE 235 (1988); Luca Enriques, *EU Company Law Directives and Regulations: How Trivial are They?* 27 U. PA. J. INT'L ECON. L. 1, 23-33 (2006).

[23] *E.g.*, Loukas Panetsos, *Accounting Standards and Legal Capital in EU Law,* 12 UTRECHT L. REV. 139, 144 (2016).

[24] *E.g.*, 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, 360, 366

2.2. Economic and doctrinal path dependence

Convergence theory posits that market forces reward efficient economies and legal systems and push them towards adopting efficient rules. However, often there is no single rule that is optimal across countries. Desirability of a law – even when defined in efficiency terms – depends on its legal, cultural and economic context.[25] In the short and medium term, diversity in legal rules will therefore dominate the global competition for convergence. In other contexts, a corporate governance system could create greater wealth if it adjusted to a specific set of rules, such as a set of accounting standards that provides the most useful disclosures for investors. In open financial markets, firms subject to the best set of rules should be more successful in attracting investment.[26]

In the presence of path dependence, a jurisdiction will be locked into a certain set of rules because it embarked on a path in the past from which it is difficult to deviate. Even if change would be economically efficient in principle, switching could be prohibitively costly. A jurisdiction may be at a local optimum that can be reached without incurring a prohibitive cost, but it will not move to the global optimum because the cost would fall heavily on one interest group that has the political power to block change.

(2010); Erlend Kvaal & Christopher Nobes, *IFRS Policy Changes and the Continuation of National Patterns of IFRS Practice*, 21 EUR. ACCT. REV. 343 (2012); Isabel Costa Lourenco, Raquel Sarquis, Manuel Castelo Branco & Claudio Pais, *Extending the Classification of European Countries by their IFRS Practices: A Research Note*, 12 ACCT. IN EUR. 223, 223-24 (2015); *see also* Mark T. Bradshaw & Gregory S. Miller, *Will Harmonizing Accounting Standards Really Harmonize Accounting? Evidence from Non-U.S. Firms Adopting U.S. GAAP*, 23 J. ACCT. AUD. & FIN. 233 (2008).

[25] *E.g.*, Curtis J. Milhaupt, *Property Rights in Firms*, 84 VAND. L. REV. 1145, 1189–90 (1998); on culture as a driver of path dependence in accounting *see* Amir N. Licht, *The Mother of All Path Dependencies: Toward a Cross-Cultural Theory of Corporate Governance Systems*, 26 DEL. J. CORP. L. 147, 180 (2001).

[26] Bebchuk & Roe, *supra* note 6, at 169. *See also* Ronald Dye & Shyam Sunder, *Why Not Allow FASB and IASB Standards to Compete in the U.S.?*, 15 ACCT. HORIZONS 257, 257 (2001) (discussing the introduction of "introducing competition into the accounting standard-setting process" by allowing firms to choose between US GAAP and IFRS).

Conceptually, one could distinguish between *economic* and *doctrinal* path dependence. Scholars often suggest that path dependence persists because of economic interests of key pressure groups. Past institutional choices have created interest groups whose members enjoy advantages from the present system. Such interest groups will lobby against changes that eliminate rents they draw from the current institutional arrangement. Powerful controlling shareholders may effectively oppose broader disclosure and approval requirements for related-party transactions. Families dominating the largest firms in a medium-size country may constitute a well-organized interest group that can easily convert their intra-firm power into political influence undercutting beneficial reform to protect their rents.[27]

However, sometimes path dependence seems to arise simply because a past choice, which has tied up significant institutional capital, makes it hard to construct a new, more efficient path.[28] Doctrinal pathways that solidify over decades (or centuries) frequently depend on the happenstance of a specific court decision or legislative choice that was reasonable at the time, but may be suboptimal today. Legal doctrine self-perpetuates. Eva Micheler points out that "[l]egal system[s] have a certain limited set of doctrinal tools which they apply whenever a new challenge for the law appears." While market participants may be willing to take risks, they put a premium on legal certainty. Lawyers therefore proceed on trodden paths. Likewise, legislators and judges that need to address new problems "apply existing legal concepts to accommodate new developments rather than adopt new solutions that may create more efficient, but less well-tested,

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[27] *E.g.*, Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641, 651-652 (1996).

[28] *See* Simon Deakin, *Evolution for our Time: A Theory of Legal Memetics,* 55 CUR. LEG. PROBS. 1, 11 (2002).

results."[29] Doctrinal path dependence thus refers to the constraints on legal developments because of past choices within a particular legal system. After employing a framework of rules for a long time, these rules are hard to change, e.g., because of doctrinal structures to which the current generation of lawyers has become very used, because of *stare decisis*, or because new legislation would have to amend large bodies of law, which could have unforeseeable ripple effects and undermine legal certainty.

However, doctrinal path dependence may just be a specific type of economic path dependence. Not only are legal professionals creatures of habit, but they also have human capital specialized in the current rules. Most obviously, they will generally oppose the abolition of requirements that give them a source of income. Attorneys will support the requirement of legal representation at trial; civil law notaries will support rules that require notarial deeds for certain transactions; similarly, public accountants will want to uphold mandatory audit obligations.

But legal professionals' human capital can also be destroyed through obsolescence. The German jurist Julius von Kirchmann famously wrote in 1848 that "three correcting words of the legislature, and entire libraries become useless."[30] An incumbent generation of professionals with considerable knowledge has a competitive advantage over newcomers and has more at stake in the maintenance of a particular legal structure or system. A fundamental reform that does not organically grow out of the existing law would eliminate this advantage, making their past investment obsolete by equivalizing their position in the market with newcomers. They will

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[29] Eva Micheler, *English and German securities law: a thesis in doctrinal path dependence*, 123 L.Q. REV. 251, 254 (2007).

[30] JULIUS VON KIRCHMANN, DIE WERTHLOSIGKEIT DER JURISPRUDENZ ALS WISSENSCHAFT 23 (1848).

therefore often oppose change to a more efficient system on plausible, but ultimately dubious grounds, such as when the proposed reform would provide a bad match relative to other aspects of the law or reduce coherence within the system.

Moreover, lawyers may have incentives to obfuscate a body of rules, thus creating a high startup cost for potential competitors. For example, Delaware corporate law has been described as "surprisingly indeterminate."[31] One possibility is that "[a] lack of clarity requires more litigation – benefiting Delaware lawyers and courts – and makes Delaware's body of law more difficult to copy."[32] To the extent that Delaware obtains economic rents, captured by its bar (and judiciary) from maintaining its preeminent position in US corporate law, this state of affairs could be described as an example of doctrinal path dependence.

2.3. Applying path dependence theory to accounting

Financial reporting requirements obviously benefit the accounting profession to a certain extent. All countries mandate that publicly traded firms disclose audited financial statements,[33] which clearly benefits the firms that will audit them. Some jurisdictions, notably the EU members as well as the UK, require that all limited liability business entities must deposit at least some (not

[31] Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1071 (2000).

[32] Brian J. Broughman & Darian M. Ibrahim, *Delaware's Familiarity*, 52 SAN DIEGO L. REV. 304 (2015); *see also* Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law,* 65 TEX. L. REV. 469, 504-05 (1987).

[33] *E.g.*, Martin Gelter, *General Report: Global Securities Litigation and Enforcement*, in GLOBAL SECURITIES LITIGATION AND ENFORCEMENT 3, 28 (Pierre-Henri Conac & Martin Gelter eds., 2019).

necessarily audited) financials with the register of companies.[34] This helps to create a class of accounting firms specializing in preparing such statements for small business entities.

It is less clear if the choice of the content of accounting standards will necessarily create or benefit interest groups that draw an economic benefit not related to the nature of their expertise. If accounting firms are limited to working within one jurisdiction and are dominated by the interests of local professionals, one would expect them to protect the interests of these incumbents. Local accountants would then prefer a sufficiently complex jurisdiction-specific web of rules that protects their rents against outside competitors. Newcomers must play by the incumbents' rules to enter the market.

Over the past decades, the top tier of the accounting industry has integrated globally and coalesced into the Big 4 firms. International cooperation clearly has advantages given the presence of multinational corporations that require accounting services and prefer coordinating them across borders.[35] Increased cross-border economic activity and large corporations operating internationally logically fosters the development of a more international accounting industry to provide these services.[36]

[34] Directive (EU) 2017/1132 of the European Parliament and of the Council of 14 June 2017 relating to certain aspects of company law (codification), 2017 O.J. (L 169) 46, art. 14(f) [hereinafter Codified Company Law Directive] (codifying a requirement previously found in the First Company Law Directive of 1968).

[35] *E.g.*, Axel Haller, *Financial accounting developments in the European Union: past events and future prospects*, 11 EUR. ACCT. REV. 153, 160-62 (2002); Stephen A. Zeff, *The Evolution of the IASC into the IASB, and the Challenges It Faces*, 87 ACCT. REV. 807, 819 (2012); Kavame Eroglu, *supra* note 2, at 504-9.

[36] Buxbaum, *supra* note 7, at 1794.

In many countries, international accounting firms have grown by absorbing local firms into their network,[37] but they have little to gain from protecting a local turf with a highly specific set of standards. To the contrary, they are in a better position to scale their operations with standardization across markets, which allows them to better scale training and human capital.[38] In this situation, individual with localized human capital employees may be more easily dispensable, which will shift bargaining power toward owners (partners) from mere employees.[39] But even more importantly, with an international set of accounting standards applying to publicly traded and other large corporations, international accounting firms may be in a position to gain market share at the expense of purely domestic ones. International firms likely have an incentive to make it difficult for local firms outside to scale internationally. It is thus not surprising that the Big 4 are the group exerting the most influence on the development of IFRS.[40] Both the complexity of IFRS as well as their ever-changing nature may in part be explicable with the interests of the large firms dominating the market for large audits.

2.4. Accounting standards and varieties of financial systems

Americans following the debate about US GAAP and IFRS are often not aware that the biggest cleavage between accounting "languages" is not between these two sets of standards, but

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[37] *Id.* at 1791-92.

[38] *See* Mary Tokar, *Convergence and the Implementation of a Single Set of Global Standards: The Real-Life Challenge*, 25 NW. J. INT'L L. & BUS. 687, 692-709 (2005).

[39] *See generally* Luigi Zingales, *In Search of New Foundations*, 55 J. FIN. 1623, 1648 (2000) (comparing capital-owned firms with firms dominated by human capital, where employees are less easily replaced, using an advertising agency as an example).

[40] *See* James Perry & Andreas Nölke, *International Accounting Standard Setting: A Network Approach*, BUS. & POL., Dec. 2005, art. 5, at 6; Peter Walton, *Accounting and Politics in Europe: Influencing the Standard*, ACCT. IN EUR. (forthcoming 2020).

between accounting standards oriented toward capital and other markets. The most obvious superficial distinction, at least between Continental European countries and the Anglo-Saxon world, is the stronger integration of accounting standards into formal law in Continental Europe, whereas in the US and the UK, accounting standards have traditionally been promulgated by private standard setting bodies.[41] For example, in Germany, financial statements traditionally had to be drawn up according to provisions in the respective Commercial Code;[42] this is still true outside of the scope of application of the IFRS Regulation. The situation is similar in France.[43] While German law also refers to "principles of proper bookkeeping" (*Grundsätze ordnungsmäßiger Buchführung*),[44] the body of legislation into which the EU Accounting Directives were transposed is referred to as "accounting law" (*droit comptable* or *Bilanzrecht*) in both Germany and France,[45] a term rather alien to Anglophone ears. While both GAAP and IFRS are promulgated by private standard-setting bodies,[46] in Continental European countries the role of the government is greater. While there always were recommendations by professional accounting organizations, in Germany "accounting principles [were] considered to be legal rules ('Rechtsnormen') and not professional standards ('Fachnormen')."[47] In practice, these principles

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[41] *See, e.g.*, VANESSA EDWARDS, EC COMPANY LAW 119 (1999).

[42] HANDELSGESETZBUCH (HGB) (GERMANY) §§ 238-342e.

[43] Loi 83-353 du 30 avril 1983 (introducing art. L.123-12 to L.123-28 into the CODE DE COMMERCE [FRANCE]).

[44] HGB §§ 238(1), 264(2) (requiring the application of "principles of proper bookkeeping").

[45] For France, *see* Christian Hoarau, *International accounting harmonization. American hegemony or mutual recognition with benchmarks*, 4 EUR. ACCT. REV. 217, 224 (1995); LUCIA QUAGLIA, THE EU AND GLOBAL FINANCIAL REGULATION 133 (2014).

[46] In the US, only § 108 of the Sarbanes-Oxley Act of 2002 created an explicit legal basis for the recognition of FASB by the SEC.

[47] Christian Leuz & Jens Wüstemann, *The Role of Accounting in the German Financial System*, *in* THE GERMAN FINANCIAL SYSTEM 450, 457 (Jan Pieter Krahnen & Reinhard H. Schmidt eds., 2004). Germany did not have a formally recognized standard setting body until 1999, and even the one created then has a very limited scope of tasks

have since the 1950s been understood as the set of rules deductively developed from the principles underlying accounting law and codified in it.[48] In France, the commercial code's provisions on accounting[49] were supplemented by a general accounting plan (*plan comptable général*) developed by a ministerial committee with the representation of various interest groups.[50] These standards were subordinate to the applicable law and had to be promulgated by the ministry of the economy until 2009.[51] Only after a 2007 reform were these replaced with an independent regulatory agency which, however, is still subject to considerable government influence.[52]

The different nature of accounting standards is linked to different purposes of accounting that grew out of wholly different economic and financial environments. Unlike the US, where financial statements are a securities law requirement intended to inform investors,[53] European

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relating mainly to the use of IFRS in consolidated accounts in the specific German context. *See id.* at 458-59; Matthias Schmidt, *On the Legitimacy of Accounting Standard Setting by Privately Organised Institutions in Germany and Europe*, 54 SCHMALENBACH BUS. REV. 171, 173 (2002).

[48] Lisa Evans, *Language, translation and the problem of international accounting communication,* 17 ACCT. AUD. & ACCOUNTABILITY J. 210, 227-28 (2003); Leuz & Wüstemann, *supra* note 47, at 456-57; David Alexander, *Legal Certainty, European-ness and Realpolitik,* 3 ACCT. IN EUR. 65, 71-72 (2006). *See* Georg Döllerer, *Grundsätze ordnungsmäßiger Bilanzierung, deren Entstehung und Ermittlung*, 14 BETRIEBS-BERATER 1217, 1220 (1959) (famously suggesting that principles of proper financial reporting were to be developed "through reflection").

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

[50] *See* CHRISTOPHER NOBES & ROBERT PARKER, COMPARATIVE INTERNATIONAL ACCOUNTING 331 (12th ed., 2012). Between 1998 and 2009, the National Accounting Council (*Conseil national de la comptabilité* or CNC) and the Accounting Regulation Committee (*Comité de Réglementation Comptable* or CRC) shared the standard-setting role. *See* CHRISTIAN DE LAUZAINGHEIN, JEAN-LOUIS NAVARRO & DOMINIQUE NECHELIS, DROIT COMPTABLE ¶ 24 (3rd ed., 2004).

[51] *See* Hoarau, *supra* note 45, at 224 (discussing state and private-sector influence on accounting standard setting in France).

[52] 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).

[53] Martin Gelter & Zehra Kavame Eroglu, *Whose Trojan Horse? The Dynamics of Resistance Against IFRS*, 36 U. PA. J. INT'L L. 89, 138-39 (2014).

accounting had to encapsulate multiple goals. First, the disclosure of at least simplified financial statements is required of all limited liability business associations as an instrument to protect creditors.[54] Second, the accounting provisions harmonized by EU law were also to be used for purposes of the legal capital system, and thus to limit the amount of funds distributable to shareholders.[55] Third, Continental European countries tended to exhibit a greater deal of book-tax conformity, i.e., corporate taxes are based on the entity-level financial accounts.[56] These features tend to lead to conservatism in accounting.[57] Firms may then make accounting choices that will reduce earnings to minimize their tax loss. Arguably, this should not affect group-level consolidated accounts that are of interest to investors; however, these are sometimes not as independent from individual entity accounts in practice as they are in theory.[58]

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[54] Codified Company Law Directive, art. 14(f) (requiring disclosure of at least a limited set of financial statements for all firms). *See* EDWARDS, *supra* note 41, at 123 n.41.

[55] *See* Codified Company Law Directive, art. 56(1). Leuz & Wüstemann, *supra* note 47, at 459; *see also* 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).

[56] For Germany, *see* 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, 124 (Theodor Baums et al. eds., 2000); Wolfgang Schön, *The Odd Couple: A Common Future for Financial and Tax Accounting?*, 58 TAX L. REV. 111, 119-22; for Germany, *see* A. Frydlander & D. Pham, *Relationship between accounting and taxation in France*, 4 EUR. ACCT. REV. 845, 845-46 (Supp. 1996); *see generally* Peter Essers & Ronald Russo, *The Precious Relationship between IAS/IFRS, National Tax Accounting and the CCCTB, in* THE INFLUENCE OF IAS/IFRS ON THE CCCTB, TAX ACCOUNTING, DISCLOSURE AND CORPORATE LAW ACCOUNTING CONCEPTS 29, 33 (Peter Essers et al. eds., 2009); Daniel Shaviro, *The Optimal Relationship between Taxable Income and Financial Accounting Income: Analysis and a Proposal*, 97 GEO. L.J. 423, 428 n.13 (2009).

[57] *See* Jonathan Rickford, *Legal Approaches to Restricting Distributions to Shareholders: Balance Sheet Tests and Solvency Tests*, 7 EUR. BUS. ORG. L. REV. 135, 146-55 (2006); Wolfgang Schön, *Balance Sheet Tests or Solvency Tests – or Both?* 7 EUR. BUS. ORG. L. REV. 181, 186-87 (2006); Leuz & Wüstemann, *supra* note 47, at 459; Ferran, *supra* note 55, at 209-210.

[58] 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, 100-06 (2010) (describing the reduction of "tax pollution" in German consolidated accounts in the 2000s).

Accounting regulation may match the respective financial system of a country. Scholarship has long divided countries into "arm's length finance" (or outsider) and "control-oriented finance" (insider) systems. While in the former, firms rely on small equity ownership as well as bonds for debt finance, the latter are characterized by control or significant blocks (e.g., by families or other key shareholders) on the equity side, and on relational lending arrangements with a main bank on the debt side.[59] The debate on the origins of dispersed and concentrated ownership structures maps onto this dichotomy.[60]

Accounting principles developed for financial markets, such as both US GAAP and IFRS, are aimed at providing useful information for investors. Mandatory disclosure of accounting information is of far greater importance in an outsider system, where it increases market liquidity by giving dispersed stockholders and bondholders access to credible financial information.[61] By contrast, long-term investors — such as family blockholders, other large shareholders with a longstanding relationship with the firm, and banks with a long-term lending relationship in an insider finance country — will typically have direct access to internal information of the investee firm, either through representation on the board or through their bargaining power. While they will certainly be interested in the firm's financials, they will be less dependent on standardized financial

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[59] *E.g.*, Erik Berglöf, *A Note on the Typology of Financial Systems,* in COMPARATIVE CORPORATE GOVERNANCE 151, 159-64 (Klaus J. Hopt & Eddy Wymeersch eds., 1997); ALAN DIGNAM & MICHAEL GALANIS, THE GLOBALIZATION OF CORPORATE GOVERNANCE 64 (2009); Christian Leuz, *Different approaches to corporate reporting regulation: how jurisdictions differ and why,* 40 ACCT. & BUS. RES. 229, 236-37 (2010).

[60] *E.g.*, Marco Becht & Alisa Roëll, *Blockholdings in Europe: An International Comparison*, 43 EUR. ECON. REV. 1049 (1999); Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471–517 (1999).

[61] *E.g.*, Mark H. Lang, *International Accounting in Light of Enron: Evidence from Empirical Research,* 28 N.C. J. INT'L L. & COMM. REG. 953, 956 (2003); Hail et al., *supra* note 24, at 357; Dimitrios Katsikas, *Global Regulation and Institutional Change in European Governance,* 34 WEST. EUR. POL. 819, 826 (2011); Kavame Eroglu, *supra* note 2, at 471.

information.[62] They are both in the position to request information about financial idiosyncrasies or unusual accounting choices, and sufficiently sophisticated to evaluate them. Differences between IFRS, GAAP and other accounting principles are unlikely to pose a hurdle.

The timing of the "internationalization" of accounting standards in many jurisdictions traditionally characterized as following a "control" model, particularly in civil law countries, is therefore not a surprise. During the 1990s, the EU's accounting directives were increasingly seen as a failure because Member State options meant that financial statements were not comparable between countries.[63] Continental financial statements were criticized as insufficient in providing useful information for investors.[64] Arguably, an accounting system serving different purposes would necessarily have to be different, for example, when creditor protection is an important goal. The permissive attitude of IFRS toward "fair value" accounting[65] thus became an issue of debate when contrasted with the traditional Continental European adherence to historical cost. Using fair

[62] 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, 723 (2008); Hail et al., *supra* note 24, at 361.

[63] BUXBAUM & HOPT, *supra* note 22, at 235; Ebke, *supra* note 56, at 119–20; Enriques, *supra* note 22, at 26–27; Martin Gelter & Alexandra M. Reif, *What is Dead May Never Die: The UK's Influence on EU Company Law*, 40 FORDHAM INT'L L.J. 1413, 1436 (2017).

[64] The Daimler-Benz 1993 cross-listing in New York and use of US GAAP famously exposed that German accounting standards were maybe not as conservative as previously believed. *E.g.*, Walter Mattli & Tim Büthe, *Global Private Governance: Lessons from a National Model of Setting Standards in Accounting*, 68 L. & CONT. PROBS. 225, 256 (2005); Lawrence A. Cunningham, *Accounting and Financial Reporting: Global Aspirations, Local Realities, in* OXFORD HANDBOOK, *supra* note 11, at 489, 490.

[65] IFRS permit fair value accounting more broadly and allow its use in many asset classes beyond those permissible under US GAAP. *E.g.*, for property, plant and equipment, see IAS 16.

values to value an asset *above* its historical cost could lead to the creation of fictitious equity that might result in the distribution of unrealized profits.[66]

Critics of traditional accounting would counter that creditors would be better served by timely information rather than legal capital,[67] even if some evidence suggests that creditors often prefer conservative accounting.[68] Moreover, the information needs of bondholders are different from a bank with a close relationship with the debtor, who may also be more interested in long-term value rather short-term movements in fair value. Historically, banks tended to prefer balance sheets comprising only tangible assets and preferred the exclusion of intangible values such as goodwill, whereas investors preferred financial statements showing more short-term values.[69] Consequently, in a finance system with little arm's length lending, the benefits of information disclosure are smaller than a system relying on capital markets. The EU's turn toward IFRS – beginning with some reforms of the directives[70] and culminating in the IAS Regulation in 2002[71]

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[66] *E.g.*, Giovanni Strampelli, *The IAS/IFRS after the crisis: limiting the impact of fair value accounting on companies' capital*, 2011 EUR. COMPANY & FIN. L. REV 1, 8. Technically, such distributions can be prevented by a reconciliation from IFRS or the creation of a fair value reserve that is maintained as a contra-account to the asset and is removed only when the asset in question is removed from the financial statement. *E.g.*, Bernhard Pellens & Thorsten Sellhorn, *Improving Creditor Protection through IFRS Reporting and Solvency Tests*, 2006 EUR. COMPANY & FIN. L. REV. 365, 377-378; Strampelli, *supra* note 66., at 21.

[67] Pellens & Sellhorn, *supra* note 66, at 376-77. For a survey of the criticism of legal capital rules *see, e.g.*, Panetsos, *supra* note 23, at 151-52.

[68] Stefano Cascino, Mark Clatworthy, Beatriz García Osma, Joachim Gassen, Shahed Imam & Thomas Jeanjean, *Who Uses Financial Reports and for What Purpose? Evidence from Capital Providers*, 11 ACCT. IN EUR. 185, 196 (2017).

[69] S*ee* Ding et al., *supra* note 62, at 723, 726-27.

[70] *E.g.*, Directive 2001/65/EC of the European Parliament and of the Council of 27 September 2001, 2001 O.J. (L 283) 28 ("Fair Value Directive").

[71] *Supra* note 4 and accompanying text.

– thus coincides with an increased orientation toward capital markets, and an increasing desire to attract foreign institutional investors; the same phenomenon can be observed in other countries.[72]

3. Convergence and divergence in accounting systems in historical perspective

This section presents two case studies highlighting how the accounting industry, especially international firms, had very different interests and incentives. Section 3.1 suggests that Continental European countries, specifically Germany, superficially adopted IFRS, but under the radar cling to domestic traditions. Conversely, section 3.2 argues that in the US the interests of the accounting industry ultimately favored the retention of US GAAP. In combination, these two developments mean that accounting ultimately did not converge.

3.1. Europe: IFRS with a substratum of traditional domestic accounting

In Europe, there have been two vehicles for convergence, namely the EU Accounting Directives and IFRS. The EEC (later EC, then EU) put accounting harmonization on its agenda during the 1960s, when company law harmonization began. The original accounting directives date back to 1978 and 1983, respectively.[73] Scholars often find the success of the EU Company Directives questionable in general. Hansmann and Kraakman called them a weak force of convergence,[74] and Enriques describes them as trivial, as they often govern unimportant matters,

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[72] *E.g.*, for Japan, see Noriyuki Tsunogaya et al., *Adoption of IFRS in Japan: challenges and consequences*, 27 PAC. ACCT. REV. 3 (2015).

[73] Fourth Council Directive 78/660/EEC, of 25 July 1978, O.J. (L 222) 11; Seventh Council Directive of 13 June 1983, O.J. (L 193) 1. Both directives were recast as Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013, O.J. (L 182) 19 [hereinafter Accounting Directive].

[74] Hansmann & Kraakman, *supra* note 1, at 454.

provide many Member State options, and are insufficiently enforced.[75] While the directives superficially seemed to govern financial reporting comprehensively, in fact they created a large number of Member State options.[76] With the increasing significance of capital markets during the 1990s, many scholars, accountants and investors criticized that there still was no comparability between financial reports drawn up from different Member States.[77]

Paralleling EEC harmonization, IASC – the predecessor to today's IASB – was formed in 1973 following an early initiative of the British and American accounting professions.[78] Arguably, it was a response to the impending European harmonization promoted particularly by the British accounting industry, which feared the dominance of Continental European models and sought to set up a more respectable international counterweight.[79] Even if representatives from other countries were involved, Anglo-Saxon accounting culture dominated, as the individuals involved were typically trained in the English-speaking countries and socialized within the large

[75] Enriques, *supra* note 22, at 57-64.

[76] *E.g.*, *id.*, at 27 n.95.

[77] *E.g.*, Ebke, *supra* note 56, at 119-20; Gelter, *supra* note 14, at 331-32.

[78] Kavame Eroglu, *supra* note 2, at 490-91.

[79] *E.g.*, John Flower, *The Future Shape of Harmonization: The EU Versus the IASC Versus the SEC*, 6 EUR. ACCT. REV. 281, 288-89 (1997); Leonardo Martinez-Diaz, *Strategic Experts and Improvising Regulators: Explaining the IASC's Rise to Global Influence, 1973-2001*, BUS. & POL., Dec. 2005, art. 3, at 8; Zeff, *supra* note 35, at 809; Gelter & Kavame Eroglu, *supra* note 53, at 147-48.

international accounting firms.[80] While common law countries did not immediately form a majority in the representation on IASC, the English-speaking jurisdictions dominated.[81]

Compromises within the Directives sometimes catered to UK views. For example, they took up the UK principle that accounting disclosure should constitute a "price" for the privilege of limited liability, which is why all limited liability entities must disclose at least an abridged balance sheet.[82] Another famous example is the famous "true and fair view" requirement,[83] which originated in the UK Companies Act of 1948.[84] The directive also included the "overriding principle", according to which reporting firms must deviate from specific accounting rules if their application would be incompatible with a "true and fair view" of the company's assets, liabilities, profit and loss and financial position.[85] This provision was also met with resistance, especially in the German-speaking and Scandinavian countries, where it was not properly implemented in national law for several decades.[86] Arguably, such a principle may not be a good fit for a system

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[80] Mattli & Büthe, *supra* note 64, at 254; Alain Burlaud & Bernard Colasse, *Normalisation comptable internationale: le retour du politique ?*, 16 COMPTABILITE CONTROLE AUDIT 153, 155-56 (2010); *see also* Eve Chiapello & Karim Medjad, *Une privatisation inédite de la norme : le cas de la politique comptable européenne*, 49 SOCIOLOGIE DU TRAVAIL 46, 49 (2007); Stavros Gadinis, *Three Pathways to Global Standards: Private, Regulator, and Ministry Networks*, 109 AM. J. INT'L L. 1, 23-24 (2015).

[81] *E.g.*, *id.* at 255; 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); Katsikas, *supra* note 61, at 830; Burlaud & Colasse, *supra* note 80, at 155-56; Gelter & Kavame Eroglu, *supra* note 53, at 113-14; QUAGLIA, *supra* note 45, at 137-38.

[82] *Supra* note 54 and accompanying text; on the idea of publicity as a price or collateral for limited liability, see EDWARDS, *supra* note 41, at 123 n.41.

[83] Accounting Directive, art. 4(3).

[84] *E.g.*, Lawrence E. Cunningham, *Semiotics, Hermeneutics, and Cash: An Essay on the True and Fair View*, 28 N.C.J. INT'L L. & COM. REG. 893, 904 (2003); Dieter Ordelheide, *True and Fair View: A European and a German Perspective*, 2 EUR. ACCT. REV. 81, 82 (1993).

[85] Accounting Directive, art. 4(3).

[86] *See* David Alexander & Eva Jermakowicz, *A True and Fair View of the Principles/Rules Debate*, 42 ABACUS 132, 139 (2006); Cunningham, *supra* note 84, at 910–11 (2003); Bernhard Großfeld, *Comparative Corporate Governance:*

with strong book-tax conformity, which might lead to more instances of questionable manipulation of taxable income.

From today's perspective, the Directives were an instrument that helped entrench Continental European accounting systems that were not in line with a shareholder primacy vision of convergence in corporate law.[87] However, IAS (which later became IFRS) eventually carried the day with the rise of capital markets in the 1990s. During this period, an increasing number of companies sought to cross-list their stock in the US, which created pressure of accounting standards that would useful to investors and acceptable from an American perspective.[88] By supporting the internationalizing of accounting, the European Commission sought to address a competitive disadvantage for multinational European firms.[89] Given that the wholesale adoption of US GAAP — which cross-listed companies were already using — was not an option, IAS/IFRS were the only international alternative.[90]

The EU adopted IFRS with the IFRS Regulation of 2002,[91] which requires publicly traded firms to disclose consolidated financial statements using IFRS, but includes Member State options to permit or require listed firms to draw up their entity-level accounts under either IFRS or domestic standards, and also includes the same choice for both entity-level and consolidated

Generally Accepted Accounting Principles v. International Accounting Standards, 28 N.C. J. INT'L L. & COMM. REG. 847, 861-62 (2003).

[87] *See* Gelter, *supra* note 14, at 341-42.

[88] QUAGLIA, *supra* note 45, at 135.

[89] Katsikas, *supra* note 61, at 828.

[90] Philippe Maystadt, *Why and How EFRAG was Reformed*, ACCT. ECON. & L., 2017, at 31, 32.

[91] The IFRS Regulation was preceded by laws in the late 1990s in several Member states permitting firms to use IAS or GAAP in consolidated accounts. Gelter & Kavame Eroglu, *supra* note 53, at 150-52.

accounts of non-listed firms.[92] Since many countries still use these options to require domestic accounting standards for entity level financial statements,[93] convergence to IFRS is incomplete. In most countries, those firms that have the choice still select domestic accounting standards.[94] Borrowing from linguistics, one could argue that national accounting standards and laws constitute a "substratum" to the prestige language of IFRS:[95] A substratum of the traditional accounting principle persists in low-prestige financial statements (entity-level accounts, non-listed firms, tax accounting), while high-profile accounts – consolidated statements of publicly traded firms – use the *lingua franca* of IFRS.

While from the US perspective, IFRS may look like an intrusion from abroad, from the Continental European perspective they look like an invader coming from the Anglo-Saxon world of capital markets. Nevertheless, the eventual compromise carved out a prominent space for IFRS. While IFRS must be officially endorsed by the European Commission to became part of EU law, the Commission exercises this power through a delegated committee procedure involving a body called EFRAG (European Financial Reporting Advisory Group), which at least initially had

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[92] IFRS Regulation, art. 5.

[93] *See* Thomas Sellhorn & Sylwia Gornik-Tomaszewski, *Implications of the 'IAS Regulation' for Research into the International Differences in Accounting Systems*, 3 ACCT. IN EUR. 187, 195 (2006); Strampelli, *supra* note 66, at 10; Gelter & Kavame Eroglu, *supra* note 53, at 153-56, Panetsos, *supra* note 23, at 147; Paul André, *The Role and Current Status of IFRS in the Completion of National Accounting Rules – Evidence from European Countries,* 14 ACCT. IN EUR. 1, 2-5 (2017).

[94] André,*supra* note 93, at 6.

[95] A substratum occurs when a lower-prestige language influences the development of a higher-prestige language in the area was formerly spoken. A now extinct language might influence a new language that superseded it (e.g. Gaulish likely influenced the Latin spoken in the Roman province of Gaul, and consequently French.

limited oversight from the commission and, under the rubric of "expertise", strong representation from the large accounting firms.[96]

International accounting was in the interest of large, capital-market oriented firms, which were on the ascendency during the "convergence in corporate governance" phase. But the shift toward IFRS also suited the domestic branches of the large accounting firms, who are favored in terms of market share in the audit market, relative to more local professionals.[97] Large firms such as the Big 4 are typically better able to "scale" human capital by training staff in IFRS across countries and applying uniform methods.[98] Moreover, they may be better able to handle the complexity of IFRS, having been more involved in the standard setting process.[99] In addition, there may be audit tasks at which large firms are better than small ones, such as reviewing the fair valuations under IFRS.[100] Empirical research found that European firms were significantly more

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[96] Chiapello & Medjad, *supra* note 80, at 58; *but see* van der Tas & van der Zanden, *supra* note 81, at 9 (noting the influence of accountants, but also the disagreement between IASB and EFRAG about parts of IAS 39). After its 2014 reorganization, EFRAG has now stronger input from national standard setters and European supervisory authorities. Carien Van Mourik & Peter Walton, *The European IFRS Endorsement Process – in Search of a Single Voice,* 15 ACCT. IN EUR. 1, 17 (2018).

[97] *See* Martin Glaum & Donna L. Street, *Compliance with the Disclosure Requirements of Germany's New Market: IAS Versus US GAAP*, 14 J. INT'L MGMT. & ACCT 64 (2003) (finding that firms with a Big 4 auditor were more likely to use US GAAP or IAS rather than German accounting standards); Chen Chen & Zili Zhuang, *How does Mandatory IFRS Adoption Affect the Audit Service Market* (2014) (finding that mandatory IFRS adoption favored the Big 4 relative to other firms).

[98] *See* Tokar, *supra* note 38 (discussing KPMG's international training activities regarding IFRS); Hichem Khlif & Imen Achek, *IFRS Adoption and Auditing: a review,* 24 ASIAN REV. ACCT. 338, 340 (2016) (summarizing tentative evidence that IFRS compliance is associated with Big 4 auditors).

[99] Chen & Zhuang, *supra* note 97, at 7-8.

[100] *Id.* at 8-11.

likely to switch to an international accounting firm in the year of mandatory IFRS introduction.[101] Studies in a number of countries found that IFRS were associated with increased audit fees.[102]

That said, it is not clear that the Big 4 caused the introduction of IFRS;[103] the interests of large businesses also played a role. However, it certainly suited the large accounting firms' interests.[104] At the same time, the entrenched doctrinal system was too strong for a complete transition to IFRS. This may be in part a consequence of purely doctrinal path dependence that would have made a transition too costly. Local accounting professionals would have favored preserving the status quo.

3.2. The US: Resistance to IFRS is NOT futile.

The US has not adopted IFRS for domestic issuers, which like GAAP are in principle geared to investor interests, thus creating a distinction within the Anglo-Saxon world of arm's length financial systems. While in Europe there is no full convergence "in substance", US accounting requirements failed to converge "in form" to the international trend.[105]

[101] Maria Wieczynska, *The "Big" Consequences of IFRS: How and When Does the Adoption of IFRS Benefit Global Accounting Firms?*, 91 ACCT. REV. 1257 (2016).

[102] Jeong-Bon Kim, Xiaohong Liu & Liu Zheng, *The Impact of Mandatory IFRS Adoption on Audit Fees: Theory and Evidence*, 87 ACCT. REV. 2061 (2012); Khlif & Achek, *supra* note 98, at 344-45.

[103] *See* Karthik Ramanna & Ewa Sletten, *Network Effects of Countries' Adoption of IFRS*, 89 ACCT. REV. 1517 (2014) (finding a strong univariate correlation between the presence of the Big 4 and IFRS, which does not show up as statistically significant in multivariate regressions including other variables).

[104] Tony Porter, *Private Authority, Technical Authority, and the Globalization of Accounting Standards*, BUS. & POL. 2005, issue 3, art. 2, at 9-10.

[105] See Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329 (2001) (distinguishing formal and functional convergence).

The SEC, the US profession and FASB have supported IASC/IASB for decades.[106] IASC began to grow in influence through its cooperation with IOSCO (International Organization of Securities Commissions) from 1987 onwards, which aimed at facilitating international cross-listings.[107] The leading national regulator within IOSCO, which formally endorsed IAS in May 2000,[108] was the American SEC. IOSCO and IASC were thus often seen as instruments of American influence, with IASC representing the interests of FASB above all.[109] IOSCO's endorsement was instrumental in lending credibility to IFRS, for which SEC approval and sufficient similarity with US GAAP were crucial.[110] When IASC became IASB, it had not only adopted an organizational structure resembling FASB's, but IAS (now re-christened IFRS) were by many observers considered similar to US GAAP.[111]

After the scandals of 2001, Enron and WorldCom, US GAAP increasingly came under scrutiny in public debates as being too "rules-based."[112] Firms that followed accounting standards in letter, but not in spirit, were able to hide malfeasance with great skill, which their auditors

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[106] *See* Zeff, *supra* note 35, at 811-12.

[107] Zeff, *supra* note 35, at 814-15.

[108] Cunningham, *supra* note 64, at 491; Zehra Kavame Eroglu, *Why and How the World Adopts IFRS*, § 1.2 (forthcoming, manuscript available from the author).

[109] Gordon L. Clark et al., *Emergent Frameworks in Global Finance: Accounting Standards and German Supplementary Pensions*, 77 ECON. GEOGRAPHY 250, 255 (2001).

[110] Beth A. Simmons, *The International Politics of Harmonization: The Case of Capital Market Regulation,* 55 INT'L ORG. 589, 611 (2001); Kavame Eroglu, *supra* note 2, at 493-94.

[111] William W. Bratton, *Heedless Globalism: The SEC's Roadmap to Accounting Convergence*, 79 U. CIN. L. REV. 471, 475-76 (2010); Leuz, *supra* note 59, at 250; Cunningham, *supra* note 64, at 492; Kavame Eroglu, *supra* note 2, at 497.

[112] Lance J. Phillips, *The Implications of IFRS on the Functioning of the Securities Antifraud Regime in the United States*, 108 MICH. L. REV. 616–17 (2010); *see also* William W. Bratton, *Enron, Sarbanes-Oxley and Accounting: Rules Versus Principles Versus Rents*, 48 VILL. L. REV. 1036-37 (2003); John C. Coffee, Jr. & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. 707, 749–59 (2009).

approved.[113] IFRS became the alternative system of reference against which US GAAP were frequently compared. If IFRS are indeed more "principles-based", then they are less at risk for circumvention in cases of accounting practices pushing the envelope.[114] For a number of years, the SEC considered adopting IFRS, or at least giving firms the choice between the two now relatively similar systems.[115] Ultimately, the SEC only allowed foreign issuers to use IFRS for purposes of US securities trading in 2008, which means they no longer need to reconcile their IFRS statements to US GAAP.[116] With the 2008/09 financial crisis, international accounting became a side issue for the SEC, whose staff issued a final work plan in 2012, after which the adoption of IFRS was permanently put on hold.[117]

Arguably, there is no need for further convergence from the perspective of the US. As Zehra Kavame Eroglu pointed out, US actors such as FASB and the SEC strategically promoted IASC/IASB to export a vision of accounting standards more in line with American practices.[118] Given the hegemonic position of US capital markets, US issuers have little to gain from adjusting to international standards that are already quite similar to the American ones. US institutional investors have a foreign system available that suits their needs oversees, and the foreign multinationals listed in the United States can use IFRS in American markets. The loss to

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[113] John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403, 1416–17 (2002); *see also* Bratton, *supra* note 112, at 1041–43.

[114] Frederick Gill, *Principles-Based Accounting Standards*, 28 N.C. J. INT'L L. & COMM. REG. 967 (2003); van der Tas & van der Zanden, *supra* note 81, at 4; *but 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. 1409, 1453-60 (2007).

[115] Cunningham, *supra* note 64, at 492.

[116] *Supra* note 3 and accompanying text.

[117] Cunningham, *supra* note 64, at 493.

[118] Kavame Eroglu, *supra* note 2, at 514-15.

comparability between financial statements using IFRS and US GAAP does not appear to impose sufficient additional cost on the local investing public to create pressure to adjust.[119]

Within the US, there are good reasons to believe that the political economy of accounting is further stacked against IFRS. First, there is a natural level of inertia. An established domestic standard setter (FASB) that is firmly entrenched into the securities law framework is likely going to be reluctant to give up its role to a foreign competitor.

Second, the US accounting industry would likely have something to lose from a full transition to IFRS. As discussed in section 2, one could interpret this as a form of doctrinal path dependence, resulting from professionals having human capital tied up in the existing system, which will make a changeover difficult and costly. This cost did not prevent the introduction of IFRS in Europe; to the contrary, international accounting firms there benefited from IFRS. Arguably, the Big 4 might have used the opportunity in the United States for the same purpose, as there are still publicly traded firms audited by other large (significantly smaller) accounting firms.

It is also possible that they would not have a similar advantage as in European countries, given that US GAAP themselves are even more complex than IFRS.[120] International accounting firms can make bigger gains in markets where domestic standards are very different from IFRS and they hence enjoy an advantage as market disrupters.[121] Given the relative similarities between US GAAP and IFRS compared to, say, the larger distance between German accounting law and

[119] *Id.*

[120] Hail et al., *supra* note 24, at 375-76.

[121] *See* Chen & Zhuang, *supra* note 97 (finding that auditors with high IFRS expertise make bigger gains in markets requiring greater adjustment in the changeover).

IFRS, large accounting firms would not have been in the position to sell international accounting as fundamentally new as in Europe.[122]

Moreover, the debate about rules-based and principles-based accounting standards ties back into larger themes in comparative corporate governance. Within comparative corporate law, it is easy to overemphasize similarities between common law jurisdictions, particularly the US on one hand, and the UK and other Commonwealth jurisdictions on the other. A distinguishing factor is the extent to which each of the two system relies on investor litigation to police conduct and discipline boards. In the US, shareholder litigation has long been thought to be important to curb managerial agency cost.[123] There are a relatively large number of investor lawsuits every year, including both corporate and securities law actions.[124] By contrast, in the UK institutional ownership has been stronger.[125] British institutional investors were geographically concentrated in the City of London and were historically in a better position to monitor management through a

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[122] Hail et al., *supra* note 24, at 371.

[123] Alessio M. Pacces, *Controlling the Corporate Controller's Misbehavior*, 11 J. CORP. L. STUD. 177, 203-04 (2011).

[124] *See* Robert B. Thompson & Randall S. Thomas, *A New Look at Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 169 (2004); Jesssica Erickson, *Corporate Governance in the Courtroom: An Empirical Analysis*, 51 WM. & MARY L. REV. 1749, 1764 (2010).

[125] *E.g.*, John Armour, *Enforcement Strategies in UK Corporate Governance, in* RATIONALITY IN COMPANY LAW 71, 108 (John Armour & Jennifer Payne eds., 2009).

higher level of direct engagement.[126] Correspondingly, the incidence of securities lawsuits against issuers has remained rare.[127]

The heavy reliance on litigation in the US likely contributed to the shape of accounting standards.[128] The prevalence of litigation in the US distinguishes it from the UK, in whose capital market ecosystem IFRS evolved, and whose GAAP are thought to be closest to IFRS.[129] In a system, a high level of litigation generates high litigation cost, and consequently higher liability risks and higher insurance premia.[130] Issuers and accounting professionals therefore have greater incentives to push for accounting standards that will help them avoid liability.[131]

With a rules-based accounting system, which arguably exists in the US, accounting firms and issuers may be better able to avoid liability and minimize insurance premia by following the rules to the letter. If courts tend to defer to accounting standard setters, then defendants will have

[126] *See* ALESSIO M. PACCES, RETHINKING CORPORATE GOVERNANCE 286-87 (2012) (discussing policing of activities of controlling shareholders by boards in the UK); *see also* Marc T. Moore, *United Kingdom, in* COMPARATIVE CORPORATE GOVERNANCE 913, 925-26, 929 (Andreas Fleckner & Klaus Hopt eds., 2013) (discussing the relatively larger powers of UK shareholders); Andrew F. Tuch, *Proxy Advisor Influence in a Comparative Light,* 99 B.U.L. REV. 1459, 1488 n.175, 1502-03, 1511 (2019) (noting changes in UK ownership patterns because of increasing foreign ownership).

[127] Christopher Hung Nie Woo, *United States Securities Regulation and Foreign Private Issuers: Lessons from the Sarbanes-Oxley Act*, 48 AM. BUS. L.J. 132 (2011); Iris H.-Y. Chiu, *United Kingdom: A Confidence Trick: Ex Ante versus Ex Post Frameworks in Minority Investor Protection, in* GLOBAL SECURITIES, *supra* note 33, at 627, 642.

[128] *E.g.*, Phillips, *supra* note 112, at 608–12; Moritz Pöschke, *Incorporation of IFRS in the United States: An Analysis of the SEC's Options and the Implications for the EU*, 9 EUR. CORP. & FIN. L. REV. 66-69 (2012); Robert M. Bushman & Joseph D. Piotroski, *Financial Reporting Incentives for Conservative Accounting: The Influence of Legal and Political Institutions*, 42 J. ACCT. & ECON. 107 (2006).

[129] *E.g.*, Kee-Hong Bae, Hongping Tan & Michael Welker, *International GAAP differences, The impact on foreign analysts,* 83 ACCT. REV. 593, 601-02 (2008); François Brochet, Alan D. Jagolinzer, Edward J. Riedl, *Mandatory IFRS Adoption and Financial Statement Comparability,* 30 CONT. ACCT. RES. 1373, 1376 (2013); Karthik Ramanna, *The International Politics of IFRS Harmonization,* ACCT. ECON. & L. 2013, iss. 2., at 1, 3-4, 10-11.

[130] *See* Dain C. Donelson, John M. McInnis & Richard D. Mergenthaler, *Rules Based Accounting Standards and Litigation*, 87 ACCT. REV. 1247 (2012) (finding an empirical link between rules-based accounting and a lower incidence of litigation).

[131] *See also* Gill, *supra* note 114, at 979.

less to fear from plaintiff lawyers and be in a much better position when negotiating a settlement. By contrast, in a principles-based system, accounting standards are not complied with unless financial statement conform to general principles such as “fair presentation.” IFRS implements an open-ended “fair presentation standard” goal that is paired with an “overriding principle” requiring deviations from specific rules where they do not achieve fair presentation.[132] Writing in 1995, Stephen Zeff explains that auditors “want to be able to cite express provision of GAAP in support of their financial reporting” to avoid litigation, especially in an environment where clients often engage in “opinion shopping.”[133] Given the considerable fear of investor litigation among US professionals by generating additional grey areas in accounting, IFRS might expose the accounting industry to greater liability risks (and potentially incentivize them to make less aggressive accounting choices).[134]

One objection to this argument is that the federal courts have also typically found that following GAAP does not create a safe haven from criminal or civil liability.[135] However, as Cunningham explains, this was the position of both the SEC and the federal courts up to the 1970s, but subsequently fell into disuse.[136] Zeff summarized this situation by saying that the “standard of quality … is conformity with GAAP. There is no subjective override” comparable to “true and fair view.”[137] After Enron, the federal courts failed to return to the position that GAAP do not create a

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[132] IAS 1.19 *passim.*

[133] Stephen A. Zeff, *A Perspective on the U.S. Public/Private-Sector Approach to the Regulation of Financial Reporting*, 9 ACCT. HORIZONS 52, 65 (1995).

[134] *See also* Hail et al, *supra* note 24, at 376-77.

[135] United States v. Simon, 425 F.2d 796 (2d Cir. 1969).

[136] Cunningham, *supra* note 114, at 1468 n.254.

[137] Zeff, *supra* note 133, at 65.

safe haven.[138] Arguably, cases against auditors are hard to win in practice. First, for a 10b-5[139] securities fraud claim, plaintiffs must show scienter,[140] which is hard to establish with respect an auditor who did not uncover a misapplication of accounting standards. Second, the U.S. Supreme Court found that 10b-5 does not allow aiding and abetting liability,[141] which would be one way in which an outside auditor could be held liable for an issuer's false disclosures. Third, the usefulness of section 11 of the Securities Act[142], which may be a basis for liability resulting from false disclosures in registration statements, is limited by a "tracing requirement", which reduces the plaintiff class typically to the initial purchaser of securities.[143]

Nevertheless, the general prevalence of investor litigation in the United States keeps the possibility of auditor liability alive. At the very least, the rules-based approach seems to provide comfort to the accounting industry,[144] even if it may ultimately be an illusion in serious cases. Consequently, one may well say that a transition to IFRS would not serve the interests of the accounting industry. In Continental European countries, there are at least a subset of internationally affiliated accountants in the position to gain from the transition; this is not true in the US. The persistence of US GAAP is thus not merely a case of doctrinal path dependence, but sone of economic path dependence as well.

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[138] In re Global Crossing, Ltd. Sec. Litig., 322 F. Supp. 2d 319, 340 (S.D.N.Y. 2004); Cunningham, *supra* note 114, at 1468 n.254.

[139] 17 C.F.R. § 240.10b-5, based on Section 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j(b).

[140] Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

[141] Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994).

[142] 15 U.S.C. § 77k(a).

[143] Franklin A. Gevurtz, *United States: The Protection of Minority Investors and Compensation of their Losses, in* GLOBAL SECURITIES *supra* note 33, at 109, 119.

[144] Cunningham, *supra* note 64, at 497.

4. Conclusion

This chapter attempted to highlight links between accounting and convergence in corporate governance. Accounting professionals are another interest group affecting the political economy of comparative corporate governance. Convergence on shareholder and capital market orientation is influenced by developments in accounting and accounting law. As we have seen, in Continental European jurisdictions, the introduction of IFRS (with compromises) served the interest of international accounting firms, while in the US their adoption would have been against the interests of the accounting industry. Consequently, the persistence of certain accounting standards is best characterized as an incidence not only of doctrinal, but also of economic, path dependence subject to the influence of coordinated interest groups.

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