

The Global Accounting Experiment

BY NICOLAS VÉRON



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Nicolas Véron, Bruegel

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The author is a non-remunerated member of the Accounting and Auditing Practices Committee of the International Corporate Governance Network, an investor-led group that seeks to promote good corporate governance worldwide. The author is also a consultant to the Association of French Asset Managers (*Association Française de la Gestion financière*) and to the Association of French Insurers (*Fédération Française des Sociétés d'Assurances*). The corresponding assignments do not create material financial dependence of the author vis-à-vis these organisations.

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Abbreviations

Accounting is an acronym-intensive topic. Apologies are expressed to the reader for the inconvenience this causes.

AICPA	American Institute of Certified Public Accountants
APB	Accounting Principles Board, within the AICPA {1959-1973}
ASBJ	Accounting Standards Board of Japan
CESR	Committee of European Securities Regulators
EFRAG	European Financial Reporting Advisory Group
ERP	Enterprise Resource Planning
FAS	Financial Accounting Standard: denomination of some of the rules that collectively form US GAAP
FASB	Financial Accounting Standards Board of the US
GAAP	Generally Accepted Accounting Principles
IAS	International Accounting Standards
IASB	International Accounting Standards Board {since 2001}
IASC	International Accounting Standards Committee {1973-2001}. The acronym remains in use by the IASC Foundation, created in 2001.
IFRIC	International Financial Reporting Interpretations Committee {since 2001}
IFRS	International Financial Reporting Standards
IOSCO	International Organisation of Securities COmmissions
NYSE	New York Stock Exchange
OECD	Organisation for Economic Co-operation and Development
SEC	Securities and Exchange Commission
SIC	Standards Interpretations Committee of the IASC {1997-2001}
SMEs	Small and Medium-sized Enterprises
XBRL	eXtensible Business Reporting Language
XML	eXtensible Markup Language

Foreword

Accounting was for long regarded as a mere technicality by everybody but accountants. Even after the corporate scandals of the early 2000s, and since the controversies about financial reporting standards have been drawing attention to its intricacies, it remains an improbable topic for economic analysis. Yet as Nicolas Véron forcefully argues, much is at stake in what he calls the Global Accounting Experiment. A reduction of the cost of capital should result from the harmonisation of standards. Beyond this, there are two important reasons why the fate of this experiment matters greatly for the world economy and for Europe.

The first reason has to do with the nature of rules-setting institutions. In the old times – twenty years ago or so – the power of setting rules belonged exclusively to national governments and their offshoots, such as the international financial institutions. Global economic governance was about negotiating rules in committees and steering the international organisations in charge of implementing them. Then came ICANN (the Internet Corporation) whose model is based on self-governance by the participants in the network, but it could be regarded as a specific structure for a specific sector. The ascent of the International Accounting Standard Board (IASB) as a non-governmental standard-setting institution, whose decisions directly impact the way business is conducted throughout the world, is a true revolution in the governance of the world economy. It demonstrates that governmental rule-setting institutions have no monopoly and that if they prove unable to produce the rules the advance of market integration calls for, they can be substituted by private ones.

To picture the story as a triumph of private initiative over public inertia would however be inaccurate. As this pamphlet recalls, it is the European Union's landmark decision to cut short intergovernmental negotiations and endorse an outside standard instead of attempting to create one of its own which triggered similar responses by other governments and the spread of International Financial Reporting Standards (IFRS) the world over. Furthermore, the International Accounting Standards Board's new power has profound implications for its own governance, which Véron spells out in detail. What he argues is that the business of creating legitimate private gover-

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nance of the accounting world is largely unfinished and that without significant improvements in stakeholder representation, accountability and transparency, the sustainability of the Global Accounting Experiment cannot be taken for granted.

In short, private initiative can succeed in solving problems which the public sector has been unable to tackle, but it cannot overlook them. To remedy their legitimacy deficit without compromising their agility, the accounting institutions need to transform. This is not an impossible task, but not an easy one either.

The second reason has to do with the relationship between the US and the EU. In this field, as in many other aspects of deep integration, they are still the only two big players in town. To become global, rules – whoever has drafted them – need to benefit from a degree of US and EU consent and if they do, they have a high probability of being accepted by others. This situation will not last for long. The rise of the emerging world that has transformed global trade negotiations will soon happen in other fields, such as financial regulation, patents or competition. But for a decade or so, the joint EU-US leadership will remain undisputed. A major issue for them is therefore whether there will be sufficient convergence of view across the Atlantic to make use of this window for action and shape the rules of tomorrow's world economy. What is clear, at any rate, is that EU Internal Market Commissioner Charlie McCreevy was right to observe that accounting and auditing are the “precursors” of the deepened EU-US cooperation which German Chancellor Angela Merkel is advocating through the launch of a new transatlantic initiative¹.

Nicolas Véron outlines carefully and clearly the challenges for the two players. By endorsing the IFRS instead of setting its own rules – a move that could be regarded as a sign of weakness – the EU has paradoxically put itself in a leadership position and now needs to follow up, both at home with thorough implementation and in its dialogue with IASB, the standard-setting authority. The US in a way faces the opposite challenge. It has not adopted the standards and in this field like in others, it is tempted to aim for the best of both worlds – exercising influence over the definition of the rules, while not adopting them for itself. In short, the risk for the EU is to fail to exercise the power it is entitled to by its leadership. The risk for the US is to fail to deliver leadership commensurate with its power.

Students of international governance have shown how key principles of the post-

1. See Charlie McCreevy, 'On the road towards convergence and equivalence – state of play in international accounting', Remarks at a SEC Roundtable, Washington, DC, 6 March 2007.

WWII global order were first experimented with in unglamorous bodies such as the Universal Postal Union or the World Meteorological Organisation. It perhaps takes a subject as dry as accounting to serve as a testing ground for the principles of world governance in the XXIst century.

*Jean Pisani-Ferry, Director, Bruegel
Brussels, April 2007*

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Executive summary

The adoption of International Financial Reporting Standards by the European Union and other jurisdictions around the world must now be accompanied by follow-on measures at several levels, if its remarkable early steps are to be transformed into durable success.

Accounting practices and standards play an increasingly central role in intermediating information in capital markets and shaping business behaviour. Thus, the decision made by the European Union in the early 2000s to abandon national accounting standards for its listed companies and adopt instead the International Financial Reporting Standards (IFRS) can be considered among the most momentous of financial market policy initiatives of the past few decades. The EU decision also had a key influence in triggering similar moves to adopt IFRS in a number of jurisdictions, including China, Australia, Canada, South Korea, and possibly Japan and India as well in the near future. Even the United States, which in the past half-century had led many developments in accounting, is now considering recognition of IFRS as an acceptable set of standards for at least some of the companies listed on its markets.

The International Accounting Standards Board (IASB), the non-profit body that develops IFRS, has thus been put in a central position of responsibility vis-à-vis companies and market participants all around the world. Beyond the economic impact, the spread of IFRS adoption also has significance at a different level, as a frontier experiment in private-sector led global governance of a key policy area. Therefore, whether this 'Global Accounting Experiment' succeeds or fails has implications that go beyond the sole area of accounting.

This second volume of the **Bruegel Blueprint Series** analyses the reasons behind the spectacular expansion of IFRS use in recent years, and questions the sustainability of a development that rests crucially on two fragile pillars: first, the legitimacy of the IASB and the acceptance of its authority by its many stakeholders, including the states which have endorsed its standards; and second, the consistency of IFRS implementation in their various jurisdictions, above all in the

European Union which, by effectively starting the experiment, has become its de facto leader.

At this point, neither of these two conditions is fully met. Therefore, prompt initiatives need to be taken if the Global Accounting Experiment is to succeed. Among its recommendations to the various players involved, this Blueprint calls for:

- The IASB's transformation from a self-appointed body into a truly accountable institution, including by granting governance powers to stakeholders (and by modifying the funding framework accordingly), without infringing upon the independence of standard-setting;
- The IASB's affirmation of independence vis-à-vis US authorities, in the same spirit as its independence vis-à-vis Europeans was established in the run-up to first-time application on 1 January 2005: this may lead the IASB to renegotiate its current 'convergence' timetable with the US Financial Accounting Standards Board;
- In Europe, the formation of a new public body able to enforce consistent IFRS implementation on a cross-border basis, with appropriate governance and oversight arrangements;
- The mobilisation of market participants, especially of investors and other users of financial information, to participate more actively in the standard-setting process and the IASB's governance; and of the accounting profession and its regulators, to ensure that a competitive audit market provides the right incentives for a high quality of IFRS implementation.

Introduction

'The world today does not have enough international institutions that can confer legitimacy on collective action, and creating new institutions that will better balance the requirements of legitimacy and effectiveness will be the prime task for the coming generation. [...] Formal organizations acting on the basis of instructions that come up the accountability channels of sovereign states are too inefficient to suit the economic needs of the global economy.'

Francis Fukuyama, *America at the Crossroads*

Economic and financial interdependence has been rising continuously in the past few decades. This trend generates a demand for policymaking on issues of a cross-border nature, which sometimes makes them difficult to address by individual nation-states or even by traditional, treaty-based international organisations. As pointed out by Francis Fukuyama, the need for efficiency in addressing such challenges inevitably leads to a debate about alternative forms of governance, based on organisations that can react ably to changes in surrounding conditions but lack the kind of legitimacy conferred by democratic sovereignty. The extent to which such governance forms can durably respond to the expectations placed on them is one of the parameters that may shape future collective responses to globalisation.

Accounting standard-setting, though generally thought of as a dour matter, is one of the most advanced attempts at managing international collective challenges through such non-traditional means. By making the strategic move in 2000-02 to endorse International Financial Reporting Standards (IFRS), a body of norms prepared by a private-sector organisation with global scope but no democratic accountability, the European Union has started a worldwide experiment whose rapidly unfolding consequences will provide lessons for other areas of policy in the financial sector and beyond. This experiment is unique by its combination of global reach, private-sector governance and significant economic impact. Whether it succeeds or fails, and what can be done to maximise chances of success, is the central question of this Blueprint, which is part of a broader effort conducted by Bruegel to explore the consequences of financial globalisation and related regulatory choices. In it, we

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deliberately leave aside some important debates on accounting and auditing in order to keep the focus on how accounting standards are produced and implemented.

The choice of the word ‘experiment’ emphasises the unprecedented nature of the international accounting standard-setting process, and its location at the frontier of institutional innovation. Many international organisations are endowed with policy-making tasks. Many private-sector bodies issue technical norms which are then followed on a worldwide basis. But accounting provides a unique combination of *de facto* international policymaking power and of private-sector governance and funding, which is unmatched in most other existing organisations.

The importance of accounting has been underlined in many headlines over the past few years, most of them related to scandals, from Enron and WorldCom to AIG and Parmalat. Hank Paulson, US Secretary of the Treasury, has called accounting ‘*the lifeblood of capital markets*’². In a world where financial operations are ever more complex and fast changing, accounting provides the foundation of trust underlying capital markets. When financial statements can no longer be relied on, the whole construct of markets is threatened. The corresponding debate is not only about whether accounting rules are properly implemented, but also and increasingly whether the rules themselves are appropriate.

Heated arguments were exchanged in the US in the early 2000s about a standard requiring the expensing of stock options, denounced by some stakeholders as heavily detrimental to the competitiveness of the US economy. Likewise in the European Union, the shift from national accounting standards towards IFRS, though decided by near-unanimity in 2000-02, has later developed into a fierce political fight in which senior officials and even heads of states have become involved. The reason is that accounting standards are not just a norm for neutral measurement. They can influence economic behaviour. And when standards are changed the shift often creates winners and losers. Accounting for stock options as an expense effectively results in less stock options being granted³, and similar real-world effects can be found for virtually all rules that govern the preparation of financial statements.

Therefore, and even when not intended as such, setting accounting standards is a form of economic policymaking which brings to the standard-setting entity a significant

2. November 2006 speech by Hank Paulson: see Bibliography.

3. In the year of transition towards IFRS use, a study by PricewaterhouseCoopers found that the proportion of executive incentive awards accounted for by stock options fell sharply, from 36% to 21%. *Financial Times*, “IFRS Put Damper on Share Option Schemes”, 11 August 2005.

degree of power—political power. The argument should not be overstated: as in the case of stock options, the effect of new standards is generally to reveal situations to which the market did not pay sufficient attention, rather than to introduce new and autonomous dynamics of change. But it is a significant power nevertheless. As the old financial maxim goes, ‘*you manage what you measure*’. And as the economy becomes more complex, the choice of what you should measure becomes more difficult and critical, and the power attached to standard-setting authority increases.

This work starts with a brief summary of the historical developments which led to what we call the Global Accounting Experiment, ie the endorsement of IFRS (or of standards modeled almost entirely on IFRS) in a growing number of jurisdictions, thus conferring *de facto* international policymaking power on the entity that sets them, the International Accounting Standards Board (IASB). The question of why countries have been willing to abandon this power is the focus of the following section. We then turn to other questions of a more forward-looking nature. Can the IASB build legitimacy on a global scale? Can it avoid capture by specific national or sectoral interests? Can its global standards be effectively enforced in individual countries? Ultimately, how can the experiment succeed?

‘Success’, here, is meant as the continuation of the experiment, which implies prolonged public acceptance of the arrangement by which the standard-setting authority is kept in the hands of a private-sector entity, and the maintenance of standards that enable users to benefit from an acceptable level of quality of financial statements. In this definition, success can be sustained even without the use of IFRS becoming universal: specifically, their eventual adoption by the United States, though evidently an important matter, is not an indispensable condition for success, because IFRS can work in most countries without being endorsed by all. Conversely, ‘failure’ would be characterised by a reversal of the decision to adopt IFRS in a significant number of jurisdictions, and a return to national or regional arrangements for accounting standard-setting.

The Global Accounting Experiment is just beginning. The IASB in its current form has existed only since 2001, even though its predecessor bodies’ history goes back more than three decades. Most companies which publish yearly financial statements using IFRS have done so only since 2006. The dust has not yet settled on difficulties or inconsistencies of implementation. Many politicians have not yet realised the exact consequences of IFRS adoption, nor has the wider public. We are still at the early stages of a long learning process, which can in any case not be considered completed as long as no serious financial crisis has put financial reporting under IFRS to the test.

What is at stake is significant, and goes well beyond the obvious issue of survival of the IASB as an autonomous organisation, or the write-down of the significant amounts of money invested by listed companies and other market participants in the transition to IFRS. The cross-border harmonisation of accounting rules brings with it the promise of comparability of financial statements of companies across borders, and thus a better international allocation of capital, which should result in enhanced growth and job creation worldwide. Conversely, failure of the Global Accounting Experiment, inasmuch as it would result in fragmentation of rules across national or regional borders, would be most likely to increase the cost of capital.

Yet for the European Union, there is an additional reason to feel concerned. The EU is the one jurisdiction that effectively started the experiment, or at least that gave it its present dimension. Even if, as we shall see, this was done in large part for internal reasons (because it needed a single body of accounting standards and had proved unable to set them itself), the EU has effectively taken global leadership on this issue, and its leadership would therefore be damaged in the case of failure.

The initial achievements, especially in the past few years, have been spectacular; but equally humbling are the challenges ahead. Our analysis leads us to rate the Global Accounting Experiment's chances of success, under the current arrangements, as moderate at best. In other words, public passivity would probably lead to failure. In the last section, we outline a number of recommendations to the EU, the IASB and other players if they want to avert such an outcome, and transform this remarkable experiment into a lasting achievement.

1. A short history of accounting and standards

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Financial accounting has developed hand in hand with the capitalist system, from its origins in medieval Italy through its expansion during the Industrial Revolution to the advent of widespread equity ownership, leading to the eventual adoption of national accounting standards in all developed countries. International accounting standards, which trace their origins back to the late 1960s, have developed gradually before starting to play a major policy role following their endorsement by the European Union in 2000-2002, quickly followed by their spread to many other national jurisdictions.

1.1 The operating system of capitalism

Systems of inventory accounting developed as early as writing itself, starting in the Middle East and China about five millennia ago. Many non-capitalist systems of enterprise accounting have thrived since then, as illustrated well into the last century by the elaborate number-crunching of the late Soviet Union's Gosplan.

Financial accounting, however, has its own history with a specific starting point, Northern Italy in the 13th-14th centuries. There, the practice emerged of using the so-called double-entry bookkeeping method, by which credit and debit operations are simultaneously recorded. Remarkably, this technique, which is still at the core of modern accounting, was born a sibling of capitalist enterprise, when merchants started to assemble into 'companies' and entrust their operations (eg a naval commerce expedition) to hired managers (eg the ship's captain) who had no ownership of the business.

True, some iconic capitalist enterprises never used the double-entry method, such as the Dutch East Indian Company, active between 1602 and 1798, which was the first corporate entity whose shares were publicly listed. There exists, though, a close rela-

tionship between the economic system in which the managers of an enterprise are separate from its owners, and the unrivalled system of remote control⁴ provided by the double-entry method. Indeed, the worldwide expansion of both inventions has followed a largely parallel course over the centuries ever since Luca Pacioli, a Franciscan friar and distinguished humanist, first codified double-entry accounting in a treatise published in 1494. It is not an overstatement to portray accounting as the 'operating system' of capitalism.

The Industrial Revolution spurred entirely new types of company, in response to which accounting had to adapt and was profoundly transformed. Large companies started expanding overseas, especially British companies into India, Hong Kong, and other parts of the Empire. This led to a much-increased need for reporting and supervision of operations carried out far away, often by little-trusted managers. The introduction of limited liability for joint-stock companies in the 1860s also vastly accelerated corporate expansion and specialisation.

These developments explain the mushrooming of a new breed of specialised players, whose names are still familiar. The 'Big Four' firms which now dominate international accounting (Deloitte, Ernst & Young, KPMG and PricewaterhouseCoopers) all directly trace their origins back to firms founded between the invention of railways and the beginning of World War I. These include Deloitte (founded in London, 1845), Price (London, 1849; added the name Waterhouse in 1874), Coopers (London, 1854), Peat (London, 1867) and Marwick (Glasgow, 1887; they are now the 'P' and 'M' in KPMG), Young (Chicago, 1894) and Ernst (Cleveland, 1903). Arthur Andersen, which collapsed in 2002 following the Enron scandal, had been the latest one in this series, created in 1913 in Chicago by the eponymous Norwegian immigrant.

Simultaneously, accounting practices became less intuitive, much more elaborate and complex. For example, consolidation, the technique through which the financials of a whole set of mutually associated companies can be summarised in one single set of accounting statements, appeared in the 1890s, together with complex groupings of companies organised around a trust or a holding entity.

However, in a first phase modern financial accounting was developed, primarily in the United Kingdom, for the purpose of internal control and for the use of head-office managers and directors rather than for external shareholders or the public.

4. 'Control', as it happens, is another word whose source is in medieval accounting: the contre-rôle or counter-roll was the copy of a register that was kept for the record, in case the original disappeared or was falsified.

Companies retained considerable freedom to choose accounting policies that were best suited to their specificities, and to report their financials to external investors as they saw fit. As a consequence, even when internal control systems were efficient and elaborate, companies provided the public with information that was generally scarce, often of dubious quality, and difficult to compare from one company to the other.

The move towards more public disclosure of financial information happened not in the UK but on the other side of the Atlantic. In the US, the shares of many publicly-listed companies were dispersed among a large number of individual shareholders across an immense territory. This created problems of access to information which were far more pressing than in the well-informed circles of the City of London. As a result, as early as the mid-19th century, financial journalism and, later, financial rating developed on an unprecedented scale. The introduction of corporate income tax, which was pioneered by the US in 1909, was a further driver of harmonisation of accounting practices and improved financial transparency⁵. But despite the pressure from outside stakeholders, in the early decades of the 20th century financial disclosures by publicly-listed companies were still patchy at best. Though companies were increasingly reliant on public capital markets for their funding, managers still felt they could keep critical financial information for themselves and their close associates, bankers, and controlling shareholders.

This was changed forever by the stock market crash of October 1929. The ensuing scandals and outcry resulted in a vigorous call for legislation to improve the quality and reliability of the financials provided by companies to individual investors. Shortly after Franklin D. Roosevelt's election, the landmark US securities legislation of 1933 and 1934 set up the Securities and Exchange Commission (SEC) as the regulator of all national capital markets; made independent external audit compulsory for all publicly-listed companies; and paved the way for the emergence of a formally identified set of 'Generally Accepted Accounting Principles' (GAAP). Thus, both the modern concept of accounting standards and the requirement for statutory audits as we know them were born directly from the stock market crisis. The SEC, however, soon decided to rely on the US accounting profession's expertise for the preparation of standards. It thus recognised early on that accounting standards were ambiguous in nature: publicly-enforced rules prepared by private-sector players, on the grounds that private practitioners are more aware of market practices and better equipped to

5. See Mihir Desai, Alexander Dyck and Luigi Zingales, "Theft and Taxes", ECGI-Finance Research Paper No.63/2005 (October 2005), available at SSRN: <http://ssrn.com/abstract=629350>.

master their more technical aspects than civil servants.

By the mid-1950s US GAAP had been constituted as a full body of rules, which have since then been constantly updated. The accounting profession kept charge of standard-setting until 1973; at that date, the task was entrusted by the SEC to the Financial Accounting Standards Board (FASB), a newly-created private-sector body. FASB's formal governance framework, as well as its working processes, establish it as an autonomous body at the nexus of influence by all major stakeholders in capital markets. Listed companies provide most of its funding; major audit firms provide additional funding and most of its expertise; and the SEC, itself a representative of both the US government and, through its mandate, of investors, grants FASB its unique standard-setting authority. Though the purpose of accounting standards is to ensure that financial disclosures provide clear and relevant information on corporate performance, they also reflect compromises between these various stakeholders, whose interests may converge on some issues but diverge on others. As highlighted in the introduction, standards have real-world effects on economic behaviour. Therefore, their preparation cannot be a purely academic exercise, but is embedded in the fabric of society and subject to pressures from all kinds of interest groups.

This explains why accounting standard-setting has long remained markedly different from one country to another, reflecting wider differences in economic systems. Partly because of the size and diversity of the US and of its (perhaps related) pervasive culture of litigation, accounting in the US is heavily 'rules-based', with US GAAP a prescriptive body of detailed rules. By contrast, accounting in the UK, though sharing with the US a primary orientation towards the needs of market participants rather than of government, has been more 'principles-based', with fewer and less all-encompassing rules, and a stronger emphasis on accountants' professional judgment. As Ethiopis Tafara, a senior official at the SEC, recently remarked, the heavy focus on retail investors in the US inevitably leads to more rigid rule-making. In his metaphor, the UK market is like formula one motor racing: what counts is the driver's judgment, which allows him or her to make choices based on an informed assessment of constraints and risks. By contrast, the US is more like a public road system, where *'the 50 mph speed limit provides the optimal protection'*⁶.

Still different traditions developed in other industrialised countries. An alternative model of accounting was provided by the 'General Chart of Accounts' (*Kontenrahmen* in German, *Plan Comptable Général* in French). First developed in the 1920s by

6. Quoted in Robert Bruce, "Oceans apart on the rights and wrongs of control", *Financial Times*, 18 January 2007.

Eugen Schmalenbach, a German academic, it was subsequently adopted by Nazi Germany as well as the Vichy régime and the post-war Fourth French Republic. This system, unlike in the US, provides a uniform framework that facilitates detailed comparisons and aggregation by national statisticians of the financials of all companies, and is therefore well-adapted to the needs of wartime or planned economies. However, its rigidity makes it less well suited for the information requirements of private-sector investors. Partly as a result of European-level legislation since the 1970s, Germany, France and other developed countries have gradually shifted from this approach and developed hybrid systems that incorporate many features of UK accounting practices and American standards. But their standard-setting processes have retained specificities linked to their respective economic models, including, in some countries such as France, the presence of organised labour as a constituent in the national standard-setting bodies. Furthermore, accounting standard-setting in France has been directed by the state and heavily influenced by state needs such as tax collection, the production of national statistics, and banking and insurance supervision. In Germany, standard-setting has been dominated by creditors' concerns, and thus overseen by the justice ministry, in charge of bankruptcy law. In most Commonwealth countries, as in the UK, it was entrusted by government to private-sector bodies emanating mainly from the accounting profession. Overall, in the second half of the 20th century all developed countries formally developed national accounting standards and issued laws mandating their use by a wide array of companies incorporated in the country, including all listed ones.

Developments in Asia and other parts of the world have tended to follow those in Europe and the US. In Japan, a US-style accounting framework for listed companies was created in 1949 following the introduction of new securities legislation, and the standard-setting function was transferred to an independent entity, the Accounting Standards Board of Japan, in 2001. In Malaysia, Singapore and Hong Kong, UK-style institutions based on a strong organisation of the accounting profession survived the end of British colonial rule, and later followed accounting standards' developments in the UK. Following the opening of China to capitalist enterprise, a financial accounting framework was set up as well, likewise in Russia and other post-Communist countries after the fall of the Berlin Wall.

1.2 The birth and development of international standards

In June 1966, Henry Benson was elected President of the Institute of Chartered Accountants of England and Wales. Later (1981) to be made Lord Benson of Drovers

in the County of West Sussex, he was the grandson of one of four brothers who founded the accounting firm Coopers (now part of PricewaterhouseCoopers) in 1854. By the 1960s, he was already one of the most prominent figures in the accounting profession in the UK and internationally, following distinguished public service during the war and the spectacular development of his family's firm into a worldwide leader.

When elected, Benson gave a short address to the Institute's Council, in which he mentioned invitations he had received to visit his counterparts at the Canadian Institute of Chartered Accountants and the American Institute of Certified Public Accountants. He then added: *'I have had the feeling for a long time that our relations with those Institutes were very friendly but somewhat remote and, with the Council's approval, I shall see whether I can perhaps get them on to a more intimate basis'*.

These characteristically understated words marked the beginning of international accounting standard-setting. Benson recalls the moment in his autobiography, published in 1989 under the title *Accounting for Life*:

'My private but unstated ambition at that stage was to make it, as I think it turned out to be, a turning point in the history of the accountancy profession. The United Kingdom, America and Canada were the three most important countries at that time in the world of accountancy, but there was very little dialogue between them. No attempt had been made to make them closer together to advance the interests of the profession as a whole or to get a common approach to accountancy and audit problems. The Canadian institute was closer to the American institute than we were because of their geographical position but each of the three pursued its own policies without reference or collaboration with the other two. I hoped to change this.'

Following Benson's visits, the three bodies jointly established an Accountants International Study Group in February 1967, which soon published papers on accounting topics and gradually developed its own doctrinal framework. This then formed the basis for the creation in 1973 of the International Accounting Standards Committee (IASC) by an extended array of accounting bodies from Australia, France, Germany, Japan, Mexico and the Netherlands, in addition to Canada, the United Kingdom (plus Ireland associated with it), and the United States. The IASC's stated aim was to issue international standards of reference which would guide the convergence of national standards over time. Benson was duly elected the IASC's first chairman, and opened its offices in London.

In the ensuing years, the IASC prepared and published a growing number of documents constituting an increasingly comprehensive body of rules, eventually completed in 1998 as a set of 39 so-called ‘core’ International Accounting Standards (IAS). Simultaneously, its governance evolved constantly to accommodate a growing and increasingly diverse stakeholder base. Belgium, India, Israel, New Zealand, Pakistan and Zimbabwe joined as associate members as early as 1974, and many other countries later followed suit. In 1981, the IASC’s Consultative Group was formed with representatives of the World Bank, United Nations, OECD, and various market participants. This group was joined in 1987 by the International Organisation of Securities Commissions (IOSCO, which brings together the SEC and its national counterparts around the world), and in 1990 by the European Commission and FASB, the US standard-setting body, as these two organisations joined IASC meetings as observers. In 2000, IOSCO recommended the use of IAS for cross-border offerings or listings. By the same time, a number of developing countries had taken the habit of using them as the reference for drafting their own national standards. Some, like Lebanon and Zimbabwe, had even made their use a requirement for banks or publicly-listed companies. Several developed countries, such as Belgium, France, Italy and Germany, had also adopted laws allowing large listed companies to publish consolidated accounts using IAS or standards very similar to them, without having to ‘reconcile’ them with national standards. Following the Asian crisis of the late 1990s, international accounting standards were also endorsed by the G7 Group of industrialised countries and by the Financial Stability Forum, a group of financial regulators hosted by the Bank for International Settlements in Basel.

In the late 1990s, it became clear that the IASC’s somewhat rudimentary governance framework, which was dominated by accounting firms and national organisations representing the accounting profession, were not appropriate given its high ambitions of having its standards adopted by major companies and jurisdictions. Therefore, the standard-setting organisation’s governance was extensively overhauled to increase its independence from the accounting profession. As the same concern had led in the US to the creation of FASB in 1973, the new governance framework, enshrined in a statutory ‘Constitution’ adopted in 2000, was closely modeled on FASB’s. However, this approach ignored the specificity of the international standard-setting organisation, which does not draw its legitimacy from a public authority, as does FASB from its endorsement by the SEC. The reform created the Delaware-incorporated IASC Foundation, a supervisory body governed by a group of trustees, and its subsidiary entity, the London-incorporated International Accounting Standards Board (IASB), both of which became operational in 2001.

TASTING THE IASB/IFRS ALPHABET SOUP

The International Accounting Standards Committee (IASC) was in operation from its creation in 1973 to the entry into force of the new 'Constitution' in 2001. At that date, it was replaced by the London-based International Accounting Standards Board (IASB), itself overseen by the Delaware-based IASC Foundation (IASCF). The 2001 reform also created an International Financial Reporting Interpretations Committee (IFRIC), replacing the former IASC's Standards Interpretations Committee (SIC) that had been created in the 1990s.

Simultaneously, the standards themselves were renamed. Prior to 2001 the IASC had issued International Accounting Standards (IAS), numbered 1 to 41. After 2001, new standards were named International Financial Reporting Standards (IFRS), of which eight have been adopted so far (IFRS 1 to IFRS 8, as of March 2007). However, it was decided to keep the IAS label for those standards which had been published before, even those that were revised after 2001, so they remained IAS 1 to IAS 41 – only 30 standards in fact, as some have been discontinued. Likewise, the existing SIC interpretations (SIC 1 to SIC 33) have been kept, even though two thirds of them have now been superseded, and the new ones since 2001 called IFRIC, numbered IFRIC 1 to IFRIC 12 as of March 2007.

Here we follow the common practice of using the collective 'IFRS' to refer to the entire body of standards and interpretations, ie all individual texts named IAS, SIC, IFRS and IFRIC once they have been approved by the IASB.

We also frequently use the acronym 'IASB' as shorthand for the entire standard-setting organisation that encompasses the IASB, the IASC Foundation as well as IFRIC and the Standards Advisory Council (SAC), which was also created in 2001. In some cases, to facilitate reading we also use 'IASB' in places where technically the IASC Foundation should be referred to, for example when referring to the 'Constitution' or annual reports.

The Foundation, in spite of its name, does not rely on a sizeable endowment and is therefore responsible for raising the necessary yearly funds for the functioning of the IASB and its staff. In 2005, total expenses were about £14m (€21m, \$28m), a level similar to the previous year's. The corresponding revenue was £9.4m in contributions from donors, and £4.5m from sales of publications.

182 financial supporters of the IASB were listed in the annual report for 2005. Public entities were a minority: 27 central banks and few other national bodies, the Bank of

WHO'S WHO AT THE IASB

The architecture created by the 2001 reform divides the tasks associated with standards-setting between different groups of individuals. We describe them here briefly, with reference to the organisation's 'Constitution' as last modified in June 2005.

The IASC Foundation has 22 trustees, of which *'six Trustees appointed from North America; six Trustees appointed from Europe; six Trustees appointed from the Asia/Oceania region; and four Trustees appointed from any area, subject to establishing overall geographical balance.'* Furthermore, the same text states that *'the mix of Trustees shall broadly reflect the world's capital markets and a diversity of geographical and professional backgrounds. [...] The Trustees shall comprise individuals that as a group provide an appropriate balance of professional backgrounds, including auditors, preparers, users⁷, academics, and other officials serving the public interest.'*

Under these provisions, current trustees co-opt new ones every time a position becomes vacant. In November 2005, an independent Trustee Appointments Advisory Group was created to help in the recruitment effort.

The Foundation's trustees raise funds and appoint the IASB's members, who are the only ones in charge of setting the standards. Paul Volcker, a former Federal Reserve Board Chairman, was elected the first Chairman of the trustees in 2001. In early 2006 he was replaced by Tommaso Padoa-Schioppa, who soon had to resign following his appointment as Italy's finance minister. Phil Laskawy, former Chairman and CEO of Ernst & Young, was then appointed as a caretaker during the search for a new high-profile chair, which is still underway at the time of writing (March 2007).

The IASB has 14 members, of which 12 full-time and 2 part-time, all appointed by the trustees. The Constitution stresses that *'the selection of members of the IASB shall not be based on geographical criteria'* and that *'the main qualifications for membership of the IASB shall be professional competence and practical experience. The Trustees shall select members of the IASB so that it will comprise a group of people representing, within that group, the best available combination of technical expertise and diversity of international business and market experience*

7. In the profession's jargon, 'preparers' mean employees of the (generally publicly-listed) companies which issue public financial statements, typically corporate financial executives; and 'users' mean the people who use the financial information to advise, prepare, or make investment decisions, typically financial analysts, employees of rating agencies, and investors, including individual investors and investment fund employees.

in order to contribute to the development of high quality, global accounting standards.'

In 2001, David Tweedie, a Scottish accountant who formerly headed the Accounting Standards Board of the UK, was appointed the first Chairman of the IASB, a position he still holds. As of March 2007, the other members are Thomas Jones (Vice-Chairman), Mary Barth (part-time), Hans-Georg Bruns, Anthony Cope, Philippe Danjou, Jan Engström, Robert Garnett, Gilbert Gélard, James Leisenring, Warren McGregor, Patricia O'Malley, John Smith (part-time), and Tsatsumi Yamada. In July 2007, Hans-Georg Bruns is due to retire and the terms of Anthony Cope and Patricia O'Malley will expire. At that date, Zhang Wei-Guo is due to join the Board, and John Smith to become a full-time member. The names of the other individuals who would fill the vacant positions are not known at the time of writing.

In addition to the trustees and IASB members, the standard-setting organisation also includes the 12 members of IFRIC, 41 members of the Standards Advisory Council (SAC), and the IASB's permanent staff, which in late 2006 numbered about 65, almost all based in London.

Full-time members of the IASB are asked to resign all their other positions when joining the Board. Trustees, IFRIC and SAC members, and the two part-time members of the IASB all hold another job, aside from their involvement in international standards-setting.

International Settlements, the World Bank, and the International Monetary Fund. Their total contribution was less than £1m, or 8.5% of the total budget for 2005⁸. Other contributors were the Big Four accounting firms, contributing \$1m each, and private-sector companies from the financial and non-financial sectors, as well as a few industry organisations. The 131 contributing companies listed in 2005 (not counting the Big Four) could be divided between geographical zones as follows, using the location of the main headquarters as a criterion: 52 (or 40% of the total) from Europe, 33 (25%) from the US, 29 (22%) from Japan, 7 (5%) from Latin America, 6 (5%) from Canada, and 4 (3%) from the rest of the world⁹.

The IASB, therefore, is a private-sector (though non-profit) body, in whose governance the role of public institutions is fairly limited. It can be accurately described as essentially entrepreneurial in nature. The enterprise was initiated by an individual,

8. IASB press release, 'EU Finance Ministers Support Trustees' Long-Term Financing Plan', July 2006.

9. As the IASB does not disclose the exact amounts of individual contributions, the geographical breakdown of total funding may differ somewhat from these percentages.

Henry Benson, and to this day its incentives and processes make it fundamentally different from international organisations that are created by a treaty and supported by nation-states.

1.3 Connecting to the real world: EU adoption and global spread of IFRS

The IASB's mandate is described in Article 2 of its 'Constitution':

- ‘[a] To develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions;
- [b] To promote the use and rigorous application of those standards;
- [c] In fulfilling the objectives associated with [a] and [b], to take account of, as appropriate, the special needs of small and medium-sized entities and emerging economies; and
- [d] To bring about convergence of national accounting standards and International Accounting Standards and International Financial Reporting Standards to high quality solutions.’

The IASB develops standards, and is the sole decision-maker as to their content. But as regards their eventual endorsement in national (or international) legislation, implementation, and enforcement, the IASB has no powers of its own. It can only *‘promote the use and rigorous application’* of IFRS, not make them a requirement. This is where nations and governments come in.

As recently as 2000, as we have seen, no significant jurisdiction had made use of IFRS compulsory. Indeed, only a few had allowed their use for public financial statements as an alternative to national standards. As the US was the dominant national market, US GAAP were universally seen as the dominant system of accounting standards, even though a number of countries had drawn on the IASB's technical work to draft their own national standards.

Now, in early 2007, almost all publicly-listed companies in the European Union report their financial statements using IFRS¹⁰. Increasingly, countries beyond the EU have

10. With the only exception of a few provisions of the IAS 39 standard on financial instruments, which as we shall see have not yet been endorsed by the EU. Furthermore, some European listed companies that report under US GAAP rather than IFRS are authorised to continue doing so until 2009.

made use of the international standards compulsory, and others, such as Australia, have made their own national standards completely or almost identical to IFRS. Others, including Canada and possibly Japan as well, are poised to do so within the next few years, and others still authorise listed companies to use IFRS for their public accounts, even when there is no requirement to do so.

A quick review of the world 500 largest publicly-listed companies illustrates the shift¹¹. 37% of them are primarily listed in the US and report only under US GAAP. 39% are listed in jurisdictions, such as the European Union, Australia, China, Hong Kong or Singapore, which mandate IFRS or near-identical standards. An additional 20% are in countries, such as Canada, South Korea or Japan, in which convergence of national standards towards IFRS can be presented as only a matter of time. As things stand, it looks as if IFRS, not US GAAP, are becoming the dominant system of accounting standards worldwide.

The single watershed event behind this dramatic shift has been the decision taken by the EU in 2000, in the wake of the Financial Services Action Plan it had announced a few months earlier. That year, the European Commission formally proposed the adoption of IFRS as the sole set of standards for the publication of consolidated accounts by publicly-listed companies from 2005 on. This was swiftly (by EU standards) confirmed in a Regulation of the European Parliament and European Council of 19 July 2002, which set out an endorsement process by which the IASB's standards and interpretations would be given legal currency in all EU member states.

As a result, thousands of European publicly-listed companies released their 2005 consolidated financial statements using IFRS, and have now correspondingly ceased publishing consolidated financials under the national accounting standards of their respective countries. National standards remain in use only for the publication of individual (non-consolidated) financial statements, which are much less used by investors than consolidated figures.

The adoption of IFRS in the EU has triggered a series of similar moves all around the world, including in major developed economies. Even though some of these jurisdictions were gradually harmonising their accounting standards with IFRS before, it is unlikely that this would have led to complete convergence without the momentum provided by the EU decision.

11. Ranking: FT Global 500, update of 31 December 2006; from www.ft.com.

THE EU ENDORSEMENT PROCESS

While the July 2002 regulation (Regulation of the European Parliament and of the Council, No. 1606/2002) affirmed the principle of IFRS adoption by companies listed in the EU, it did not endorse any specific accounting standard but only set up a process for such endorsements in the future.

Thus, IFRS standards or IFRIC interpretations, once adopted by the IASB, need to be specifically acknowledged (and translated into many languages) by the European Commission to become part of EU law. For example, a first such Commission regulation, of 29 September 2003, adopted all existing IAS and SIC at that time except the controversial IAS 32 and IAS 39, which were later adopted (with reservations) in late 2004. In total, there have been 15 such Commission regulations from 2003 to 2006 included. As a result, the standards applicable in the EU may differ from the full body of IFRS if some standards or interpretations are temporarily or permanently not adopted. Furthermore, in the case of IAS 39 some provisions were disregarded in the adopted text (see the end of this box).

The endorsement is subject to a series of consultations: of the private-sector European Financial Reporting Advisory Group (EFRAG), where diverse business interests are represented; of the 27 EU Member States represented in an EU Accounting Regulatory Committee; since late 2006, of the Economic and Monetary Affairs Committee of the European Parliament; and also, since March 2007, of a Standards Advice Review Group of accounting experts.

The July 2002 regulation specifies three conditions which are necessary for a standard or interpretation to be adopted: (1) the text is not contrary to the principle, enshrined in existing EU directives, that annual and consolidated accounts shall give “a true and fair view” of the company’s or group of companies’ assets, liabilities, financial position and profit or loss; (2) the standard is ‘conducive to the European public good’; and (3) the standard meets ‘the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management’.

As it happens, the IASB’s conceptual framework explicitly endorses the aims of understandability, relevance, reliability and comparability as the key criteria for the quality of accounting standards. Therefore, the main consequence of the regulation’s wording is that the Commission, first, reserves the right not to adopt standards in which the IASB does not respect the principles currently set out in its own framework; and, second, may also refuse standards which would not be deemed

‘conducive to the European public good’. This latter, emphatically fuzzy legal notion can be seen as a way to preserve a discretionary right of refusal of each standard. But crucially, the regulation does not give the European Commission the option to amend or rewrite a given standard. It can only adopt each text, or decline to do so. In a 2003 article (see bibliography), Karel Van Hulle, an official in the European Commission and key member of the team which drafted the July 2002 Regulation, wrote: ‘As there exists no intention to develop euro-IAS, endorsement will always be full endorsement (or no endorsement) of any given standard’.

There has been one exception to this principle, in the case of the controversial IAS 39 standard on accounting for financial instruments (see also section 3). The Commission regulation that adopted it on 19 November 2004 ‘carved out’ (i.e., suppressed) some provisions from the text of the standard. This move, whose legal robustness is fairly uncertain, is now described by the European Commission as a temporary fix. Indeed, one of the two ‘carved-out’ provisions, on the so-called Fair Value Option, has now been reworded by the IASB and subsequently adopted by the European Commission in November 2005. The same is likely to happen in the near future for the remaining ‘carved-out’ items.

Notwithstanding the specific case of IAS 39, as of March 2007 the EU had adopted all existing IAS standards (numbered 1 to 41) and SIC interpretations (1 to 33); IFRS standards numbered 1 to 7; and IFRIC interpretations numbered 1 to 9. At the time of writing, it has given no indication that it will permanently reject any of the texts adopted by the IASB that it has not yet endorsed.

In the rest of this text, for EU-based companies we often refer to financial statements using IFRS where technically the right wording would be ‘those international accounting standards and interpretations adopted by the European Union’, the main difference at this point being the few still ‘carved-out’ provisions of IAS 39.

- The EU’s immediate neighbours have almost entirely shifted to IFRS simultaneously with the EU. Members of the European Economic Area, such as Norway and Iceland, have to comply with EU regulations anyway so they did not have a choice. Switzerland likewise requires the use of IFRS since January 2005, except for those Swiss companies whose international activities are small, which can continue using national standards. Turkey also requires IFRS use from all companies listed on the Istanbul Stock Exchange, and Israel is eliminating its national standards in favour of IFRS as well.

- Australia's Financial Reporting Council decided in July 2002 to adopt national standards equivalent to IFRS (dubbed A-IFRS), to be implemented by listed companies in accordance with the same timetable as the EU, i.e. for reporting periods starting from 1 January 2005 on. A-IFRS are nearly identical to IFRS, and the Australian authorities are progressively removing those differences that still exist (which actually make A-IFRS generally more demanding than IFRS).
- Hong Kong Financial Reporting Standards are also identical to IFRS for all practical purposes since the end of 2004. Singaporean standards still keep some differences with IFRS, none of which is very significant.
- Canada is now taking a similar route. In September 2004, the Accounting Standards Board of Canada started a consultation process on the possible convergence of its standards towards IFRS, and in January 2006 it ratified a strategic plan that confirms the objective that after a multi-year transition period, Canadian accounting standards will become identical to IFRS and will cease to exist as a separate set of rules. 2011 is currently envisaged as the date by which Canadian standards will have completed their gradual convergence towards IFRS.

Japan's approach to the Global Accounting Experiment has been more cautious than that of Europe, Australia and Canada, but it now also seems to be engaged in an unambiguous, if gradual, process of convergence towards IFRS. In early 2005, the Accounting Standards Board of Japan (ASBJ) started a formal process of discussion with the IASB, with simultaneous work on several standards and regular meetings between the two bodies. This process is likely to result in a pattern of adoption similar to that in the EU, even though no deadline has been set yet for completion and some thorny issues still need to be resolved.

Other major Asian economies, such as Taiwan or South Korea, have increasingly taken IFRS as a source of inspiration for their national standards after the 1997 crisis. On 16 March 2007, South Korea announced its own roadmap towards full IFRS adoption, with completion scheduled for 2011.

IFRS are also spreading in many emerging economies:

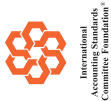
- Brazil is adopting IFRS for its banks, if not at this point for the rest of its listed companies¹².

12. As is the case for most of Latin America, many of Brazil's large listed companies are simultaneously listed on a US exchange and therefore already publish financial statements using US GAAP.

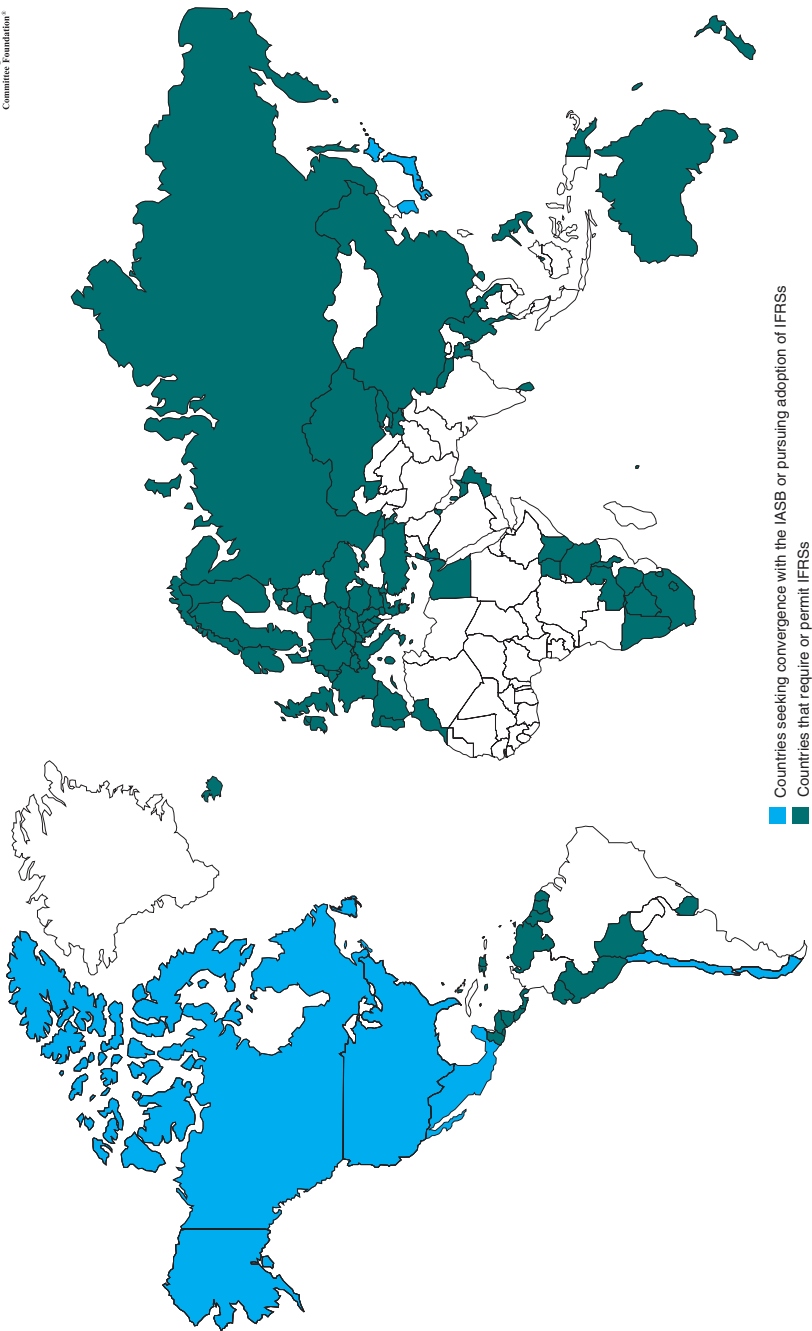
In March 2006, the Board of Directors of the Central Bank of Brazil decided to require that all Brazilian banks, as well as other financial institutions including leasing companies and savings and loan institutions, fully comply with IFRS beginning with the financial statements for the year ending 31 December 2010.

- In Russia, Finance Minister Alexei Kudrin announced in early 2003 a plan to require all companies publicly listed in Russia to publish their consolidated financial statements using IFRS, starting with the disclosures for the financial year 2004. The corresponding legislation was given preliminary approval by the Duma (parliament) on 29 October 2004, even though the move was later delayed. Furthermore, many of Russia's large companies already report financial statements using either IFRS or US GAAP: for example, Gazprom, Russia's largest listed firm by market capitalisation, reports financial statements in accordance with IFRS.
- In India, Prime Minister Manmohan Singh announced in March 2006 that his government would introduce comprehensive new company legislation that will include aligning Indian accounting standards with IFRS. In October 2006, a working group was set up to this end by the Institute of Chartered Accountants of India.
- Last but not least, China has now also adopted IFRS. By the early 1990s, accounting standards were mainly determined by the needs of state planning for most enterprises, except joint ventures involving foreign partners. However, financial reporting standards were gradually developed with many references to IFRS, since 1998 under the direction of a new body, the China Accounting Standards Committee. In November 2005, this committee decided to eliminate most of the remaining differences, and adopted the corresponding standards in February 2006. As a result, the standards applicable, from January 2007 on, to some 1,200 companies listed in Shanghai and Shenzhen can be considered near-identical to IFRS. The main remaining difference is on 'transactions with related parties', which can hardly be comprehensively reported because the pervasive presence of the Chinese state makes it difficult to mention them all (any two state-owned enterprises should be considered related parties).

In China as in other developing economies, however, any reference to financial statements prepared 'in accordance with IFRS' needs to be taken with a pinch of salt. The most daunting challenge there is not the standards' adoption, but their proper enforcement in



THE MOMENTUM TOWARDS GLOBAL IFRS ADOPTION
More than 100 countries require or permit the use of International Financial Reporting Standards (IFRSs), or are converging with the IASB's standards.



Source: IASB [2006], based on information from Deloitte.
N.B.: the map does not differentiate between countries and regions that require IFRS use by listed companies, such as the EU and China, and countries that permit it without making it a requirement, such as Russia.

a context of massive underdevelopment of the accounting profession, both quantitatively and qualitatively: China has no more than 70,000 practising accountants (many of them poorly trained), while the size of its economy would probably require between 300,000 and one million¹³.

Nevertheless, with the Chinese adoption of IFRS and the convergence processes in Canada, India, South Korea and Japan, it can be said that most of the non-US world either has adopted IFRS or has made a strategic decision to adopt them in the near future.

1.4 The United States and the IASB: another special relationship

At least since the aftermath of World War II, the United States has been at the forefront of corporate finance innovation and regulation. It was also associated with the Global Accounting Experiment from the outset. The dominance of US capital markets and the unparalleled powers of the SEC among securities regulators worldwide meant that the US financial environment, be it through SEC representatives or US members of the accounting profession, has always exerted a strong influence. For example, when the IASC decided to overhaul its governance in the late 1990s, the nominating committee for the appointment of the new trustees was chaired by Arthur Levitt, then Chairman of the SEC. Paul Volcker, former Chairman of the US Federal Reserve Board, was subsequently elected in 2001 the first Chairman of the Trustees of the IASC Foundation. And within the proceedings of the IASB, American members such as Thomas Jones or James Leisenring have been particularly influential.

The US authorities, and especially the SEC, have given important institutional backing to the Experiment, particularly in the 1990s when International Accounting Standards came closer to forming a comprehensive set that could be used as the sole rules to prepare financial statements (an aim that was completed in 1998), rather than a series of documents on specific issues that could only inspire national standard-setters on a piecemeal basis. This backing came both directly and indirectly through IOSCO, an organisation in which the SEC is considered the largest source of influence. The formal backing of International Accounting Standards by IOSCO, first envisaged in 1987 and eventually granted in 2000, was essential to give them the credibility that enabled the EU to consider their endorsement. At the beginning of the 21st century, it looked like the SEC had a fairly comfortable position: at home, it was

13. According to *The Economist*, "Chinese accounting: Cultural revolution", 13 January 2007.

in control of US GAAP; and outside the US, it could exert significant influence on international accounting standards whose use it encouraged.

However, this context was profoundly modified by the Enron bankruptcy in December 2001 and other accounting scandals that erupted in 2002, following the bursting of the late-1990s stock market bubble. Before this wave of controversy, specific US GAAP standards had been occasionally criticised but overall it was widely considered, in the US and elsewhere, that US GAAP as a whole were the best available set of accounting standards. The US had been the first country to issue accounting standards (in the 1930s), and the first one (with the creation of FASB in 1973) to rely on a standard-setting body that could credibly claim independence both from the accounting profession and from direct political pressure. It had been at the forefront of introducing new and workable solutions to many difficult accounting issues such as reporting for business segments (in 1969), goodwill amortisation (1970), financial leases (1976), or post-retirement health costs (1990)¹⁴. But Enron's collapse shattered the perception of high quality. It exposed the shortcomings of some detailed US GAAP rules, most notably those on consolidation which gave Enron enough leeway to hide its now famous 'special-purpose entities' (with their funny names such as Chewco, Raptor, Jedi, or Big Doe) off its balance sheet, packing them with real debts backed by flimsy assets.

A new situation emerged, in which IFRS, recently bolstered by their European endorsement, could be seen as an alternative to US GAAP. Some observers, such as Robert Litan at the Brookings Institution, advocated free regulatory competition between the two sets of standards. In February 2002, a Senate Committee investigating the Enron debacle heard the testimony of IASB Chairman David Tweedie who explicitly criticised the rules-based approach which is prevalent in US GAAP, contrasting it with the more principles-based stance adopted by the IASB. Shortly thereafter, the Sarbanes-Oxley Act specifically mandated the SEC to study how a more principles-based system (such as IFRS) could be introduced in the United States¹⁵.

This sequence of events frames the present, somewhat unstable, state of the relationship between the IASB and the US. On the one hand, the US is home to the largest capital markets, has been a key backer of the Global Accounting Experiment from the outset, and the IASB and trustees see eventual IFRS recognition in the US as the Holy Grail of

14. There were some cases, however, where change and progress came from elsewhere than the US. For example, the requirement to add a statement of cash flows to the yearly financial statements was adopted first in Australia in 1983, then in Canada in 1985, and only in 1987 in US GAAP.

15. The SEC's report, published in 2003 (see Bibliography), disputes the principles-based nature of IFRS, and proposes limited reforms to the US accounting framework.

their whole enterprise. On the other hand, US leadership in worldwide capital markets has been eroded, scandals such as Enron have been followed by a call for more 'light-touch' regulation and principles-based standards, and the IASB is in fact in a strong position to treat the US as just another constituency that may adopt its standards. The first set of factors explains the feeling, increasingly frequent in Europe, that the IASB is subservient to its US interlocutors, especially the SEC and FASB. The second set results in an increasing number of US stakeholders being tempted to endorse IFRS on their own merits.

Since the early 2000s the FASB and IASB have been seeking to narrow the differences between US GAAP and IFRS – a process they call 'convergence', but which in fact is very different from the unilateral convergence of, say, Australian or South Korean accounting standards towards IFRS. The premise, enshrined in the so-called Norwalk Agreement of September 2002¹⁶ and renewed by a FASB-IASB Memorandum of Understanding in February 2006, is that both sides would need to move some way towards each other. In this process, on some issues FASB adopts standards identical or near-identical to existing IFRS (e.g. for stock option expensing); on other issues the IASB adopts standards identical or near-identical to existing US GAAP rules, as with the IFRS 8 standard on 'operating segments' (see section 3); and on yet other issues the two bodies jointly develop entirely new projects. But the process is fraught with difficulties and can hardly be expected to lead to complete convergence, as some US GAAP rules remain firmly embedded in the US national context and cannot easily be transposed to other environments, while the IASB claims to issue principles-based standards for global use.

In parallel with the IASB-FASB convergence process, the US authorities and their international counterparts, most prominently the EU, are discussing the possibility of mutual recognition. They start from an asymmetric situation. The EU currently allows listed companies to report under US GAAP with no requirement to 'reconcile' their financial statements with IFRS (i.e., to explain all differences between statements under US GAAP and IFRS) at least until 2009. By contrast, the SEC forces all companies listed in the US to reconcile their financials with US GAAP. In April 2005 the SEC agreed with European Commissioner Charlie McCreevy a 'roadmap' that may lead to the eventual elimination of the reconciliation requirement for European companies that prepare their accounts using IFRS, *"as early as possible between now and 2009 at the latest"* in the words of the then SEC Chairman, William Donaldson¹⁷. This aim has since been reaffirmed by Donaldson's successor, Christopher Cox. Moreover, if

16. It was signed in FASB's home city of Norwalk, Connecticut.

17. Press release of the SEC, 21 April 2005.

foreign US-listed companies are allowed to report financial statements prepared using IFRS only, then some US companies may also be interested by this option and they may lobby the SEC to be allowed to ditch US GAAP altogether, as emerged in the latest discussions about this matter¹⁸. How the US Congress and executive branch would react to such a prospect, however, remains to be seen.

18. See *CFO.com*, "Will the SEC Let U.S. GAAP Die?", 7 March 2007.

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2. The forces at play

The birth of international accounting standard-setting in the late 1960s and early 1970s is mainly attributable to market needs, linked to growing internationalisation of both corporate activity and investment patterns. Their striking expansion in the past few years has been driven by a different set of forces, namely policy dynamics of the European Union in the late 1990s and early 2000s.

At this point, it can be argued that the IFRS are emerging as a global reference for accounting standards, which are themselves among the key rules that govern capital markets and corporate development. What may disrupt the trend towards IFRS dominance is the subject of the next section. In this one, we focus on the forces that appear to have sustained it until now.

Two key factors help explain the remarkable expansion of the Global Accounting Experiment so far. The first one is the support it received, from its inception in the early 1970s and with renewed force in the 1990s, from the international financial community, not least in the US, that encouraged the commitment to it of the accounting profession in most countries. The second factor is the European decision, essentially made in early 2000, to make IFRS compulsory for its own listed companies. This is what ultimately transformed the IASB from little more than a high-profile accounting think tank into an organisation with de facto power over what thousands of large companies do or do not do. Once again the numerous countries which have endorsed IFRS since 2000 would probably not have done it so swiftly in the absence of the initial European impetus.

2.1 The birth: a response to market needs

Beyond Henry Benson's entrepreneurial drive, the Global Accounting Experiment was primarily a response to the needs of market participants, whose activities assumed an increasingly cross-border character in the 1960s and early 1970s. This was pri-

marily the case for the multinational corporations which emerged at that time and to which the use of markedly different accounting standards from one country to another appeared costly, unnecessary and potentially dangerous as it multiplied the risks of error or malpractice.

Also, on the investment side it was a time of increasing cross-border mobility as investors moved funds from one developed country to another to chase the best investment opportunities. For international investors, it was desirable to be able to assess companies' economic performance on the basis of comparable information whatever their country of incorporation. International accounting standards were an attractive proposition to achieve that goal.

At the time, both the largest multinational companies and the most powerful investors were US-based, and the influence from the US over the development of the IASC should not be underestimated. Indeed, though the father was clearly Benson, Americans were present all around the cradle. The IASC's first secretary (its most senior full-time official) was Paul Rosenfield, an American accountant seconded by the American Institute of Certified Public Accountants (AICPA). When Henry Benson's term as the body's first chairman expired in 1976, his successor was another American, Joseph Cummings. As has been noted above, key American public and private figures have lent their support to the international body at various key moments of its development. Altogether, it seems fair to portray the Global Accounting Experiment in these early years as a UK-born idea which survived thanks to US backing¹⁹.

The late 1960s and early 1970s was a time of intense debate about accounting standards among US market participants and regulators. Indeed, FASB was created as an independent, private-sector standard-setter in the US the same year as the IASC, in 1973. The formation of FASB followed years of criticism of the previous regime, in which the SEC essentially relied on the Accounting Principles Board (APB), a committee formed in 1959 by the AICPA, to develop and update US GAAP rules. The criticisms, relayed by the financial press, focused on the incapacity of the APB to 'narrow the difference' between companies' still widely divergent accounting practices. The then 'Big Eight' accounting firms were partly responsible for this lack of consistency. Each large firm tended to defend its own views on what the best accounting practices

19. The history of the IASC, from its birth to its replacement by the IASB in 2001, is covered by a new book by Kees Camfferman and Stephen Zeff referenced in the Bibliography. However, its date of publication (March 2007) has not permitted to use it as a source for this text.

were, even though Arthur Andersen, whose name at the time stood for the highest professional standards, regularly advocated more uniformity of rules.

One example of the interplay of interests around accounting standards at that time is linked to the intense merger and acquisition activity during the 1960s, which led to the formation of powerful conglomerates. Conglomerates often disclosed only aggregated financial information, which meant little due to the heterogeneous business models of their different divisions. In 1966, the US Senate's Subcommittee on Antitrust and Monopoly held hearings that persuaded several lawmakers that the economic effects of mergers could not be properly assessed if one had no information on the individual performance, including revenues and profits, of each of a conglomerate's 'segments'. In 1967, the APB issued a statement on segment reporting, but, under heavy lobbying from corporate financial executives, failed to make it mandatory. Because of the wide discontent this state of affairs created among investors and other market participants, the SEC had to overrule the APB and itself impose a segment reporting requirement, first (in 1969) for new issuers and later for all listed companies. Only in 1976 did FASB issue its own standard on the subject²⁰.

In this context, the reforms of the early 1970s were driven by two concerns: first, to make the standard-setting process more independent from corporate interests, and second, to bring consistency to the accounting rules and therefore meet the growing market demand for financial information that would be relevant ('decision-useful', in the profession's jargon) in order to make investment choices. Thus, one study group established in 1970 led to the creation of FASB in 1973, and another one published a document on Objectives of Financial Statements. The conceptual clarification exercise formed the basis for the later publication, from 1978 to 1985, of FASB's 'Concepts Statements', describing the fundamental concepts on which FASB is supposed to ground any individual standard. Alongside the SEC, some of the major accounting firms, including Arthur Andersen, played an instrumental role in bringing about this evolution.

In this light, the IASC's establishment offered to US stakeholders an opportunity to broaden the debate: both to make sure that other countries would not diverge too markedly from the demanding conceptual framework that was being built in the US, and also, for the US accounting profession to bring external voices that would possibly loosen the SEC's embrace on all things accounting. In effect, the accounting philosophy adopted by the IASC, which (to put it briefly) puts emphasis on balance

20. This historical analysis owes much to the paper by Prof. Stephen Zeff, referenced in the Bibliography.

sheet items (assets, liabilities and equity) as a basis for the determination of revenues and costs, is very close to the one formed by FASB in its early years of activity. When in the late 1980s the IASC eventually completed its own conceptual document, the Framework for the Preparation and Presentation of Financial Statements, it largely based itself on FASB's Concepts Statements.

Simultaneously, because it was not bound by the highly litigious US environment, the IASC could issue standards that were more principles-based than the detailed, prescriptive US GAAP rules as they had evolved over the years. This was also in harmony with the British tradition of emphasising 'substance over form' in accounting choices, which resulted in short, principles-based standards enabling the exercise of judgment in assessing diverse real-world situations. The IASC was also more independent than FASB from US special interest groups, which made it on several occasions useful for the SEC to overcome local opposition to certain accounting reforms. A recent example of this dynamic is the reform of the accounting treatment ('expensing') of stock options, whose prior adoption by the IASB was used by the SEC to impose it in the US in 2004-05 in spite of fierce political opposition, most prominently from the high-technology sector.

Thus, the IASC very much followed the pattern of other international initiatives, including outside the financial or economic area, which were shaped by the US interest in fostering an open environment based on the rule of law throughout the non-Communist world. But, in the IASC's case, market participants and the accounting profession played the key initial role, and public authorities affirmed their interest in the experiment only later. The interaction between the IASC and its US constituents has been a complex one, with many ups and downs and shifting alliances, but it continuously displayed a strong degree of dependence; it is doubtful that the IASC would have survived without US backing. However, the next defining step was to come not from the US, but from Europe.

2.2 The spread: European integration through global rules

Promising as its start had been, the international standard-setting organisation had only limited policymaking power until its standards began being adopted by major jurisdictions. It was the EU's adoption of IFRS in 2000-2002 which definitely saved it from the risk of irrelevance and gave it its current prominence on the world stage. Therefore, one needs to focus on the causes of this decision in order to trace the roots of the IASB's current clout.

Europe's endorsement of IFRS was a radical decision: a rare example of EU countries in effect delegating sovereignty to a global body without taking the intermediate step of organising the corresponding function at EU level. To understand it, one must look back at the steps that came before. In the 1970s, there had been much talk about harmonising accounting standards across Europe. These efforts resulted in the two landmark directives (European-level framework legislation), on annual (individual) corporate accounts in 1978 and on consolidated accounts in 1983. These texts, coupled with market pressure, led to some convergence of heavily state-bound accounting systems such as the ones prevalent in France and much of southern Europe, and of intermediate systems such as Germany's, towards a more investor-oriented philosophy for practices and standards as already existed in the English-speaking world. However, the convergence that took place remained well short of harmonisation, let alone unification of standards, and it stalled in the 1980s. In the absence of a European standard-setting authority and of any enforceable process to drive convergence, standard-setting remained a national task which was only marginally impacted by the two directives.

A critical new development happened in the 1990s, when it became clear all across Europe, and not least in Germany, that prominent corporations and high-growth companies were attracted to listing their shares on the New York Stock Exchange (NYSE) or on Nasdaq²¹. For this, such issuers had to comply with US securities legislation and therefore to publish sets of financial statements using US GAAP, under close oversight by the SEC, alongside the ones they published before using the accounting rules of their home country. This highlighted the extent of the differences between US GAAP and most continental European standards, in a way which generally made US GAAP appear more rigorous and demanding. The watershed in this respect was probably when Daimler-Benz, the Stuttgart-based industrial giant, became the first German company to list its shares (or more accurately, American depositary receipts) on the NYSE in October 1993. The SEC forced Daimler to reclassify 4 billion Deutsche Mark (DM) in pension provisions as extraordinary profit for 1992, and for 1993 the company had to publish a loss under US GAAP of DM1.8bn (ca. €950m) while its accounts using German standards showed a net profit of DM615m (€315m). Following this and other cases, the opinion became widespread that accounts in US GAAP could provide investors with higher-value information than accounts prepared in accordance with most national European rules.

21. Some continental European companies had listed in New York already in the decades before, but the trend intensified in the 1990s.

The flow of secondary listings of European companies on US markets accelerated during the second half of the 1990s, including in the technology sector as a consequence of very high valuation levels. This led to European fears that the most dynamic parts of the European corporate world would be increasingly subject to US rather than European regulation and legislation, a concern that was only accelerated by the late-1990s technology bubble when Nasdaq appeared as the preferred venue for hot international Initial Public Offerings. Therefore, policymakers felt an urge to counter the 'flight' to the high-quality US GAAP environment by the adoption of better standards in Europe, which would bring credibility to the European market environment and simultaneously preserve a voice for national governments and EU institutions in the preparation and adoption of the rules.

This defensive concern dovetailed with Europe's own integration agenda, which in the area of financial markets had lagged somewhat and was made more visible by the adoption of the euro, effective since January 1999. The renewed interest in Europe's financial integration triggered a series of market developments, including the first project for a combination between the London Stock Exchange and Deutsche Börse in 1998, and soon afterwards the merger between the Paris, Brussels and Amsterdam bourses to form Euronext. The European Commission eventually pushed an ambitious set of legislative and regulatory initiatives, the Financial Services Action Plan, which it adopted in May 1999.

Although the Action Plan did not explicitly endorse IFRS, it included the aim of "*moving towards a single set of financial statements for listed companies*"²². This same objective was repeated at the EU's Lisbon European Council meeting in March 2000, which, apart from famously setting the goal for Europe to become "*the most competitive and dynamic knowledge-based economy in the world*" by 2010, also specified 2005 as the deadline for the unification of accounting standards EU-wide. Eventually, in June 2000 the Commission announced in a policy paper that it "*believes that the adoption of International Accounting Standards are [sic] the way forward*"²³. The European Commission then decided to adopt the standards by means of a regulation, i.e. legislation directly applicable as national law in all EU member states, and thus more immediately efficient for harmonisation than the directives which had been adopted in the 1970s, and which require 'transposition' into national legislation by each EU member state. After its ratification by the European Parliament and Council (the then 15 member states' governments), the regulation was officially adopted on 19 July 2002.

22. European Commission Press Release, 11 May 1999.

23. European Commission Press Release, 14 June 2000.

Therefore, the decision path can be summarised in three steps, which explains the apparent paradox that the EU adoption of IFRS was both a surprisingly bold public policy initiative, and a move whose intent was primarily defensive. First, the completion of the Single Market Programme and of Economic and Monetary Union, coupled with the ‘irrational exuberance’ and vibrant market development of the late 1990s, persuaded governments that they could no longer adhere to purely national accounting standards. A common accounting language was needed.

Second, for several reasons the idea of creating EU-wide standards could attract no decisive support. One reason was the failure of directive-led accounting harmonisation in the 1970s and 1980s. Another was the low appetite in some countries including the UK, home to Europe’s largest financial centre, to see the emergence of EU-level rulemaking in a matter as crucial for business as accounting standards. From the City’s point of view, IFRS adoption provided a means to achieve desirable accounting harmonisation, while still ‘keeping Brussels at bay’—not to mention the advantage of having the standard-setter already located in London. Furthermore, it was far from obvious that the EU could assemble the technical capabilities, skills and efficient processes that would enable it to issue standards that could compete with IFRS and US GAAP on the same level of quality. Finally, and perhaps most decisively, the rapid pace of global integration of financial markets made many participants doubt that creating a new set of standards with primarily European scope would make any sense at all.

The third step, then, was straightforward. If the EU could not contemplate standards of its own, then it only had two options left: either totally surrendering accounting sovereignty to FASB through the flight of the best companies towards US GAAP, as was spontaneously happening (pre-Enron); or just partially surrendering it to the IASB. It is hardly surprising that Europeans chose the second option rather than the first one.

Nevertheless, the initial degree of consensus around the decision was remarkable, and would prove short lived. The regulation was approved in March 2002 in the European Parliament by 492 votes out of 526 (with only 5 votes against, and 29 abstentions), and then unanimously by the Council in June (including the ten ‘enlargement’ countries that would become EU Member States in 2004, and which then participated as observers to the process). Only later did controversy, most prominently about the IAS 39 standard on financial instruments, show how much sovereignty they had abandoned in the process – namely, that accounting standards were really

important as a *de facto* policymaking instrument, and that the IASB was essentially independent from European special interests. For better or worse, the landmark EU adoption of IFRS was decided by leaders who, at least in some cases, probably failed to recognise the wider political implications of their choice.

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3. The next challenges

The forces driving the Global Accounting Experiment are insufficient to guarantee its continued success. It is bound to face major challenges in the next few years. Two main factors are behind this: the deficit of legitimacy and accountability of the IASB, and the difficulty of ensuring consistent implementation of IFRS across sectors and countries.

An extrapolation of the dynamics presented in section 1 seems to point towards universal IFRS adoption. Even the US, it now seems, may soon consider endorsing the use of IFRS alongside US GAAP. But the trend is also very recent. Only ten years ago, anyone who had have described the present situation as a credible scenario would have been considered a day-dreamer, including probably within the IASC.

Strong as it presently looks, one should not forget the international accounting framework's essential frailty. The IASB is a small-sized private-sector organisation, with no broad-based legitimacy outside its continued capacity to develop good-quality financial reporting standards, and with unresolved funding problems. Unlike FASB, it cannot rely on the godfatherly protection of as powerful a public agency as the SEC. With the July 2002 regulation, the European Union has granted it substantial power; but this power can be taken back with just another regulation. The same is true of other countries as well. There is no international treaty supporting the Global Accounting Experiment, and there are no current plans to create one. As the SEC's Chairman put it recently, *'As the world's securities markets continue to integrate, it's easy to imagine that the process of continued harmonisation of standards is inexorable – somehow impelled by forces of nature. But it isn't so.'*²⁴

The IASB would be wrong to conclude from the awesome achievements in the past few years that it can now declare 'mission accomplished' and to steer a business-as-usual course. The seeds of a possible backlash abound. IFRS adoption has many distributional effects, and creates its own winners and losers. To give but one example,

24. March 2007 speech by Christopher Cox: see Bibliography.

relationship-based financial systems such as those which traditionally prevailed in Germany or Japan are challenged by IFRS adoption, and politicians are increasingly taking notice. A recent academic paper expressed the striking opinion that *“long-term [human resource] investments become more difficult to pursue [following IFRS adoption], thereby increasing tensions with labor and demotivating workers to invest into their skills. In sum, the introduction of fair value accounting techniques as prescribed by the IASB threatens to undermine core comparative advantages of the Rhenish model”*²⁵. Justified or not, such opinions may gain ground as the use of IFRS spreads.

One must remember that so far, no market downturn has put the solidity of IFRS accounting to its ultimate real-world test. Therefore, the pitfalls that could appear along the way must be taken seriously.

3.1 The legitimacy challenge and the Spider-Man Principle

“With great power there must also come – great responsibility!” What is known to fans as the Spider-Man Principle is first expressed when Uncle Ben advises Peter Parker / Spider-Man not to abuse his newly-acquired superhuman powers, and to instead use them actively for the common good. Uncle Ben soon dies; Parker never forgets the lesson²⁶.

Only now is the IASB gradually discovering the full extent of the responsibility that its success has imposed upon it. Until around late 2002, when European companies started to realise in earnest that they had to prepare for the shift to IFRS accounting, the IASB's proceedings were followed only by a small group of specialised accountants. Now, most listed companies worldwide are affected by the IASB's output, including those which report under Japanese or even US standards through the indirect impact of the convergence process. This means unprecedented political pressure. The IASB now needs to understand the interests of its various constituencies – multinational corporations, audit firms, investment banks, fund-management companies, various public authorities in the EU, China, the US and elsewhere, international organisations, central banks, and many others still. It needs, crucially, to strike the right balance between these interests, to fulfill its mandate²⁷ and to ensure its own survival.

25. Paper by Andreas Nölke at Vrije Universiteit Amsterdam: see Bibliography.

26. Original story: Stan Lee and Steve Ditko, *Amazing Fantasy*, Number 15, August 1962.

27. Unfortunately, the mandate itself rests partly on a fudge. By claiming that all stakeholders' information needs are best served when accounting standards provide the best-quality information to investors, the IASB's 'Framework for the preparation and presentation of financial statements' papers over substantial divergences of interests among stakeholders, and thus provides a fragile base for the IASB to resist conflicting claims from different groups.

The IASB has tested its ‘superhuman powers’ already once, in the European debate about the standard on financial instruments, or IAS 39. This standard extended the scope of financial assets and liabilities to be accounted for at ‘fair value’, compared with the existing national standards in most countries which allowed accounting at historical cost (i.e., the price paid when the instrument was acquired even if this was long ago, as opposed to the amount at which it could be exchanged in an arm’s length transaction between informed and willing parties—the standard definition of fair value), or no accounting at all in the case of financial derivatives.

IAS 39 was opposed by many European banks, for various reasons. It was a complex standard, and open to technical criticism on several accounts. More importantly, it was ill-adapted (or perhaps threatening) to banking practices and business models that are common in several European countries, such as long-term fixed-rate retail loans, or specific savings accounts with attached options like the French *Plan Épargne Logement*.

The discussion soon went beyond the technical, and in 2003-04 it evolved into open warfare. Banks, which enjoyed enormous influence in their home jurisdictions, found it difficult to admit that the IASB would not heed their arguments. Specifically, in several European countries, the banking industry had benefited for decades from a sector-specific set of accounting standards, with a number of prudential provisions that increased the banks’ ability to survive crises but made them less than transparent vis-à-vis investors. Instead of seeking a technical compromise, the IASB stonewalled and escalated the discussion into a decisive test of its independence. The banks escalated even more, hoping that the threat of the EU refusing to endorse IAS 39 would force the IASB to knuckle under. In the summer of 2003, France’s President Jacques Chirac intervened directly in the debate with a letter to Romano Prodi, then President of the European Commission, highlighting that some IFRS rules may result in harmful financialisation, an untranslatable word expressing the evils of unfettered finance. But in the end, the EU blinked. The IASB did not amend its standard, and the face-saving compromise was the previously mentioned ‘carve-out’ of several paragraphs of IAS 39 in the version that was endorsed by the EU, at the eleventh hour in November 2004.

The IASB had met its objective of showing its independence vis-à-vis European stakeholders. Its strategy was sound but the tactics had been highly rigid, which lost it several friends and the support of many in Europe, not least within the European Commission.

This defines the first of five major risks of failure of responsibility that can be identified at the current juncture: the risk of the IASB losing its European constituency, which arguably remains its most important one to this day. The experience of IAS 39 proved that the endorsement process gives the EU only limited leverage. However, the EU has the more material option, if it is really not happy with the IASB, to reverse its 2002 regulation and to stop relying on IFRS as such. As explained in the previous section, creating a new Europe-wide standard-setting organisation would be fraught with major difficulties, but not impossible, especially if (unlike in the 1990s) the move were to be supported by the UK. The use of this 'nuclear option' would be a potentially lethal failure for the IASB, and would greatly reduce the prospects of its standards being adopted by other countries in the future – just as the IFRS adoption by the EU in 2002 has spurred similar moves all around the world. The fact that there is no prospect of this in the short term does not mean that the possibility does not exist. Facing anger at the European Commission, and the European Parliament's increasing concern about what it perceives as a lack of public accountability, the IASB will need time and dedication to rebuild some goodwill in Brussels, Strasbourg, and not a few corners of the City of London. Doing so, while keeping the standard-setting process' independence intact at the same time, will be a challenge.

The second risk is a symmetrical one vis-à-vis the other side of the Atlantic: avoiding harmful capture by the US constituency, while keeping alive the prospect of the SEC's endorsement of IFRS. This is a complex political balancing act to manage, and until now the IASB members have not generally behaved as natural-born politicians. The convergence process with US GAAP, as heralded in the Norwalk Agreement of 2002 and ensuing joint IASB-FASB documents, is riddled with ambiguities. As previously noted, this particular breed of 'convergence' means that each party has to go some way towards the other, with no guarantee of improved standards quality as a result. Furthermore, the dialogue is unequal. FASB derives strong public legitimacy from its backing by the SEC, itself a mighty public agency under close oversight by the democratically-elected US Congress. The IASB has been established in 2001 with a governance structure that mirrors FASB's, but the parallel is utterly misleading as it has nothing comparable to the SEC's institutional support. FASB is also a larger body, with more staff and arguably more experience than the IASB. Moreover, many individuals who spent a large part of their career at FASB hold prominent positions in the IASB's own staff. Therefore, the discussion is heavily tilted towards the IASB being led to adopt US GAAP rules rather than FASB embracing IASB principles, with a risk of negative net effect on IFRS quality.

The most visible example so far is probably the IFRS 8 standard on 'operating segments', adopted by the IASB on 30 November 2006. This is essentially a copy of FAS 131, the corresponding US GAAP rule. Most representatives of users of financial information, during the public consultation conducted by the IASB in 2006, expressed doubts about this standard. Compared with the previous IAS 14 standard which it replaces, IFRS 8 runs the risk of leading to lower-quality disclosures and to a decrease in the quality of information available to investors to assess key elements of companies' performance and value, both by failing to impose consistent reporting formats for the operating segments and by allowing companies to restrict their disclosures on geographical segments. Therefore, the change from IAS 14 to IFRS 8 can be described as a decision taken solely for the sake of convergence with US GAAP, in spite of the criticism emanating from users which see it as a poor move from the point of view of standards' quality.

A third major risk is disengagement by market participants. On the corporate side, many corporate chiefs and financial executives have expressed doubts over the relevance of the depiction of their company's operations under IFRS. In August 2005, Jon Symonds, chief financial officer of AstraZeneca and chairman of the Hundred Group of finance directors [of UK-based companies], voiced sharp criticism of IFRS, saying he did not want *"a technical and theoretical approach [to accounting] to undermine communication between business and owners"* and, about the convergence process, expressing *"some concern that the strength of the relationship between the IASB and FASB means we are heading down a US path without adequate debate"*²⁸. Companies have made a big investment to comply with the 2005 deadline and publish their first financial statements under international accounting standards. Now, many of them have felt frustration that reporting under IFRS is ill suited for the specific character of their operations, and that they need to communicate with the financial community using non-IFRS measurements of performance (often referred to as 'pro forma'). Still more troubling, some prominent representatives of the investment community, the 'users' whose needs IFRS are meant to serve as a priority, have criticised important IASB choices and projects, not least the currently debated revision of the IASB's conceptual document, the Framework for the Preparation and Presentation of Financial Statements²⁹. These multiple misgivings mean that, in the event of difficulties, the need for collective action could be undermined by the temptation to indulge in mutual blaming and finger-pointing.

28. Barney Jopson, "UK's top groups in U-turn on accounts", *Financial Times*, 26 August 2005.

29. See the letter sent to the IASB by the International Corporate Governance Network (ICGN), a group of large investors and governance experts worldwide, 2 November 2006; available on www.icgn.org.

Fourth, there is the risk of paralysis—of the IASB becoming overly cautious, and therefore unable of addressing the challenges of the day. All its key standards, including the IFRS 2 rule which covers stock-option accounting, were completed or almost completed before the IASB started causing large-scale controversy. Since then, the IASB has mainly completed texts with a narrow or predominantly technical scope, such as IFRS 5 (non-current assets held for sale and discontinued operations), IFRS 6 (exploration for and evaluation of mineral assets), and IFRS 7 (disclosures regarding financial instruments). But it has had to postpone more sensitive proposals such as the one on financial statement presentation (or ‘performance reporting’, as it was previously called), which could significantly alter the way companies report their activity, or the one on insurance liabilities which promises to raise tricky technical and political difficulties. However, the IASB cannot defer these and other projects indefinitely. Insurance liabilities require a rule consistent with the IAS 39 standard that governs accounting for insurers’ financial assets; and financial statement presentation is a keystone without which the body of IFRS remains badly incomplete – even if the IASB has been unable to build a consensus on its early proposals to solve this need.

Finally, the ancillary issue of the Global Accounting Experiment’s funding is unresolved to this day. Before 2001, the IASC was mainly funded by national accountancy bodies but in the 1990s this was rightly considered incompatible with the requirement for independence. Furthermore, its size and budget have significantly increased in the past few years. In 2001, the somewhat haphazard current funding framework was put together for an initial period of five years, with the commitment that a more stable financing scheme would be in place by 1 January 2006. This deadline was then extended by two years, until 2008, during the ‘Constitution Review’ in 2004-2005 which resulted in the latest amendments to the IASB’s statutory document. The trustees have now decided a number of no-nonsense principles for the eventual funding framework³⁰, but getting the money in does not seem to be proving easy.

A 2006 speech³¹ by Tommaso Padoa-Schioppa, then Chairman of the Trustees, graphically conveys the organisation’s uneasy sense of urgency about its own funding in the medium term. It also illustrates the ambiguity of the IASB and IASC Foundation regarding the issue of accountability. As Padoa-Schioppa puts it, “*true, there is a*

30. “Principles for a new funding system”, blueprint approved by the IASC Foundation’s Trustees in their March 2006 meeting; available on www.iasb.org.

31. March 2006 speech by Tommaso Padoa-Schioppa: see Bibliography.

sense in which the IASB is accountable, but the equivalence to other public bodies has a limit in the fact that the IASB does not have the power to make the standards obligatory". This is technically correct but, as highlighted before, the EU's and other jurisdictions' leverage is limited. Consequently, the IASB has so far refused to argue for a tax-like funding mechanism, but faces the difficult challenge of raising more than \$30m yearly in the future (the March 2006 document mentions £18m in 2008) on a purely voluntary basis for what is in essence a regulatory function. It is possible that the trustees will succeed in this effort, but there will also be a strong incentive for the voluntary funders, be they listed corporations, audit firms or trade associations, to do some tough bargaining before displaying their 'sense of responsibility'. Or, to put it in the blunter language of one of the most in-depth studies of IASB governance so far, "*it appears that powerful firms will seek to trade cash for favors as long as IASB funding is voluntary*"³².

3.2 The implementation challenge and the Curse of Babel

One of the staples of the European Commission's rhetoric on IFRS adoption since 2000 has been that it would put an end to the "*accounting tower of Babel*" that plagued Europe under the previous regime of national standards³³. However, the biblical story of Babel is one of language unity turned into fragmentation, and not the reverse [notwithstanding the fairly short-lived exception of Pentecost, when each pilgrim heard all others "*in his own native language*" – mutual recognition then, rather than harmonisation].

The same could apply to accounting. Again, IFRS are mainly principles-based standards that do not enter – or at least, less than US GAAP – into prescriptive rulemaking. This means that there can sometimes be several different ways of implementing them in concrete situations. IFRIC, the interpretative committee attached to the IASB, has until now adopted a fairly limited conception of its role, with an average of only four to five interpretations issued every year since 1997³⁴, and has rejected many demands for interpretations. It refuses to give detailed implementation guidance in cases which the IASB think should be governed by individual, decentralised judgment. This is a consequence of the heterogeneity of implementation contexts, as Gilbert Gélard, one of the IASB's 14 members, expressed it recently:

32. Walter Mattli and Tim Büthe, "Global Private Governance": see Bibliography.

33. For example in Internal Market Commissioner Frits Bolkestein's speech while presenting the final version of the IFRS regulation. Press Release of the European Commission, 14 December 2001.

34. Including the ones issued between 1997 and 2001 by SIC, its predecessor committee.

‘IFRS cover the world, which is heterogeneous from many points of view. Too prescriptive standards would risk not giving a fair representation of transactions, either because it privileges conditions specific to some countries or some industries without being relevant for others, or because it seeks to understand all aspects of all things—an effort which is bound to fail. Global standard-setting is bound to be somewhat general, and wary of the forced uniformity that would result from too detailed rules; it emphasises relevance, which is not incompatible with differences in implementation.’³⁵

Such restraint by the standard-setter can lead to more responsibility taken by the companies which prepare financial statements, and by the auditors which examine them, as is the IASB’s intent. But it can also lead to fragmentation along sectoral or, more dangerously still, national boundaries. In the absence of guidance from the IASB, companies and auditors will inevitably turn to some third-party authority to secure their judgments and reduce legal uncertainty, be it the national securities regulator, the now-idle national standard-setting body (which, in most cases, has not been dismantled), industry groups, or other sources. If implementation is guided by nationally determined recommendations, then they may gradually diverge from one country to another, and the countries which adopted IFRS might be again plagued by the ‘curse of Babel’. The main promise of IFRS, of making the accounts of companies comparable for investors to make the right choices across countries and sectors, would be in jeopardy. The SEC’s Chairman recently insisted that *“We have got to be able to demonstrate that IFRS is indeed a single set of international accounting standards, and not a multiplicity of standards going by the same name”*³⁶. In short, as expressed by Ray Ball at the University of Chicago, *“Implementation is the Achilles heel of IFRS”*³⁷.

Even though IFRS have been implemented by European companies for two years now, it is still too early to have a complete view of early implementation. The European Central Bank warned recently that “implementation of the IFRSs appears, for the time being, to be rather diverse” but cautioned at the same time that “first-time application figures, while very interesting to observe, reflect more the nature and magnitude of the accounting adjustments that result from the transition to the new framework than what could be considered a medium or long-term impact”³⁸. The lessons of early implementation in 2005-06 will appear only slowly through a number of studies,

35. Gilbert Gélard, “Démarche normative et cadre conceptuel”: see Bibliography (our translation).

36. March 2007 speech by Christopher Cox: see Bibliography.

37. Ray Ball, “IFRS: Pros and Cons for Investors”: see Bibliography.

38. December 2006 report by the European Central Bank: see Bibliography.

including a high-profile one that was entrusted in February 2007 by the European Commission to the Institute of Chartered Accountants of England and Wales and may acquire reference status in Europe.

Against the serious existing risk of fragmentation, there are several correcting mechanisms—but all have their limits, and whether their cumulated effect will be enough is still unclear. First, auditors have among their tasks the enforcement of uniform implementation in all countries. Each of the Big Four firms has set up a global IFRS doctrine desk to harmonise internal opinions on the standards' interpretation and implementation, and to detect inconsistencies. This is a powerful mechanism to decrease the risks of cross-country divergences. Even so, it is unlikely to address all cases, and there is already anecdotal evidence of partners of the same firm in different countries putting their signature to financial statements that rely on diverging readings of IFRS rules. The generally decentralised governance of the Big Four networks makes it difficult to ensure complete consistency, even though the situation in this respect may differ from one firm to the other.

Second, there will be (and already is) market pressure from investors, financial analysts, and industry organisations, to promote uniformity of implementation. The financial community has invested ample resources in the shift of standards, and it does not want its rewards being undercut by divergent implementation. However, most investors and analysts feel they have already spent much time and money in monitoring the 2005-06 EU transition to IFRS, and will be reluctant to sustain over time the analytical effort that would be required to put sufficient pressures on companies to ensure comparability.

Third, the EU countries have identified the risk of fragmentation and created some tools to fight it, most notably within the Committee of European Securities Regulators (CESR), which brings together all 27 stock market regulatory authorities of the Union's Member States. The creation of a database of past decisions by national securities regulators on IFRS implementation could have a significant consistency-enhancing effect if such a database is made available to the public, a move that CESR says it may consider in the near future. CESR has also adopted common standards of enforcement, even though these obviously do not mean identical practice. Separately, the European Commission has also set up a 'Roundtable for the consistent application of IFRS in the EU' which brings together all supposedly key players: the Commission; the IASB; CESR; the Big Four accounting firms; the European Financial Reporting Advisory Group (EFRAG), which brings together industry partici-

pants and advises the Commission; national standard-setting bodies; and BusinessEurope, an organisation that represents companies at EU level. However, this is mainly about coordination and exchanges of best practices, and while dialogue can certainly be useful, it may also be doubted that the thorniest divergences of implementation will be eliminated this way.

Fourth, the SEC is likely to serve a useful purpose as a reference for implementation. The US securities regulator has not endorsed IFRS use, but it does oversee financial statements prepared using IFRS and published by foreign companies listed in the US, of which there are hundreds. Donald Nicolaisen, the SEC's then Chief Accountant, made it clear in April 2005 that *"securities regulators, including the SEC, need to ensure that compliance [of European companies' financial statements with IFRS] is enforced. The SEC [...] may find it necessary from time to time to weigh in on particular accounting interpretations"*³⁹. Furthermore, the SEC will monitor the implementation process more broadly to prepare its own decision on eventual IFRS recognition, which according to its previously mentioned 'roadmap' is currently envisaged in 2009. Because of the SEC's clout and skills, its pronouncements on IFRS implementation are likely to carry more weight than those of any other national securities regulators.

This would be no small paradox. As previously argued, the adoption of IFRS by the EU was at least partially a move to avoid exclusive US jurisdiction about accounting rules. The prospect of SEC-issued implementation guidance could give rise to political opposition in Europe, and to mismatches and biases due to the differences between US and European legal cultures. But it simultaneously offers the hope of at least partially reducing the risk of fragmentation in implementing the principles-based IFRS standards.

3.3 Further tests ahead

Other pitfalls may emerge that could rock the Global Accounting Experiment. According to some observers, the very relevance of having accounting standards is becoming questionable as a consequence of contemporary developments, especially new technology. The broader debate about the future of accounting is beyond the scope of this work, but several topical issues merit mentioning here.

First, the spread of enterprise resource planning (ERP) software makes it increasingly conceivable to generate all kinds of financial data in real time, without having to rely

39. Donald Nicolaisen, "A Securities Regulator Looks at Convergence": see Bibliography.

on the tedious processes of double-entry bookkeeping and in a way that allows their later adaptation to any system of accounting standards. An XML-based standard named XBRL (for eXtensible Business Reporting Language) has been developed since the late 1990s to provide an easy interface between ERP systems and the presentation of the resulting numbers in financial statements. Based on the technical possibilities of XBRL, the largest accounting firms have heralded the advent of 'real-time reporting' and started building corresponding service proposals for their clients⁴⁰.

However, the spread of XBRL has been slower than its sponsors initially expected. Furthermore, whether such a tool is useful or not to market participants, it is unlikely to eliminate the need for accounting standards. The use of financial data is poised to remain in large part based on human judgment, and that analysis requires a method to organise the immense volume of quantitative data produced by today's large companies. Accounting standards are such a method, and will continue to be used even if the double-entry technique as such were made obsolete by progress in software and automation of the production of financial data. Last but not least, the practical difficulties of generalising XBRL, which can be seen as a computer-era, multidimensional version of Eugen Schmalenbach's General Chart of Accounts, are easy to underestimate.

A potentially more serious threat to the relevance of financial reporting is the increasing importance of intangibles (copyrights, trademarks, patents, know-how and skills) in the value generated by companies. Even though the value of some intangible assets can be measured, this is generally much more difficult than with tangible assets, and in some cases downright impossible. Therefore, some analysts have argued, the advent of the 'knowledge economy' would mark the end of accounting as we know it⁴¹.

This view was especially advocated during the technology bubble of the late 1990s and 2000, when no link whatsoever could be traced between the stock market value of many internet start-ups and their financial statements (which generally indicated little revenue and much loss). A similar consideration could perhaps apply, albeit to a lesser extent, to a company like Google: very profitable, but nonetheless subject to enormous valuation multiples, with a spectacular discrepancy between accounting shareholders' equity (\$17bn at end-2006) and market value (\$143bn by late March 2007). However, one lesson that many analysts drew from the bursting of the bubble

40. "Vision from the CEOs of the International Audit Networks": see Bibliography.

41. See for example Robert Litan and Peter Wallison, *The GAAP Gap: Corporate Disclosure in the Internet Age*, Washington DC, AEI Press, November 2000.

in 2000-01 was that accounting indeed mattered, and that neglecting such things as revenue and cash flows could lead to significant investment mistakes.

Another criticism of IFRS is specific to their application to financial services companies, which, according to some observers, would run counter to objectives of ensuring financial stability. According to this line of thought, the earnings volatility created by 'fair value' accounting, especially when applied to financial instruments, and the impossibility of including cautionary provisions in a bank's balance sheet if they are not related to a precisely identified risk, have the potential of increasing systemic risk in the financial system. However, this danger becomes much less acute if a clearer distinction is drawn than has been the case in the past between the information needs of investors and those of prudential supervisors⁴². Furthermore, as noted by the European Central Bank in its recent report on this issue, "*many aspects of the new accounting framework in the EU may contribute to more financial stability*"⁴³, such as increased cross-border comparability and better information on the use of financial derivatives. It therefore appears unlikely that the sustained use of IFRS in the financial statements of banks and insurance companies will lead to insuperable incompatibilities with the objectives of financial supervision.

Finally, this brief review of the possible challenges to the Global Accounting Experiment would be incomplete without a mention of the questions raised by the current structure of the audit market for international companies, which is dominated by the Big Four international networks.

Accounting standards and the audit market are two separate discussions, both of them topical. The arguments on the high degree of concentration of the audit market and its implications in terms of choice, liability and audit quality are outside the scope of this paper. However, there are connections between the two debates, if only because of the prominent role the Big Four firms play both in setting international standards and in implementing them.

This includes issues of legitimacy of the IASB. Especially, there is resentment among a number of market participants that the accounting firms' influence leads to unnecessary complexity of the standards. According to this line of argument, complex standards create knowledge barriers that oblige companies and other entities to hire one of the big audit networks as they are the only ones to master the intricacies of

42. Claudio Borio, "When Supervisors and Accountants Clash": see Bibliography.

43. December 2006 report by the European Central Bank: see Bibliography.

IFRS accounting. However, there is no clear evidence of such rent-seeking, and the IASB retorts that its standards are no more complex than the underlying operations they help to report, which are indeed becoming more intricate with the spread of financial innovation.

A more insidious risk is that the concentrated structure of the audit market for large international companies would lead to complacency in implementing IFRS. As no regulator would want one of the Big Four to disappear (there is a growing consensus that a reduction of their number from four to three would be nearly unmanageable), incentives for conducting rigorous audits might be reduced and pose a general risk to the quality of financial reporting. This risk has been mentioned by several public authorities, including Treasury Secretary Hank Paulson in the US and the Financial Reporting Council in the UK.

At this point, there is no evidence that this risk has materialised. On the contrary, there are many signs that audit firms have become more rigorous and demanding vis-à-vis their corporate clients since the wake-up call of 2002, when the fall of Arthur Andersen showed how quickly suspicions of local malpractice could destroy an entire firm. This, however, does not close the debate about whether the current market structure allows a high level of audit quality to be sustained over time, and whether the right incentives are in place. Especially, the question of the possibility of competition from new entrants on the audit market, if an incumbent were to fall short of acceptable standards of quality in the future, remains open.

3.4 The experiment's high stakes

The challenges to the success of the Global Accounting Experiment need to be measured against the consequences of failure. The stakes are high, both from a practical and symbolic point of view.

In practical terms, accounting standards, which we have termed the operating system of capitalism, have a significant impact on the functioning of capital markets and of the economy. Financial reporting is the key conveyor of information between companies and investors, and the growing intricacy of financial operations means that accounting is both a higher-value-added function than in the past, and one that carries more risks for the financial system. Global financial integration has the potential to contribute powerfully to global growth prospects by diminishing the cost of capital, but it also creates new demands and risks of its own. Accounting standards

are thus more important than ever in fostering high quality and comparability of financial reporting, and they have more influence than ever on corporate behaviour as financial complexity increases. The Global Accounting Experiment's failure, as defined at the beginning of this text as a return to fragmentation along national or regional lines, would go against the integration of global capital markets and thus decrease the corresponding regions' growth potential, even though this effect will remain highly difficult to quantify⁴⁴.

Also important is the symbolic importance of the Experiment, especially for the European Union. International accounting standard-setting is one of the most daring attempts to entrust worldwide policy responsibility to an entity that is not governed by international treaties⁴⁵. Therefore, its outcome may have some implications for the future of 'global governance'. As remarked by Francis Fukuyama in the quote reproduced at the beginning of this work, treaty-based international organisations, whose only direct stakeholders are sovereign states, find it difficult to address the mounting challenges of an interdependent world. Whether private-sector global organisations can credibly take a leading role in key aspects of global collective action is a question with many ramifications for the future.

We are still in the early phase of IFRS adoption, and the resilience of what has been achieved has not yet been tested. Market conditions have been highly favourable since 2003-04 and until now, even allowing for recent jitters. Furthermore, many difficulties of implementation have been papered over by the use of 'first-time adoption' options left to companies for their first-time application of IFRS, which means that they will only surface over time when the markets discover the full consequences of the choices of accounting policies made in 2005. The decisive tests will come with the first accounting scandals over companies reporting under IFRS – and there can be little doubt that such unfortunate events will happen at some point. Likewise, the political controversies about IFRS endorsement in 2003-04 may have appeared heated at the time, but they are probably tame compared with things to come.

44. It is important to stress, as already mentioned in the Introduction, that we do not consider here 'failure' a situation in which the US authorities would durably refuse to recognise the use of IFRS by US companies, or even by US-listed foreign companies. The reduction of the number of internationally relevant systems of accounting standards to just two (IFRS and US GAAP) is clearly beneficial in terms of reduction of the cost of capital, especially if IFRS are implemented with some consistency. However, complete unification of standards worldwide would raise risks of its own, of politicisation and bureaucratisation of the IASB once it had stopped facing any competition. For a discussion of this trade-off, see Ray Ball, "IFRS: Pros and Cons for Investors", referenced in the Bibliography.

45. There are other examples of this, such as the International Organisation for Standardisation (known as ISO) and the Internet Corporation for Assigned Names and Numbers (ICANN), but the economic impact of the IASB's decisions is arguably larger than theirs.

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4. Recommendations for sustainability

The magnitude of the challenges facing the Global Accounting Experiment makes it unlikely that current arrangements can stay unchanged for long. This applies both to the governance of the standard-setting process, and to the enforcement of consistent implementation of the standards. If the experiment is to succeed, initiatives should be taken to address the present shortcomings, without waiting for future crises. For the key players, the time to think and act is now.

4.1 The IASB's transition to adulthood

The IASB is a peculiar organisation. It is firmly rooted in the private sector, but has acquired effective public policymaking power, and hence public responsibility. Rising to this responsibility in a sustainable way will require a kind of leadership that it has not generally displayed until now. But such leadership does not come straightforwardly to a body which mixes, as the IASB does, shy accountants, seasoned turf warriors, and various other profiles, but few with lifelong experience of high-stakes public decision-making and public exposure.

There is still a nagging sense of denial of the Board's responsibility. When challenged on the economic consequences of standards, international standard-setters' knee-jerk reaction is to reply that the decision-maker is not them, but the public jurisdictions which endorse the standards. This is specious. As one of the key aims stated in its 'Constitution' is "*to promote the use and rigorous application*" of IFRS, the IASB must accept some responsibility for the consequences of its decisions. Dodging its public duties will take it nowhere.

In adapting itself to its new role, the IASB has a promise to keep – a global promise.

As stated in its 'Constitution', its purpose is to serve a global constituency of capital market participants and investors. This ambitious aim entails that its governance be strong enough to rule out capture by a particular jurisdiction or faction. The legitimacy required to fulfil the IASB's goals cannot be of the democratic sort, because no democratic constituency is conceivable at global level. But it must give sufficient voice to the multiple stakeholder groups on which accounting standard-setting relies, without offering the chance of one group unduly dominating the others. By the same token, all constituents are not equal in this consideration. Because the aim of accounting standards is to provide useful information for users of financial statements, the governance framework must ensure that these users, and among them various subcategories whose interests do not necessarily coincide, have a strong enough role. It must also recognise that regions with large, vibrant or rapidly developing capital markets are entitled to more voice than those where financial activity is minor or stagnant, unjust though this may otherwise sound from an egalitarian point of view.

These difficult governance questions were of relatively low importance when the international standard-setting organisation was in effect little more than a high-powered research and advocacy group, but they become crucial now that the IASB's power and responsibility have become substantial. Neither the coming into force of its 'Constitution' in 2001 nor the amendments made to that text in 2005 have provided a definitive answer to these questions. More must be done, starting with the recognition that this is an experimental process and that it cannot completely rely on any existing precedent.

Change has to come from the IASB itself. As noted by two academics who have applied the conceptual framework of the agency theory⁴⁶ to the IASB:

'More far-reaching changes [than the Constitution reforms of 2001 and 2005] are unlikely, however, as a result of structural difficulties, that is, the multitude of public-sector principals of the IASB. Lack of a single or primary public principal who could threaten IASB with renegotiating the grant of authority (as the SEC can do domestically in the United States), leaves the agent with greater freedom of action for at least two reasons: First, a setting with many public principals allows the agent to play off one principal against another. Second, such a setting gives rise to the kinds of collective action problems that are familiar from the literature on multiple principals⁴⁷.'

46. The agency theory models the relationships that emerge in situations where one party, the 'agent', is acting on behalf of one or several others, the 'principal(s)', and there is an asymmetry of information between the parties.

47. Walter Mattli and Tim Büthe, "Global Private Governance": see Bibliography.

Others may help, but only the IASB can take the initiative of wide-ranging governance changes. If well thought out, these would enhance the chances of the Global Accounting Experiment's success, and hence of the IASB's own long-term survival. Here are a few suggestions.

Recommendations to the IASB

Make the trustees accountable

At the core of the IASB's legitimacy problem is the fact that its trustees are a self-appointed group. The current 'Constitution' explicitly states that "The Trustees shall be responsible for the selection of all subsequent Trustees to fill vacancies" – i.e., nobody but the trustees has power over appointments. The formation of a Trustee Appointments Advisory Group in late 2005 has been a positive step, but no more than what its name says: just a consultative body, which has no ultimate decision-making ability. Legitimacy is bound to remain contested unless the organisation's stakeholders are given means, even indirect ones, to remove non-performing trustees or to block questionable appointments. This problem persists even if the current trustees are respected and the current appointments are sound.

Creating mechanisms for the representation of the IASB's stakeholders is bound to be tricky, but not unfeasible. Perfection should not be sought in such an exercise, just fair representation of the main constituencies – first among them investors and other users of financial statements, which the IASB rightly identifies as its primary stakeholders. One possibility would be to create a limited number of constituent groups: say, a group of users (investors, analysts, rating agencies), a group of auditors, a group of 'preparers' (listed companies), a group of states and regulators; to define rules of representation in each group; and to allocate to each group a share of total power: say, 40% for users and 20% for each of the other groups, with a cap of, say, 0.5% of total voting rights applying to each member of each group. Of course, this proposal is exceedingly sketchy, the numbers are purely indicative, and much public debate would be required to define a workable scheme. The important point is that doing so is within the limits of the possible, provided there is an agreement to make the trustees accountable.

A limitation of each constituent's power, be it the 0.5% cap suggested above or otherwise, would also serve to reduce the possibility of capture by any individual organisation or small group of organisations. Especially, there currently exists a widespread

suspicion of dominant influence of the Big Four accounting firms over the trustees and IASB, possibly increased by the fact that nine out of the 14 current Board members have spent part of their career with one of the Big Four or their predecessor organisations⁴⁸. Of course, there is an easy explanation for this: accounting skills are most abundant in these firms. But the suspicion, even if unfounded, is detrimental to the legitimacy of the IASB and should be destroyed at the root.

Make funding sustainable

The issue of funding is closely linked to that of accountability to stakeholders, and the current lack of formal accountability makes the IASB's current funding philosophy highly problematic. In March 2006, the trustees decided that the future funding scheme, to be implemented from 2008 on, should be 'open-ended', that is, "The financial commitments should not be contingent on any particular action that would infringe on the independence of the IASC Foundation and the IASB". Put simply, the funding must give rise to no obligation, or put even more simply, the funders should pay the standard-setters a permanent free lunch.

This is either unsustainable or misleading. Either the funders will stop giving, or in reality they exert influence but in a non-transparent way. To be sustainable, funding has to be connected with a mechanism to ensure accountability. Funding should create explicit rights, not of course to influence the standards but to play a role in the organisation's governance. As long as the trustees escape a formal mechanism of accountability, funding will remain a vexing issue for the IASB.

Put quality above speed in IFRS/US GAAP convergence

The 'convergence' program underway between the IASB and FASB has laudable aims of progress towards a unified set of accounting standards worldwide. But as argued in the previous section, it currently results in the partial capture of the IASB's agenda of priority projects by the SEC and FASB, which is not always conducive to high-quality standards. Subservience of the IASB to its US interlocutors risks seriously undermining its legitimacy vis-à-vis all non-US stakeholders, and furthermore deprives the US of an incentive to improve its own standards.

It is often heard at the IASB that such subservience during a limited period is a fair price to pay to obtain official IFRS endorsement by the SEC, after which it could regain its full

48. Source: biographies on the IASB's website.

independence. But this reasoning is misguided. If the convergence process results even temporarily in lower-quality standards, both the IASB and the US will lose out.

The IASB should recognise that the risks of the rushed timetable for convergence, contained in its February 2006 memorandum of understanding with FASB, are greater than the opportunities. By yielding to one country, it may hamper acceptance in all others. In the short term, convergence with US GAAP is not crucial to the success of the Global Accounting Experiment. Quality of IFRS standards is, and so is completing the set of IFRS so that they form a consistent whole. Therefore, the IASB should put its priority focus on projects such as Insurance Liabilities and the Presentation of Financial Statements, whose current absence results in harmful gaps in the body of IFRS. Similar prioritisation efforts should be made by IFRIC to ensure the timely availability of a consistent set of interpretations.

Convergence with US GAAP should of course not be abandoned. The costs of having two sets of standards are significant for some companies, if less prohibitive than sometimes depicted. The key consideration is that the process should be driven by the IFRS status as a reference to be emulated and converged with (as is the case with, say, Japan or Canada), not the other way round by the IASB's desperate desire to get close enough to US GAAP to be recognised by the SEC. If Board members yield to political considerations in this convergence process, to the detriment of standards quality, then the trustees should consider taking decisive corrective action. A substantial consultation of market participants on the pros and cons of the current convergence agenda could be a meaningful starting point.

The IASB has met a similar challenge in the recent past. By resisting the European Commission and individual European stakeholders on IAS 39 in 2003-04, it has ultimately built worldwide legitimacy. In the process it has not displayed admirable diplomatic skills, and left many bad feelings in Brussels and elsewhere, but its choice of proving its independence by not yielding to pressure was strategically sound. The same nerves must now be shown vis-à-vis the Board's American interlocutors. The IASB should recognise that the current process is not conducive to quality, and subsequently renegotiate its arrangements with FASB.

Provide full transparency

The IASB's financial transparency has much improved, but is still incomplete. The IASB's annual report does not even provide an exhaustive list of its funders (two

Japanese sponsors chose to remain anonymous in 2005), and more importantly, does not give any precise indication of the individual amount donated by each – apart from the Big Four, who donate \$1m each. This situation is not satisfactory for an organisation that has such an extensive public responsibility, and could give rise to unnecessary suspicions. It should prove easy to correct.

Transparency should also be provided regarding contributions in kind, such as the secondment of experts by large accounting firms, a practice which is common but not adequately reported by the IASB.

Make all information available for free

Currently, the IASB relies on the sale of its standards and other documents for almost one-third of its funding. Given their public importance and use, it is inappropriate that the key texts and related information can only be accessed through the payment of hefty fees. All drafts and texts, including information newsletters, should be made easily and freely accessible on the IASB's website. The IASB could continue selling printed versions of its standards, or licensing printing rights to third parties; but this should not, as now, hamper the public's free access to the corresponding information⁴⁹.

Monitor practice, implementation and guidance

The IASB's reasoning is often accused of being too abstract, and only loosely connected to the reality of practice. Some of the criticism is underhand, and uses the cover of the technical complexity of accounting debates to advance a special-interests agenda. That said, the IASB's standards can be adhered to only if they are grounded in a firm understanding of contemporary business practice. For this, the IASB needs more than anecdotal experience of its members or reliance on the vast practical knowledge of the Big Four audit networks, which cannot offer entirely objective monitoring of practice as they legitimately need to defend their own business model.

The IASB therefore needs to rely on sound, neutral observation of business and accounting practice, and also of specific issues raised by the implementation of IFRS and specific guidance issued by national or regional authorities or sources of juris-

49. This situation is now partly mitigated by the fact that the EU makes freely available on its own website the texts of the standards it has adopted, as well as their translations in the EU's many languages, and other jurisdictions provide similar public disclosure. However, this does not cover the full range of the IASB's documents. Moreover, there is no justification that the IASB should need to rely on the EU for this vital information function.

prudence. This item will be further discussed in the next section, on addressing the challenges of IFRS implementation.

Improve due process

The due process that leads to the IASB's standards and interpretations has considerably improved in recent years. Public consultations are now the norm, summaries and audio-casts of IASB meeting are now available on the internet, and transparency of the Board's workings has increased.

More can still be done, however, to bring the IASB's due process up to the best standards. More publicity could be given to its consultations, especially the most significant ones, including by communicating in the media. The IASB should publish summaries of the feedback it receives in each consultations, as some public regulators do. Simply uploading the responses received onto its website is not enough, as nobody bar the largest stakeholders can support the expense of reviewing dozens of comment letters in detail. And the IASB should not only publish the reasoning underlying its standard-setting decisions, as it currently does in so-called 'basis for conclusions' documents, but also mention the main counter-arguments it has received in the public consultation, and why it has chosen not to heed them.

Minimise geographical bias

This is another area where significant progress has already been achieved. Recent appointments to the IASB, such as Philippe Danjou (effective November 2006) and Zhang Wei-Guo (effective July 2007), have reduced a prior heavy bias towards English-speaking countries⁵⁰. This rebalancing should be continued, so that the IASB and its various bodies are not dominated by any single regional or cultural group, even though English-speaking countries must stay strongly represented.

Give it a name

Finally, and even if it may sound insubstantial to some, a new name should be found for the IFRS standard-setter, which now hides embarrassingly behind a forest of acronyms. 'IASC Foundation' 'IASB', to say nothing of 'IFRIC', are mind-numbing labels for any non-expert, and none of them actually designates the institution as a whole. (In

50. When the IASB was formed in 2001, 10 of the 14 Board members were citizens of English-speaking countries, seven of whom were from the US and UK alone.

this text, for the reader's convenience we have frequently used the acronym 'IASB' where technically the IASC Foundation should have been referred to.) Having a proper name would help the public better identify the international standard-setting organisation, and better monitor how it carried out its responsibilities.

All these recommendations are to the IASB, but other players have a role to play as well.

The US: accept the IASB's global promise

The US authorities face a difficult dilemma. They may be tempted to maintain and develop a dominant influence on the IASB, or they may accept the organisation's promise of a standard-setting process which is not controlled by any specific national constituency.

As was previously argued in this text, the first option is bound ultimately to fail. An IASB subservient to the US would not be accepted in the long term by the regions which have already endorsed IFRS, including most prominently the European Union and China, or those which are in the process of endorsing them. The risk of a political backlash against such an outcome is probably the single largest danger currently facing the Global Accounting Experiment.

The SEC will have to make a choice as regards IFRS recognition for foreign and domestic companies listed on US exchanges. It may elect to retain accounting sovereignty, and keep the current requirement for all such companies to reconcile their published financial statements with US GAAP; or eliminate the reconciliation requirement for foreign companies listed in the US; or accept full regulatory competition, i.e. IFRS as an alternative to US GAAP for US companies as well, as some are starting to lobby for. This is a key choice for the SEC, most likely under the close and watchful oversight of the US Congress. But whatever the eventual decision, the autonomy of the IASB and of international accounting standard-setting should be respected.

The EU: don't compromise on standards quality

The European Union should stick to the letter and spirit of its accounting regulation adopted in July 2002. It can exert legitimate and constructive pressure on the IASB by not endorsing standards that are at odds with the IASB's stated objectives or not conducive to a higher quality of financial disclosure.

This is arguably the case with the IFRS 8 standard on operating segments. The IASB had received fairly negative feedback on this standard (when still in draft form), in comment letters from many representatives of users of financial statements which participated in the consultation held in 2006; in March 2007, the same concerns were reiterated by some in letters to the European Commission⁵¹. Market participants fear that the implementation of IFRS 8 may lead to information of a lesser quality than with the current IAS 14 standard on segment reporting. An appropriate response by the European Commission would be to call for an analysis of past and current reporting under, respectively, IAS 14 and its FAS 131 counterpart in US GAAP. If such a study led to the conclusion that segment reporting is of better quality under IAS 14, the EU should consider a refusal to endorse adopt IFRS 8. This decision would minimise the risk of adopting a poor-quality standard, and it would also send a strong signal to the IASB and FASB that the EU is not willing to endorse bad compromise standards for the sake of convergence.

More broadly, all players that have a dialogue with the IASB – including the EU, the SEC, and public authorities for all countries which have adopted or consider adopting IFRS – should use their leverage to push for better governance and changes that would create trust and legitimacy, such as the proposals outlined above. Such pressure would help the IASB to take action and reform.

The investment community: commit skills and resources

The IASB and public authorities are not the only parties to this discussion. Especially, firms and groups in the investment community have tended until now to stay away from the international standard-setting process. As Mattli and Büthe noted in the already quoted paper, “We have found that those [stakeholders] with the least technical expertise—namely the users of financial statements (mostly investors, who additionally face collective action problems)—play hardly any role in the domestic and global governance of accounting standards”.

Indeed, investors form the most diverse of communities. To name but a few examples, mutual fund managers, pension fund managers, managers of state funds or non-profit endowments, wealth management consultants, hedge fund managers, private equity investors, venture capitalists, and day-traders may have widely different perspectives on accounting standards and the way they are implemented, depending

51. See Barney Jopson, “UK investors in plea to Brussels over IFRS 8” and “War of words sparked over new standard”, *Financial Times*, 21 March 2007.

on their investment horizon, risk diversification profile, volume of managed assets, and many other parameters. Nevertheless, they lose collectively from being absent from debates about accounting. A vigorous voice from investors would be the best possible guarantee of accounting standards that are both of high quality, and firmly rooted in market needs. Therefore, investors and other user groups should make themselves ready to commit some (relatively limited, given the global scale of their industry) human and financial resources to exert more leadership in the governance and monitoring of the IASB.

4.2 Preventing failure in the EU

This second series of recommendations is specifically targeted at the EU, which has made the most high-profile decision to adopt IFRS and represents by far the biggest financial market that uses international standards. If implementation in the EU fails, the Global Accounting Experiment is likely to collapse. If instead it leads to high-quality financial reporting, the experiment will have a high chance of success. Therefore, IFRS implementation in the EU has implications far beyond the EU itself.

Beyond the obvious need to comply with the standards and avoid accounting manipulation or fraud, the key quality criterion will be comparability. As mentioned earlier, the generally principles-based nature of IFRS and the large scope left to individual judgment in the preparation of accounts under these standards raise the specter of the ‘Curse of Babel’, the fragmentation of accounting language across myriad national and sectoral borders.

The EU regulation of July 2002 is built on the stark premise that once IFRS standards are adopted, no authority in the EU shall play any role in providing guidance to companies on how to use them. European Commissioner Charlie McCreevy explained in late 2005: *“what is absolutely clear is that we do not want any EU body, formal or informal, providing EU interpretation and guidance [on IFRS]. This runs counter to the whole philosophy of IFRS”*⁵². Auditors may help make the right choice of accounting policies, but besides them no source is to have any input between the company level and the global level of IASB and IFRIC, its interpretations committee.

This strong stance, however, is likely to collide with market realities. In theory, everybody agrees that principles-based standards are preferable, but in practice, most

52. October 2005 speech by Charlie McCreevy; see Bibliography.

market participants want some clear rules. Companies need legal security on their accounting policies. Auditors need to shield their responsibility and to know precisely what counts as accepted practice. Investors and other users need comparability, which also means clarity on what accounting choices to make in given situations. In total, there is a broad need for a body of conventions that guide companies in their decisions on accounting policies, help auditors to assess them, and help analysts and investors to understand financial statements under IFRS. Such conventions, whose status is above company-level accounting policies but below IASB-level interpretations or the standards themselves, might be termed 'IFRS guidance' (even though this word too is loaded, as the IASB separately publishes 'implementation guidance' together with each of its standards). Given the early experience of IFRS implementation, the question is no longer whether such guidance will be needed: it will. What is at stake now is rather where guidance should come from, and how to keep its production and content compatible with the international scope of IFRS.

In Europe as in the US, the opposition between principles-based and rules-based standards is often naïvely presented in black-and-white terms. The truth is that there is a continuum of solutions, and that both IFRS and US GAAP, in spite of their marked differences, are hybrid systems. There is now in the US a clear willingness to make US GAAP more principles-based. In his November 2006 speech in New York, Treasury Secretary Henry M. Paulson called for more principles-based accounting, while noting that *"businesses and auditors are searching for something that doesn't exist in today's constantly changing world - a rules-based safe haven that still provides investors with an accurate portrayal of a company's financial performance"*⁵³. Almost symmetrically, accounting under IFRS is inevitably going in the next years to be framed in more detail by interpretations and guidance, whatever the theoretical merits of a purely principles-based approach. As the IASB's Gilbert Gélard put it in the previously quoted article:

'The widespread opinion that depicts US standards as rules-based and IFRS as principles-based is unfounded. [...] Between these two extremes, one must look for an optimum for the diverse market participants: users, preparers, oversight and regulatory authorities.'

IFRIC is probably right to limit the scope of its own interpretations, given the diversity of contexts, from Shanghai to Moscow to Istanbul to Stockholm, in which its standards are implemented. But that also means that the necessary guidance will have

53. November 2006 speech by Hank Paulson: see Bibliography.

to come from somewhere else. The IASB's Chairman recently recognised the inevitability of local IFRS guidance in the US context, by noting that *"if the United States cannot accept the degree of judgment deemed appropriate elsewhere then the FASB may have to issue requirements additional to those of the IASB"*⁵⁴. Market realities are bound to lead the IASB to extend the same reasoning to other jurisdictions as well.

There are other related matters on which the EU appears somewhat ill equipped. In the standard-setting process, the current arrangement is awkward. The primary source of expertise for the European Commission is the European Financial Reporting Advisory Group (EFRAG), a private-sector group. Because this was criticised as excessive reliance on corporate views, the Commission recently added a Standards Advice Review Group of independent experts, which first met in early March 2007. But even with all these additions, the Commission remains short on in-house expertise to exert influence in the workings of the IASB, especially on the crucial early steps of new standard-setting projects.

Another issue is that the EU will face the overspill effect of IFRS adoption on non-listed companies. Technically, the July 2002 regulation mandates IFRS only for companies that issue listed securities, currently less than 10,000 in the whole European Union. But in fact, many more companies will be affected by the change, and many already are. The financial system cannot be rigidly divided into two parts, one where IFRS apply and the other where they are entirely absent. For example, private-equity funds or commercial banks are increasingly likely to require financial statements using IFRS from non-listed companies, to better compare them with listed benchmarks. The move will be gradual, but it is likely that the use of IFRS will be more and more pervasive, especially among companies which need external funding. The IASB has advanced a project for a separate set of rules for small and medium-sized enterprises (SMEs). It creates difficult dilemmas: these rules should be simpler than full IFRS, but they should not be too different either to ensure a minimal degree of comparability. Given the importance of SMEs as a political constituency, this is fraught with pitfalls that the IASB has understandably been wary to address. The EU currently appears somewhat confused on this issue, torn as it is between the desire for standards that would be easy to implement by small companies, and the need to deal with more sophisticated operations at larger ones.

The institutional steps already taken are insufficient to address these multiple challenges, and especially the most crucial of them, on ensuring consistent implemen-

54. March 2007 speech by David Tweedie: see Bibliography.

tation across the EU and providing appropriate guidance when necessary. The working processes and information-sharing among national securities regulators set by the Committee of European Securities Regulators (CESR) in Europe will certainly help. But CESR has limited authority of its own. Its procedures remain subordinate to the sovereign decision-making power of each of its 27 member organisations; and its arbitration processes, in those relatively infrequent cases in which they can be used, typically add significant delays, three months at least. Reserves can also be voiced on the build-up of IFRS expertise by the SEC, which will not examine all accounts under IFRS, but only those of the minority of European listed companies that also list in the US. There might inevitably be inconsistencies between judgments made by the SEC and by CESR, even though the two organisations have set up a process to exchange information and identify possible divergences. And as previously mentioned, the SEC's positions are likely to be met in Europe with some political resistance. Aware of these hazards, the SEC's Director of Corporate Finance recently declared that the SEC *"did not intend to become the arbiter of IFRS"* in the EU.

In total, the current arrangements risk giving rise to confusion because of the many competing sources of guidance, none of which is authoritative enough to be accepted by all others: national securities regulators, whose positions CESR has limited powers to harmonise; the SEC; national standard-setting bodies, threatened as they are with gradual irrelevance; coordination by issuers in a given country or industry; and other varieties of market-driven convergence. The multiplicity of these sources of authority, combined with the not insignificant interests that may be associated with different choices of application of IFRS, make it doubtful that practices will converge sufficiently for the benefits of accounting comparability to be reaped to their full potential.

[Set up an accounting authority for the EU](#)

If the EU is to avoid falling victim to the 'Curse of Babel', it needs to give itself the means to attain more unity of purpose and action. It is difficult to see how it could do so without an expert entity, with a dedicated staff and budget, to monitor practice and issue guidance for IFRS implementation at EU level. Such a 'European Accounting Authority' should be designed to work in close coordination with national securities regulators, complementing and partly replacing currently existing national services or bodies. With a clearer public mandate than EFRAG and better technical expertise than the European Commission can ever have in-house, it would also bring a stronger European voice than is currently the case in the international accounting standard-

setting process, and could thus take a prominent part in the ex ante technical assessment of new standards under preparation by the IASB.

Of course, the formation of a new body is bound to be complex and difficult. EU Member States have until now consistently refused, or failed, to create any new agency that may even remotely resemble a single European financial regulator. This refusal is mainly explained by the protection of national sovereignty and by concern about the risks of excessive centralisation, which could lead to low quality of regulation or low standards of accountability. But guidance for IFRS implementation is a financial regulatory task for which the national level is clearly inadequate, and where the principle of subsidiarity calls for EU-level action.

Several paths could be envisaged. If there is consensus among Member States on the need, a new European agency could be formed for this purpose, as has been done for, say, aviation safety or the evaluation of medicines, with appropriate governance and financial resources. This would be the most consistent option.

If, however, no political agreement can be found for transferring this task to an EU-level agency, a different approach could be envisaged, in which those countries that see it fit would decide that their respective regulators would rely on a 'shared services centre' for IFRS guidance, in effect by merging the accounting departments of national securities regulators. If enough countries were to subscribe to such a 'bottom-up' approach to create critical mass, it would go a long way towards creating the same effect as a pan-European agency.

In any case, the EU must realise that it cannot rest on its laurels yet as regards the adoption of IFRS. Significant political commitment will be required to shape appropriate mechanisms for consistent implementation and comparability – mechanisms that do not exist today.

[Let all players contribute](#)

Europe will be the make-or-break field for IFRS implementation, but of course other jurisdictions will have their own implementation challenges as well: China probably has the most daunting one. This will require close communication and exchange of information among regulators, to limit the divergence of local guidance to a minimum level. As previously mentioned, the SEC should be a key player in this coordination, as its own IFRS guidance (for companies listed in the US which publish accounts under

both IFRS and US GAAP} will carry a heavy weight of authority. IOSCO, the organisation that brings together securities regulators around the world, also has an important role to play. It should continue the effort it has started with the setting-up of an IFRS Regulatory Interpretation and Enforcement Database, which has been operational since January 2007.

The IASB must help, too. Together with its side body IFRIC, it must accept the necessity of local IFRS guidance, but it also remains best placed to comprehensively monitor developments in jurisdictions that have adopted IFRS around the world. This monitoring should lead it to react at the appropriate level if there appears any risk that local guidance would contradict the standards themselves. Such exercise of the IASB's moral, if not legal, authority to promote the worldwide consistency of IFRS implementation will be indispensable to avoid harmful divergence of national or regional practices, including those adopted in the EU.

Evidently, implementation will be a key test of the standards' quality, and the IASB should also learn the corresponding lessons. Standards which are impractical may not pass the test and would need being reworked. By making itself more sensitive to what happens on the ground, the IASB will be better able to take corrective action if needed.

Finally, the other key watchdog of implementation will be the accounting profession. Audit firms, including the Big Four largest among them, will play a central role in the eventual failure or success of the Global Accounting Experiment. Not only are they the primary enforcers of the standards; they are also key players in disseminating understanding and knowledge about accounting in general, and IFRS in particular. They must continue the efforts they have started since the fall of Andersen to foster audit quality—especially as IFRS call for professional judgment, rather than a mechanical approach to accounting. And as mentioned in the previous section, they must convince the public that the current structure of the worldwide audit market is compatible with the highest standards of audit quality.

A high quality of audits, and a vibrant accounting profession that is open to internal debate, deliberation and contradiction, are no less crucial than IASB legitimacy or efficient public oversight of IFRS implementation. Consequently, a lot of leadership will be asked of auditors, and particularly of the largest firms. They must show this leadership, accept their public responsibility as much as their obligations to their clients, and engage in a candid discussion on how to make the Global Accounting Experiment successful.

Orchestrate a massive education drive

Finally, the experiment is unlikely to succeed if the efforts associated with it remain confined to the accounting community. IFRS implementation, as has been repeated several times in this text, relies on sound human judgment. But judgment needs to be nurtured and educated. A significant and sustained effort of education of company managers and financial market participants is a condition for long-term success. In modern capital markets, accounting prowess can no longer be considered a purely specialised skill. A minimum level of awareness of the 'operating system of capitalism' will increasingly be necessary for most participants. And accountants will need to open themselves to new forms of interaction with non-accountants, which require non-accounting skills that many of them currently lack.

In Outline of History (1920), H.G. Wells wrote that "*human history becomes more and more a race between education and catastrophe*". This phrase aptly describes the Global Accounting Experiment as well. Accounting has become a cornerstone of the knowledge economy, with a degree of complexity that increases in step with that of financial operations themselves. And its fate will be a marker of our ability efficiently to set common norms for the interconnected global economy. The outcome will be determined not by one single player, but by a wide variety of actors: public policymakers in the EU, the US and elsewhere, international standard-setters, accountants, investors, other market participants. Their choices in the next months and years will determine whether education, or catastrophe, wins this particular race.

SUMMARY OF RECOMMENDATIONS

1. Enhance the IASB's legitimacy as a global private-sector policymaking body

Recommendations to the IASB:

- Transform the trustees from a self-appointed to an accountable group;
- Make funding sustainable by linking it to accountability mechanisms;
- Reschedule the IFRS/US GAAP convergence process to make it consistent with the aim of standards' quality;
- Enhance transparency of IASB's funding and governance;
- Make key documents, including all standards and interpretations, freely available to the public on the Internet;
- Create or foster a credible mechanism for independent monitoring of IFRS implementation worldwide;
- Continue to improve due process;
- Continue to improve the balance of nationalities on the Board;
- Increase the IASB / IASC Foundation's public recognition and give the whole institution a proper name.

Recommendation to the US authorities: accept the autonomy of the IASB, and the US status as one constituency among others in its governance and decision-making processes.

Recommendation to the EU institutions: use the leverage of the existing endorsement process to steer the IASB towards high-quality standards. In the short term, delay the endorsement of the IFRS 8 standard (Operating Segments) until a thorough impact assessment is conducted.

Recommendation to the Investment Community: overcome collective action problems and mobilise financial resources and skills to play a leading role in the standard-setting process.

SUMMARY OF RECOMMENDATIONS - CONTINUED

2. Ensure the consistency of IFRS implementation across borders, particularly in the EU

Recommendation to the EU: create a European Accounting Authority endowed with the tasks of monitoring IFRS implementation, issuing relevant guidance to harmonise practice when needed, and providing ex-ante input in the IASB standard-setting process.

- If an agreement can be reached at European level, this authority should preferably take the form of a new EU Agency with its own governance and funding mechanism;
- If no such agreement is found, individual willing countries should merge the accounting departments of their securities regulators to create a cross-border authority 'from the bottom up'.

Recommendation to other jurisdictions: devote significant resources to ensure the quality and consistency of IFRS implementation, and coordinate at global level through IOSCO.

Recommendation to the IASB: monitor local implementation to improve IFRS when needed, and exercise authority to make sure the diversity of local guidance does not result in major and harmful divergence of practice.

Recommendation to the Accounting Profession: ensure a high and sustained level of audit quality to ensure the success of IFRS implementation.

Recommendation to governments and market participants: reinforce education and training to spread accounting culture much more widely than is the case today and bridge the knowledge gap between accounting professionals and other company executives and employees.

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http://ec.europa.eu/internal_market/accounting/ias_en.htm

IASB website: <http://www.iasb.org>

IAS Plus information website on IFRS (maintained by Deloitte): <http://www.ias-plus.com>

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Nicolas Véron

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However, success is less secure than it looks at first sight. Under current arrangements there is scope for strong doubts, both about the IASB's ability to cement its position as a legitimate global standard-setter, and about the ability of specific jurisdictions – in particular the EU – to enforce consistent implementation of the standards.

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