



The New GLOBAL RULERS

The Privatization of Regulation in the World Economy

Tim Büthe & Walter Mattli

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*The Privatization of Regulation
in the World Economy*

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TIM BÜTHE AND WALTER MATTLI



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■ ■ ■ *Acronyms* ■ ■ ■

| | |
|---------|---|
| ACCA | Association of Chartered Certified Accountants (UK) |
| AENOR | Asociación Española de Normalización y Certificación (Spanish Association for Standardization and Certification; Spanish ISO member body) |
| ANSI | American National Standards Institute (U.S. ISO member body) |
| API | American Petroleum Institute |
| ASB | Accounting Standards Board (UK, 1990–) |
| ASC | Accounting Standards Committee (UK, 1970–1990) |
| ASME | American Society of Mechanical Engineers |
| ASTM | American Society for Testing and Materials (now “ASTM International”) |
| BSI | British Standards Institution (UK ISO member body) |
| CEN | European Committee for Standardization |
| CENELEC | European Committee for Electrotechnical Standardization |
| CAO | Chief Accounting Officer |
| CEO | Chief Executive Officer |
| CFO | Chief Financial Officer |
| CSR | Corporate Social Responsibility (standards) |
| DIN | Deutsches Institut für Normung e.V. (German Institute for Standardization, German ISO member body) |
| EFRAG | European Financial Reporting Advisory Group |
| EU | European Union |
| FASB | Financial Accounting Standards Board (U.S. domestic accounting standards body) |
| FEI | Financial Executives Institute (now “FEI International”) |
| FSC | Forest Stewardship Council |
| GAAP | Generally Accepted Accounting Principles |
| GATT | General Agreement on Tariffs and Trade |
| ICT | Information and Communication Technology |
| IAS | International Accounting Standards (standards originally developed by the IASC) |
| IASB | International Accounting Standards Board (2001–) |
| IASC | International Accounting Standards Committee (1973–2000) |

ACRONYMS

| | |
|-------|---|
| ICAEW | Institute of Chartered Accountants in England and Wales |
| ICAS | Institute of Chartered Accountants of Scotland |
| IEC | International Electrotechnical Commission |
| IEEE | Institute of Electrical and Electronics Engineers |
| IFAC | International Federation of Accountants |
| IFRS | International Financial Reporting Standards (standards developed by the IASB) |
| IGO | International Governmental Organization |
| ILO | International Labor Organization |
| IMF | International Monetary Fund |
| IOSCO | International Organization of Securities Commissions |
| ISO | International Organization for Standardization |
| ITU | International Telecommunications Union |
| N | number of observations (survey participants who answered a given question) |
| NTBs | nontariff barriers (to trade) |
| OECD | Organization of Economic Cooperation and Development |
| R&D | Research and Development |
| SEC | Securities and Exchange Commission (of the United States) |
| SIS | Swedish Standards Institute (Swedish ISO member) |
| SDO | Standards Developing Organization |
| TBT | Technical Barriers to Trade |
| WTO | World Trade Organization |
| UN | United Nations |

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CHAPTER ONE

The Rise of Private Regulation in the World Economy

ON 28 AUGUST 2008, the world financial community awoke to stunning headline news: the Securities and Exchange Commission (SEC), the powerful U.S. financial market regulator, had put forth a timetable for switching to International Financial Reporting Standards (IFRS), produced by the International Accounting Standards Board—a private-sector regulator based in London. SEC-regulated U.S. corporations were to be required to use IFRS, possibly as soon as 2014.¹ Only a decade earlier, the suggestion that the United States might adopt IFRS “would have been laughable,”² as many experts expected U.S. standards to become the de facto global standards.

The SEC’s decision to defer to an international private standard-setter is part of a broader and highly significant shift toward global private governance of product and financial markets. What is at stake? Financial reporting standards specify how to calculate assets, liabilities, profits, and losses—and which particular types of transactions and events to disclose—in a firm’s financial statements to create accurate and easily comparable measures of its financial position. The importance of these standards, however, runs much deeper. Through the incentives they create, financial reporting standards shape research and development, executive compensation, and corporate governance; they affect all sectors of the economy and are central to the stability of a country’s financial system.

¹ See, for example, Hughes, “US Set to Adopt IFRS Rule” (2008). The SEC’s proposed “Roadmap to IFRS Adoption” of August 2008 has been elaborated and extended by the February 2010 “Work Plan.” The plan envisages that, after review and confirmation in 2011, it would become mandatory for all U.S. companies whose shares are traded on a U.S. stock exchange to prepare their regular financial statements on the basis of IFRS. This requirement is to be phased in over several years (see chapter 4 for details).

² House, “Global Standards Here to Stay” (2005), 72.

IFRS, however, differ in some important respects from U.S. Generally Accepted Accounting Principles (GAAP), the financial reporting standards so far required by the SEC.³ Having evolved in a very litigious business environment, U.S. GAAP are highly detailed and address a vast range of specific situations, protecting companies and auditors against lawsuits. IFRS, by contrast, have traditionally been principles-based. They lay out key objectives of sound reporting and offer general guidance instead of detailed rules.

The implications of a switch from U.S. GAAP to IFRS are therefore momentous: twenty-five thousand pages of complex U.S. accounting rules will become obsolete, replaced by some twenty-five hundred pages of IFRS. Accounting textbooks and business school curricula will have to be rewritten, and tens of thousands of accountants retrained. Companies will need to spend millions of dollars to overhaul their financial information systems; many will need to redesign lending agreements, executive compensation, profit sharing, and employee incentive programs.⁴ And investors as well as financial analysts will need to learn how to interpret the new figures on assets, liabilities, cash flow, and earnings. The implications run deeper still. As explained by Robert Herz, chairman of the organization producing U.S. GAAP—the Financial Accounting Standards Board (FASB): “Liv[ing] in a world of principles-based standards involves [far-reaching] changes—institutional changes, cultural changes, legal and regulatory changes.”⁵ In sum, the proposed shift of rule-making authority from the domestic to the international level will affect numerous and diverse actors, and bring deep changes to the American financial market.

The United States is not the only country to switch to international standards, of course. As figure 1.1 shows, the number of jurisdictions where stock market regulators permit or even require the use of IFRS has exploded since 2001—despite the substantial costs of the switch for many countries’ firms, investors, and regulators.⁶ In the member states of the

³ See, for example, Cunningham, “The SEC’s Global Accounting Vision: A Realistic Appraisal” (2008); Deloitte, “IFRS and US GAAP” (2008); Nobes and Parker, eds., *Comparative International Accounting* (2008), 74ff, 184f; Smith, “Convergence Is ‘Some Way Off’” (2007). Cf. Harris, *International Accounting Standards versus US-GAAP Reporting* (1995).

⁴ Rezaee et al. warn that these costs may exceed the costs of compliance with the Sarbanes-Oxley legislation, “Convergence in Accounting Standards” (2010), 145.

⁵ Robert Herz, as quoted in Dzinkowski, “Convergence or Conversion?” (2008), 115.

⁶ Until 2001, international financial reporting standards were known as International Accounting Standards (IAS). Jurisdictions with domestic stock markets, only. Financial reporting

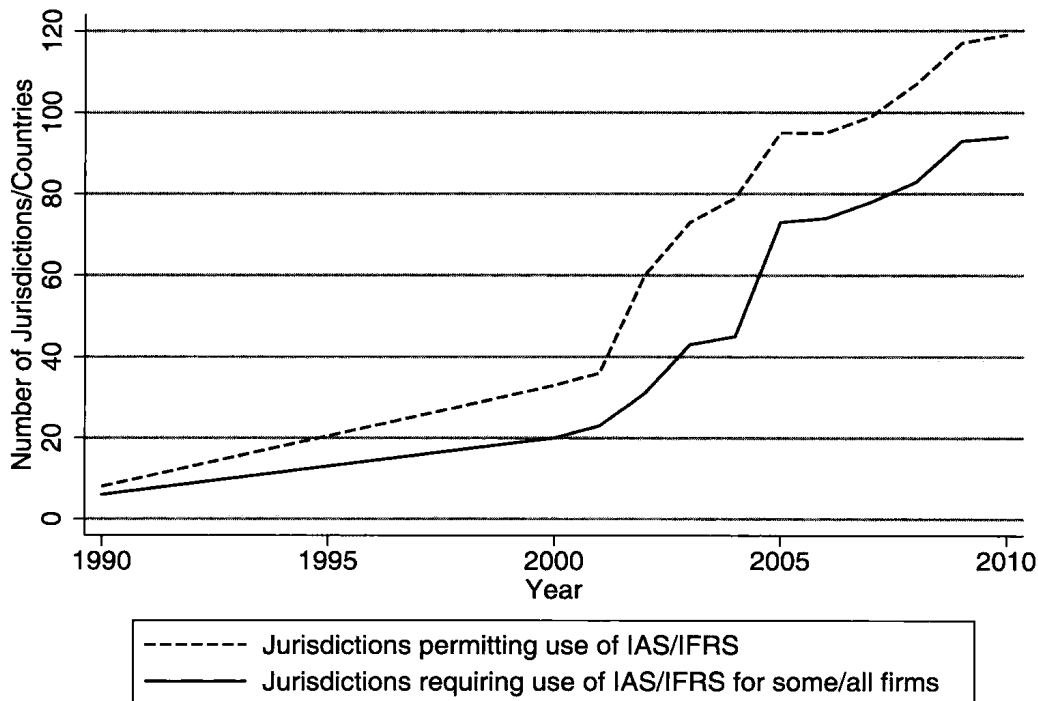


Figure 1.1 Use of IAS/IFRS as Allowed or Required by Stock Market Regulators

• • • • •

Number of jurisdictions permitting use includes number requiring use. Sources: IASC, *Survey of the Use and Application of International Accounting Standards* (1988); Cairns, *International Accounting Standards Survey 2000* (2001); Nobes, *GAAP 2000: A Survey of National Accounting Rules* (2001); Deloitte Touche Tohmatsu, "Use of IAS for Reporting by Domestic Companies, by Country" (2002), "Use of IFRS for Reporting by Domestic Listed Companies, by Country" (2004), *IAS in Your Pocket* (2001, 2002), and *IFRS in Your Pocket* (2003, 2005–10).

rules are reported by "jurisdiction" because a few states contain more than one jurisdiction (e.g., Abu Dhabi and Dubai in the United Arab Emirates) and a few jurisdictions, such as Taiwan, are not universally recognized as states. Deloitte considers a jurisdiction to be permitting/requiring international standards when they either accept IFRS-based accounts without reconciliation or when the standards "adopted" as national standards are virtually all "word-for-word" equivalent to the international standards. Most of the countries requiring IAS/IFRS prior to 2000 were "developing or newly industrialised countries [that] do not have the resources to develop their own requirements" (Cairns, "Aid for the Developing World" (1990), 82).

European Union (EU) and about sixty other countries across all continents, the use of IFRS is already mandatory for companies with publicly traded financial securities (stocks and bonds).⁷ And the trend is continuing: government regulators of several additional countries, including Japan, Canada, Brazil and India, have committed themselves to requiring IFRS in the near future.⁸

The global convergence of accounting standards is driven, in large part, by the international integration of financial markets and the increasingly multinational structure of corporations. These developments have not only led to economic growth and greater profits for many, but have also raised the costs of continued cross-national divergence of financial reporting standards for companies and investors. Indeed, cross-national differences in these rules are said to have exacerbated the global financial crisis of 2008–9—and the Asian Financial Crisis of 1997–98 before it. The belief that harmonization would bring substantial benefits has prompted firms and governments to push for a single common set of international financial reporting standards. Harmonization promises to increase the cross-national comparability of corporate information, improve the transparency of financial statements for shareholders, investors, and creditors, as well as achieve greater efficiency and stability in global capital markets.

Switching to IFRS, however, also brings costs, and these costs vary across countries. For countries with marginal capital markets and no proper accounting tradition, the costs are relatively minor.⁹ However, they can be considerable for countries or regions with large and sophisticated capital markets as well as long-standing domestic accounting traditions, such as the United States and many European countries. These costs will be larger the greater the difference between IFRS and long-established domestic rules and practices. Americans and Europeans therefore have particularly strong incentives to seek to influence the process of global rule-making in accounting. International standards that end up being identical or very similar to a country's domestic standards will minimize that country's costs of switching to "international" rules. And in highly

⁷Deloitte, "Use of IFRS by Jurisdiction" (2010).

⁸See Deloitte, "Accounting Standards Updates by Jurisdiction" (2010).

⁹The adoption of IFRS by developing countries is discussed for instance in Zeghal and Mhedhbi, "The Analysis of Factors Affecting the Adoption of International Accounting Standards by Developing Countries" (2006).