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Creation of World Wide Accounting Standards: Convergence and Independence

*David S. Ruder, Charles T. Canfield and Hudson T. Hollister**

I. INTRODUCTION

A. Convergence as a Means of Enabling Cross-Border Trading

“Cross-border trading” in the stocks of multinational companies is the code word for the ability of all companies worldwide to be able to sell their securities in the markets of all countries. In a cross-border trading environment, the world’s investment resources would be freely available to companies in all countries and capital would be allocated in an optimal fashion. One of the primary barriers to cross-border trading is the requirement that the financial statements of the companies being traded in

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the securities markets of a particular country be compatible. With comparable financial statements, multinational companies would be able to access capital markets worldwide without being required to create different financial statements that conform to the accounting requirements of different countries. Investors would be better able to compare the financial statements of all companies and would have the tools to make better investment decisions. The world's supply of capital would be allocated with more efficiency so that the cost of capital would decline.

The best method of facilitating financial statement comparability would be that the financial reports of all companies be prepared according to similar accounting principles. Ideally, all companies would use the same accounting standards in their financial reports. The next best circumstance would be that all companies keep their financial records in accordance with accounting standards that are so similar that regulators and stock exchanges worldwide would accept financial statements prepared in accordance with differing accounting standards because the differences between standards would be very small. This concept of differing but substantially similar financial statements underlies the current movement towards "convergence" of accounting standards world wide.

The concept of convergence of accounting standards was embraced by the International Organization of Securities Commissions (IOSCO), in May of 2000, as follows:

In order to respond to the significant growth in cross-border capital flows, IOSCO has sought to facilitate cross-border offerings and listings. IOSCO believes that cross-border offerings and listings would be facilitated by high quality, internationally accepted accounting standards that could be used by incoming multinational issuers in cross-border offerings and listings.¹

Convergence between U.S. accounting standards and accounting standards prepared by international accounting standard setters is particularly important. Since the United States has the world's largest financial markets, many non-U.S. companies seek to sell their securities in the United States. In a sense the term "cross-border trading" may mean the ability to cross the U.S. border and sell securities in the U.S. market.

The desire to create a worldwide accounting system that will allow foreign private issuers to sell and trade their securities in the United States continues to be a key objective in the convergence process. The European

¹ *Resolution Concerning the Use of IASC Standards for the Purpose of Facilitating Multinational Securities Offerings and Cross-Border Listings*, IOSCO (May 17, 2000), available at <http://www.iosco.org/news/pdf/IOSCONEWS26.pdf>.

Parliament and the Council of the European Union have stated the general goal as follows:

It is important for the competitiveness of the Community capital markets to achieve convergence of the standards used in Europe for preparing financial statements, with international accounting standards that can be used globally, for cross-border transactions or listings anywhere in the world.²

Dr. Alexander Schaub, Director-General, Internal Market and Services of the European Commission, has described the need for convergence as follows:

Through its adoption of IAS, the EU does not want to put its listed companies at a disadvantage in the global economy. On the contrary, listed EU companies need to be able to compete on an equal footing for available financial resources in either European capital markets or in world capital markets. In this context, it is particularly important to achieve future convergence between IAS used in Europe for the preparation of financial statements and other globally-used international standards, in particular U.S. GAAP.³

The goal of worldwide accounting standards accepted for trading in the United States places special responsibilities on the U.S. Securities and Exchange Commission (SEC), since the SEC is the regulator with power to determine whether financial statements prepared in accordance with non-U.S. accounting standards can be used in the United States for the sale of securities. At the present time, the SEC requires that financial statements prepared in accordance with non-U.S. standards be “reconciled” to U.S. standards. According to the SEC: “A foreign private issuer using accounting standards other than U.S. GAAP must provide an audited reconciliation to U.S. GAAP.”⁴ Companies required to reconcile their

² Council Regulation 1606/2002 of 19 July 2002 on the Application of International Accounting Standards, 2002 O.J. (L 243) 1-4, ¶ 5 [hereinafter IAS Regulation].

³ Dr. Alexander Schaub, *The Use of International Accounting Standards in the EU*, 25 NW. J. INT'L L. & BUS. 609 (2005) [hereinafter Schaub]. Ernst and Young Global Limited has stated with regard to the IASCF Constitution Review: “By far the most significant remaining issue in relation to the global adoption of IFRS is convergence of U.S. GAAP with IFRS.” Comment Letter from Ernst and Young Global Limited to the IASC Foundation 2 (Feb. 22, 2005), available at <http://www.iasb.org/docs/2005-itc/cl13.pdf>.

⁴ SEC Concept Release: International Accounting Standards, Securities Act Release No. 33-7801, Exchange Act Release No. 34-42430, [1999-2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,237, at III.A. (Feb. 16, 2000) [hereinafter SEC Concept Release on IAS]. “Items 17(c) and 18(c) of Form 20-F permit a foreign private issuer to provide financial statements in accordance with another comprehensive basis of accounting, provided that the issuer also provides a reconciliation of net income and balance sheet items to U.S. GAAP.”

statements to U.S. accounting standards are, in effect, required to create a second set of financial statements showing what their financial results would have been had they been reported according to U.S. standards.

The SEC's Chief Accountant has recently acknowledged the SEC's continued attention to the reconciliation issue, coupling the likelihood of reconciliation with independent standard setting and high quality standards.

My personal view is that if things continue as they have been going – if the IASB operates as a strong independent standard-setter and continues to develop and issue high quality standards, if the commitment to quality application of IFRS remains, and if good progress is made in accounting convergence and the development of an effective global reporting infrastructure – then I believe that the SEC will be able to eliminate our reconciliation requirements.⁵

B. High Quality, Transparent, and Comparable Standards

Since the purpose of creating converged accounting standards is to allow worldwide cross-border trading, mere convergence of standards is not enough. The converged standards should be high quality, transparent, and comparable. The goal is to create standards that allow investors and creditors to see the true financial condition of a company and to be able to compare that company's financial statements to the financial statements of other companies. Transparency and comparability objectives are not easy to achieve, since many businesses have extremely complicated structures and operations, and since comparisons between businesses are often difficult. The goal of "high quality" contemplates a system for creating accounting standards that will be effective in creating transparency and comparability. As the SEC has stated:

High quality accounting standards consist of a comprehensive set of neutral principles that require consistent, comparable, relevant and reliable information that is useful for investors, lenders and creditors, and others who make capital allocation decisions.⁶

Id. at note 13.

⁵ Donald T. Nicolaisen, SEC Chief Accountant, Remarks Before the IASB Meeting with World Standard Setters 2-3 (September 28, 2004), available at <http://sec.gov/news/speech/spch092084dtm.htm>. See Mr. Nicolaisen's extended comments on convergence in Donald T. Nicolaisen, *A Securities Regulator Looks at Convergence*, 25 NW. J. INT'L L. & BUS. 661 (2005).

⁶ SEC Concept Release, *supra* note 4, at II.A.

C. The Current Convergence Environment

The two standard setters that have the most influence in creating global accounting standards are the International Accounting Standards Board (the IASB), a private standards setting organization that is subject to oversight by the International Accounting Standards Committee Foundation (the IASCF), and the U.S. Financial Accounting Standards Board (the FASB), also a private standards setting organization, that is subject to oversight by the Financial Accounting Foundation (the FAF). The IASB and the FASB are working actively to use the convergence process to create high quality global accounting standards. They are cooperating with standard setters in other countries to choose the best standards from those previously available, to improve those standards, and to create new standards in a cooperative environment.

The high quality goals of the convergence project are well expressed by the IASCF's Constitution, which states that the objectives of the IASC Foundation are, among others:

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 sound economic decisions.⁷

D. Independence and Representativeness

An effective system for creating accounting standards must be well designed in order to meet its goals. For some, a well designed system means that the standard setters should be independent of outside commercial and government influence and therefore free to pursue high quality standards. In doing so they must engage in "due process" by seeking the views of the affected parties, including businesses, so that the standards they create will not have unintended consequences. To others, a well designed system should allow those affected by the standards to participate in the standard setting process in order to prevent the standards from unduly hindering business operations. They believe that in order for standards to be effective they must be prepared by representatives of affected interests, and that, if so prepared, the standards will be readily acceptable.

These two views are referred to in this article as "independence" and

⁷ International Accounting Standards Committee Foundation Constitution (Jul. 2002) (Revised), ¶ 2(a), available at <http://www.iasb.org/about/constitution.asp> [hereinafter IASCF Constitution].

“representativeness.” The independence approach is that legitimacy should be based on independence and competence. The representativeness approach is that legitimacy should be based on geographical consensus and approval.

This article supports the view that the requirement for success in creating high quality, transparent, and comparable accounting standards is that the standard setters should be independent of all business and government special interests.

When a standard setter sacrifices independence and becomes subject to influence from the companies required to comply with its standards, it is likely that the quality of standards will suffer. If the world’s standard setters fail to adhere to the concept of independence, high quality converged standards will not emerge. Most likely, economic and political pressures will result in low quality standards, enabling companies to obscure bad news, distort financial results, and prevent comparisons. Without convergence the result most probably will be that government regulators in various countries, most particularly the United States, will require financial statements prepared according to non-converged standards to be changed (or reconciled) to reflect the views of that country’s regulators.

Fortunately, both the FASB and the IASB are committed to independence. The IASB emerged in 2001 as an independent standard setter after a substantial restructuring. The IASCF, which oversees the IASB, is now completing a constitutional review that will preserve that independent system. Meanwhile, the IASB and the FASB are pursuing a cooperative program for preparing and revising standards in tandem, bringing IASB standards, also called International Financial Reporting Standards (IFRSs), and U.S. Generally Accepted Accounting Principles (GAAP) ever closer to full convergence.⁸

This paper seeks to underscore the crucial point that as the convergence of accounting standards gathers momentum, the IASCF should maintain the IASB’s independence. Part II describes the path of independence established several decades earlier in the United States when the FASB was created. It then explores the IASB’s historical transformation from an organization controlled by the accounting

⁸ New standards promulgated by the IASB are called International Financial Reporting Standards (IFRSs). The standards promulgated by the International Accounting Standards Committee (IASC), the IASB’s predecessor, were called International Accounting Standards (IASs). All IASs remained in force when the IASC became the IASB in 2001, and the “IAS” designation has been retained for them. IASs are from time to time amended by the IASB. Thus, the entire body of standards now includes both IASs and IFRSs – for example, both IAS 39 and IFRS 6 are current, valid standards maintained by the IASB. It is common for accounting literature to use the term “IFRSs” to refer to the entire body of IASB standards. This article will use the terms “IASB standards” or “IFRSs” to refer generally to the entire body of standards without being time-specific.

profession to an independent institution. Part III examines the progress being made to sustain the IASB's independence through the IASCF's current constitutional review. Part IV reinforces the importance of independence by exploring three contemporary episodes: the IASB / FASB collaboration in creating business combination standards; the U.S. controversy over the expensing of stock options; and the European controversy over the application of fair value accounting to derivatives. The business combination episode demonstrates that independent standard setters can produce converged high quality standards that benefit investors and improve markets despite attempted interference by business interests. The stock options and derivatives episodes demonstrate the danger that when business and political interests interfere with standard setting, the quality of standards may suffer and convergence may be derailed.

II. THE ROLE OF INDEPENDENCE AT THE FASB AND IASB

The International Accounting Standards Committee Foundation that oversees the IASB is a London-based nonprofit private international organization. It is the successor of the International Accounting Standards Committee (IASC), founded in 1973. During the years following its creation, the IASC grew from a vehicle for harmonizing accounting practices throughout the world to an organization devoted to issuing international accounting standards for use worldwide. In 1997, in reaction to criticisms that it lacked the structure to meet the demands of setting global accounting standards, the IASC began to restructure its standards setting process.

During the restructuring process, the IASC encountered disagreement regarding which model to adopt for its new structure. Some proposed an independence model based on accounting standards set by highly qualified full-time individuals who serve the public interest. Others proposed a representativeness model based on an international organization composed of country representatives.

The independence model can be traced back to the creation of the FASB as an independent professional organization to promulgate accounting rules for the American capital markets.⁹ The representativeness

⁹ The primary references for the descriptions of the FASB and the pre-restructured IASC were PAUL W. MILLER, RODNEY J. REDDING & PAUL R. BAHNSON, *THE FASB, THE PEOPLE, THE PROCESS, AND THE POLITICS* (4th ed., Irwin/McGraw Hill 1998); *THE IASC-US COMPARISON PROJECT: A REPORT ON THE SIMILARITIES AND DIFFERENCES BETWEEN IASC STANDARDS AND US GAAP* (Carrie Bloomer ed., Financial Accounting Standards Board of the Financial Accounting Foundation, 1st ed. 1996) [hereinafter *IASC-US COMPARISON*]; *THE IASC-US COMPARISON PROJECT: A REPORT ON THE SIMILARITIES AND DIFFERENCES BETWEEN IASC STANDARDS AND US GAAP* (Carrie Bloomer ed., Financial Accounting Standards Board of the Financial Accounting Foundation, 2nd ed. 1999) [hereinafter *IASC-*

model can be traced to the IASC's original structure. In 2001, the IASC agreed on a compromise structure that possessed traits of both models. Under that structure, the IASB functions as an independent standard setter, subject to supervision by the IASCF. The IASCF is composed of Trustees who are representatives of various interests and geographic areas, but who are committed to the independence model for the IASB.

This part of this article examines the backgrounds of both the FASB and the IASC, and the manner in which those backgrounds have influenced the structure and due processes of these organizations. After examining varying views regarding a legitimate accounting standard setting process and identifying the tension between independence and representativeness, the article describes the IASC's current structure as it reflects resolution of those tensions.

A. Independence and American Accounting Standard Setting

1. *Origins of Independence and the Creation of the FASB*

The prominence of U.S. GAAP is due in substantial part to the manner in which those principles are developed by the FASB. The FASB is a private sector accounting standard setting organization, which, like the IASB, has no statutory authority. The FASB derives its authority to set standards from the SEC, which delegated authority to promulgate accounting standards to the FASB in 1973.¹⁰

US COMPARISON 2ND ED.]; and GARY J. PREVITS & BARBARA D. MERINO, A HISTORY OF ACCOUNTANCY IN THE UNITED STATES: THE CULTURAL SIGNIFICANCE OF ACCOUNTING 5 (1998).

¹⁰ The SEC granted this authority in SEC Accounting Series Release No. 150. SEC Accounting Series Release No. 150, 39 C.F.R. 1260 (1974) [hereinafter ASR No. 150]. ASR No. 150 provides:

The body presently designated by the Council of the American Institute of Certified Public Accountants (AICPA) to establish accounting principles is the Financial Accounting Standards Board (FASB). This designation by the AICPA followed the issuance of a report in March 1972 recommending the formation of the FASB, after a study of the matter by a broadly based study group. The recommendations contained in that report were widely endorsed by industry, financial analysts, accounting educators, and practicing accountants. The Commission endorsed the establishment of the FASB in the belief that the Board would provide an institutional framework which will permit prompt and responsible actions flowing from research and consideration of varying viewpoints. The collective experience and expertise of the members of the FASB and the individuals and professional organizations supporting it are substantial. Equally important, the commitment of resources to the FASB is impressive evidence of the willingness and intention of the private sector to support the FASB in accomplishing its task. In view of these considerations, the Commission intends

a. The Securities Acts of 1933 and 1934 and the AICPA Committee on Accounting Procedure

The Securities Act of 1933¹¹ imposed stringent disclosure requirements upon underwriters and issuers of new stock offerings.¹² The Securities Exchange Act of 1934¹³ created disclosure and reporting requirements for the trading markets and created the SEC with the power to set accounting standards.¹⁴ Independent standard setting was first attempted by the Committee on Accounting Procedure (CAP), established by the American Institute of Accountants (AIA), a private organization comprised of professional accountants, at the urging of the SEC.¹⁵ Although the AIA cooperated with the SEC, a tension existed because the SEC believed that accounting rules should be designed solely to meet the needs of investors in public companies, while the AIA argued that this constituency represented a small population of financial statement users and that most businesses did not use financial statements to provide information to investors.¹⁶

b. The Accounting Principles Board and the 1972 AICPA Study

Concerned with the CAP's structure and efficiency, the American Institute of Public Accountants established the Accounting Principles Board (APB) in the fall of 1959 to replace the CAP.¹⁷ The APB was to be a formal research organization within the AICPA that would seek the active cooperation of the academic accounting community.¹⁸ Weakness in the operation of the APB, including inadequate research, led the AICPA to evaluate the APB in its 1972 Report of the Study on Establishment of

to continue its policy of looking to the private sector for leadership in establishing and improving accounting principles and standards through the FASB with the expectation that the body's conclusions will promote the interests of investors. . For purposes of this policy, principles, standards and practices promulgated by the FASB in its Statements and Interpretations will be considered by the Commission as having substantial authoritative support, and those contrary to such FASB promulgations will be considered to have no such support."

See also MILLER ET AL., *supra* note 9. Miller provides an in depth description of the FASB. Some portions of this paper refer extensively to Miller's description.

¹¹ 15 U.S.C. §§ 77a-77bbbb (2005).

¹² See generally Louis Lowenstein, *Financial Transparency and Corporate Governance: You Manage What You Measure*, 96 COLUM. L. REV. 1335 (1996).

¹³ 15 U.S.C. §§ 78a-78kk (2005).

¹⁴ *Id.*

¹⁵ MILLER ET AL., *supra* note 9, at 55-58.

¹⁶ PREVITS & MERINO, *supra* note 9, at 277.

¹⁷ MILLER ET AL., *supra* note 9, at 57.

¹⁸ PREVITS & MERINO, *supra* note 9, at 311.

Accounting Principles (AICPA Study),¹⁹ prepared under the leadership of Francis Wheat, a former SEC Commissioner.²⁰ The AICPA Study concluded that the APB's research was inadequate,²¹ that it did not have substantial academic representation, that its membership was overly concentrated in public accounting firms,²² and that it lacked convincing authority because of its large size (seventeen to twenty-one members) and the fact that members were part-time and not perceived as independent.²³ In addition, the AICPA Study criticized the APB's openness and responsiveness.²⁴

The AICPA Study called for a more independently structured accounting standard setter.²⁵ In response to this recommendation, the APB was disbanded and the FASB was established in 1973.²⁶

2. The FASB

The FASB's mission is "to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information."²⁷ The underlying objective of the FASB's mission is to satisfy the needs of financial report users by providing information that is useful for reaching economic decisions that improve the efficiency of capital markets' resource

¹⁹ ESTABLISHING FINANCIAL ACCOUNTING STANDARDS, Report of the Study on Establishment of Accounting Principles 31 (American Inst. Of Certified Pub. Accountants 1972) [hereinafter AICPA Study].

²⁰ The AICPA Study was preceded by then SEC Commissioner Francis Wheat's report: A Reappraisal of Federal Administrative Policies Under The '33 and '34 Securities Acts: Report and Recommendations to the Securities and Exchange Commission from the Disclosure Policy Study of 1969 ("Wheat Report"), which engaged in a broad reexamination of the SEC's disclosure policy. The AICPA Study is frequently referred to in the accounting literature as the "Wheat Committee Report."

²¹ AICPA Study, *supra* note 19, at 34.

²² *Id.*

²³ Regarding these weaknesses, the AICPA Study noted:

All members of the APB, including its chairman, serve in a part-time capacity. Most members appear to devote from one-half to two-thirds of their time to the Board's work. Most members of the Board are supported by an advisor, who normally also attends Board meetings, and other support is provided by their firms. None of this work is compensated by the institute. Out-of-pocket expenses of members and their staffs are defrayed by the institute if reimbursement is requested. Usually, it is not. *Id.*

²⁴ *Id.* at 35.

²⁵ *Id.* at 69.

²⁶ See MILLER ET AL., *supra* note 9, at 22. The SEC supported the establishment of the FASB and delegated its standard setting authority to the FASB. See ASR No. 150, *supra* note 10.

²⁷ IASC-US COMPARISON, *supra* note 9, at 41.

allocation.²⁸

a. Board Independence

The FASB Board consists of seven full-time independent members. In order to ensure independence and objectivity, all Board members are required to relinquish previous employment ties and to comply with the restrictions the FASB imposes upon Board members' investing activities²⁹ and future employment.³⁰ The FASB has no formal composition requirements, but the usual makeup includes three individuals from public accounting, two industry representatives, one education specialist, and one user of financial reports.³¹ To ensure independence, the FASB's members receive a competitive salary and are required to file quarterly reports disclosing relevant information regarding personal investments.³²

b. FASB's Oversight: The FAF

Oversight of the FASB is provided by the Financial Accounting Foundation, the FASB's parent organization,³³ a nonprofit private organization incorporated in Delaware. The FAF is also responsible for selecting FASB members, members of the Financial Accounting Standards Advisory Committee (FASAC), and members of its technical advisory committee, the Emerging Issues Task Force (EITF). It has no power to interfere with FASB standard setting or to control the FASB's agenda.³⁴

The FAF's sixteen member Board of Trustees meets at least four times a year.³⁵ The FAF's agenda is announced publicly and its meetings are public except for confidential matters, such as the selection of FASB members.³⁶ The FAF's Trustees can serve no more than two terms of three years each.³⁷ Thirteen of the sixteen Trustees are elected by the Trustees then in office. Eight of these Trustees are usually elected after nominations are made by six sponsoring organizations from public accounting, finance, industry, and academia.³⁸ Five Trustees are elected by the Trustees as at-

²⁸ *Id.*

²⁹ *Id.* at 43.

³⁰ *Id.*

³¹ MILLER ET AL., *supra* note 9, at 40.

³² *Id.* at 39.

³³ IASC-US COMPARISON, *supra* note 9, at 50; *see also* FASB, Financial Accounting Foundation, available at <http://www.fasb.org/faf/> (last visited Mar. 31, 2005).

³⁴ IASC-US COMPARISON, *supra* note 9, at 50.

³⁵ MILLER ET AL., *supra* note 9, at 35.

³⁶ *Id.*

³⁷ Financial Accounting Foundation Articles of Incorporation and Bylaws, Ch. A, art. I-A § 3 [hereinafter FAF Articles of Incorporation and Bylaws].

³⁸ *Id.* at Ch. A, art. I-A § 4. The nominating organizations are the Securities Industry

large members.³⁹ Three of the Trustees are financial officers or elected officials of state or local governmental entities and are elected directly by two organizations of government officials.⁴⁰ Of the eleven Trustees who are not at-large members, three must be public accountants in private practice and two must have extensive experience as financial executives, one as an investment professional, one as an accounting educator, one as an investment banker, and three as financial officers or elected officials of state or local government entities.

Prior to 1996, there were only three at-large Trustees. In 1996, Arthur Levitt, Chairman of the SEC, criticized the FAF for lack of independence and insisted on changes in the Trustee appointment process.⁴¹ After negotiations with the SEC, two new at-large members were added by reducing AICPA representatives from four to three and reducing Financial Executives International (FEI) representatives from two to one. The government members were considered to represent the public,⁴² so that today, assuming that the nominee of the American Accounting Association, whose members are academics, is counted as a public trustee, nine of the sixteen trustees can be treated as representing the public.

3. *The Financial Accounting Standards Advisory Committee*

Input from preparers and users of financial statements is provided to the FASB by the Financial Accounting Standards Advisory Committee (FASAC). The FASAC provides general advice regarding current and

Association (SIA), the Association for Investment Management and Research (AIMR), Financial Executives International (FEI), the Institute of Management Accountants (IMA), the American Accounting Association (AAA), and the AICPA (three nominees). *Id.* The Articles and Bylaws of the FAF were amended by the Trustees in 2002 to remove the right of the six sponsoring organizations to elect Trustees, instead giving them the right to nominate persons of Trustees, reserving the right of election to the Trustees, who may choose Trustees who were not so nominated. This change was intended to enhance the independence of the Trustees from the sponsoring organizations.

³⁹ *Id.* at Ch. A, art. I-A § 6.

⁴⁰ Government representatives are members of the FAF Board of Trustees because the FAF is also charged with responsibility of supervising the Government Accounting Standards Board, which promulgates standards for state and local municipalities. The two organizations are the Government Finance Officers Association and the National Association of State Auditors, Comptrollers and Treasurers. They elect persons nominated jointly by nine associations of government officials. When the FAF articles and Bylaws were amended in 2002, the government entities retained the right to elect the three government officials. *Id.* at Ch. A, art. I-A § 4.

⁴¹ MILLER ET AL., *supra* note 9, at 37. SEC Chairman Arthur Levitt is reported to have threatened to withdraw the power delegated to the FASB in Accounting Series Release 150 if the FASB did not restructure itself sufficiently to produce a majority of public representatives. *Id.*

⁴² *Id.*

potential agenda projects, priorities, major technical issues, and policy matters.⁴³ The FAF's Trustees appoint FASAC members, and the FASAC operates independently from the FASB.⁴⁴ The number of FASAC's members varies from year to year, but usually ranges from the bylaw minimum of twenty members to approximately thirty members.⁴⁵ FASAC members are selected from a variety of constituencies, including users, the public, auditors, and preparers.⁴⁶

4. *The Emerging Issues Task Force*

The Emerging Issues Task Force is charged with resolving "implementation, application and other emerging accounting issues that can be analyzed within existing GAAP."⁴⁷ EITF interpretations are reached by consensus and are ratified by the FASB at open FASB meetings. FASB Board members participate in EITF meetings. The EITF is composed of accounting experts "in a position to be aware of emerging issues before they become widespread and before divergent practices regarding them become entrenched."⁴⁸ Its membership is drawn from a range of auditors, preparers and users, and includes several members of the "Big Four" accounting firms.⁴⁹ It is chaired by the FASB's director of Research and Technical Activities.⁵⁰ The SEC's chief accountant or a deputy participates in each meeting.⁵¹

5. *FASB Due Process*

The FASB believes that acceptance of its standards will depend in part upon its willingness to allow public comment and participation in standard setting, sometimes called "due process." These due process procedures include a number of steps designed to allow public input. The FASB process for creating accounting standards involves: issue identification; preliminary evaluation, usually including input from preparers, users, auditors and the SEC; careful selection of agenda items; possible public hearings; publication of a preliminary news document; publication of an exposure draft; informal consultations; receipt of comment letters; review

⁴³ IASC-US COMPARISON, *supra* note 9, at 52.

⁴⁴ MILLER ET AL., *supra* note 9, at 20.

⁴⁵ *Id.*

⁴⁶ *Id.* at 43.

⁴⁷ FASB Emerging Issues Task Force, *available at* http://www.fasb.org/eitf/about_eitf.shtml (last visited March 31, 2005).

⁴⁸ *Id.*

⁴⁹ See FASB, Emerging Issues Task Force, Members as of September 2004, *available at* <http://www.fasb.org/eitf/eitfmembers.shtml> (last visited Mar. 9, 2005).

⁵⁰ FASB, Emerging Issues Task Force, General Information, *supra* note 748.

⁵¹ *Id.*

by the FASAC; and publication of the final FASB standard.⁵² In addition, project specific advisory groups are frequently appointed from FASB constituents to provide insight and to debate technical issues.⁵³

6. FASB Funding

Until 2003, funding for the FAF and the FASB was provided by contributions from accounting firms and businesses, placing significant responsibilities on the FAF Trustees and raising the possibility that businesses would decline or cease to contribute because they were unhappy with standards adopted by the FASB. The Sarbanes-Oxley Act of 2002 provided that an annual accounting support fee for the FASB would be collected from corporations registered with the SEC in order to “provide for an independent, stable source of funding” for the FASB.⁵⁴

B. The IASC

The FASB model, including an independent full-time FASB, public oversight by the FAF, advice from the FASAC and the EITF, and extensive due process provided a strong contrast with the IASC as it existed prior to 2000.

1. Background to the IASC Reorganization

Prior to its reorganization in 2000, the IASC’s members were the professional accounting bodies that were members of the International Federation of Accountants (IFAC).⁵⁵ As of 1999, the IASC had 133 members from 103 countries.⁵⁶ The IASC’s governing Board, which promulgated IASC standards, consisted of sixteen members. Thirteen members were countries designated by IFAC and three were organizations designated by the IASC Board: the International Council of Investment Associations; the Federation of Swiss Industrial Holding Companies; and the International Association of Financial Executives Institutes.⁵⁷ Observers permitted to participate in the deliberations, but not to vote,

⁵² See MILLER ET AL., *supra* note 9, at 67-78.

⁵³ IASC-US COMPARISON, *supra* note 9, at 53.

⁵⁴ Sarbanes-Oxley Act of 2002, 15 U.S.C. §7219e(1) (2004).

⁵⁵ See IASB, History, available at <http://www.iasb.org/about/history.asp> (last visited Mar. 9, 2005). IASC’s relationship with IFAC was set out in mutual commitments signed in 1982. Under the commitments all members of IFAC were automatically also members of IASC, and the IASC Board was required to discuss proposed changes to its constitution with IFAC. International Accounting Standards Committee Strategy Working Party, *Discussion Paper: Shaping the IASC for the Future* (Dec. 1998) ¶ 106-07 (on file with Professor Ruder) [hereinafter December 1998 SWP Paper].

⁵⁶ IASC-US COMPARISON 2ND ED., *supra* note 9, at 9.

⁵⁷ *Id.* at 12.

included the European Commission, the FASB, the International Organization of Securities Commissions (IOSCO), and the People's Republic of China.⁵⁸

Each IASC Board member had one vote and could designate two voting representatives and one technical representative. As a result, meetings of the IASC Board at which IAS standards were adopted were inefficient, with as many as 60 or 70 persons having speaking privileges participating in each meeting. The IASC structure also had problems because IASC representatives served only as part-time volunteers and maintained their employment positions.⁵⁹ The members served renewable terms of no more than five years. The usual professional background of the IASC members was one-half from public accounting, one-fourth from industry and the remainder from accounting education or the financial analyst community.⁶⁰

Although the IASC's constitution required that Board members act in the public interest,⁶¹ the IASC, like the early U.S. standard setters, was subject to criticism for lack of independence. Its large part-time Board consisted of members who were representatives of countries or organizations, with a likely tendency to represent and vote the views of their country or organization rather than act solely in the public interest.⁶²

2. *IASC Due Process*

Prior to its reorganization, IASC's due process was subject to criticism as not sufficiently open to the public. Initial drafting was done by "Working Groups" composed of non-Board members. Board meetings were not open to the public. The process for the exposure of drafts was not formalized.⁶³

⁵⁸ *Id.*

⁵⁹ IASC-US COMPARISON, *supra* note 9, at 44.

⁶⁰ *Id.* at 43.

⁶¹ International Accounting Standards Committee Constitution (Oct. 1992) ¶ 7 (on file with Professor Ruder) [hereinafter IASC Constitution].

⁶² See IASC-US COMPARISON, *supra* note 9, at 44. This was a concern of the Strategy Working Party in the December 1998 SWP Paper. The Strategy Working Party believed that "the process for appointments to the IASC Board and key IASC committees should be the responsibility of a variety of constituencies, while ensuring that those appointed are competent, independent and objective." *December 1998 SWP Paper, supra* note 55, at Executive Summary, p. 10.

⁶³ See IASC-US COMPARISON, *supra* note 9, at 101-05 (comparing IASC due process and FASB due process for exposure drafts and noting that the IASC had no minimum comment period, but rather a period that was "generally six months or longer").

3. *The "Core Standards" Project*

In the 1990s, the IASC shifted its focus from being an international body with the goal of harmonizing accounting standards throughout the world to the goal of being the primary international accounting standard setter. The shift in focus was illustrated by its "core standards" project. In 1995, the International Organization of Securities Commissions developed a work plan with the IASC for completion of a set of core standards that would facilitate a single disclosure document for cross-border offerings and listings.⁶⁴ The IASC completed the last of the core standards in December 1998.⁶⁵

4. *The SEC View of Cross Border Filing*

The core standards project became important to the Securities and Exchange Commission because it raised the question of whether foreign issuers would be able to use IASC standards without reconciliation or partial reconciliation to U.S. GAAP.⁶⁶ In April 1996, the SEC issued a press release specifying three key elements that would be necessary for the SEC's acceptance of IASC Standards:

1. The standards should include a core set of accounting pronouncements that constitute a comprehensive, generally accepted basis of accounting.
2. The standards must be of high quality—they must result in comparability and transparency, and they must provide for full disclosure.
3. The standards must be rigorously interpreted and applied.⁶⁷

In 1996, the U.S. Congress expressed interest in the establishment of a "high-quality comprehensive set of generally accepted international accounting standards" that would facilitate international financial activities. In the National Securities Markets Improvements Act of 1996, Congress requested that the SEC report by October 1997 on the progress of the completion of a set of international accounting standards that would be

⁶⁴ Securities and Exchange Commission, *Report on Promoting Global Preeminence of American Securities Markets* at II.A, available at <http://www.sec.gov/news/studies/acctgsp.htm> (Oct. 1997) [hereinafter SEC Report].

⁶⁵ See Deloitte, *Chronology of IASB and IASC*, available at <http://www.iasplus.com/restruct/chrono.htm> (last visited Mar. 31, 2005).

⁶⁶ IASC-US COMPARISON 2ND ED., *supra* note 9, at 4. See discussion of reconciliation requirements, *supra* note 5.

⁶⁷ Press Release, U.S. Securities and Exchange Commission, SEC Statement Regarding International Accounting Standards (Apr. 11, 1996), in SEC Report, *supra* note 64, at app. 5, Issue 96-61.

acceptable for cross-border offerings.⁶⁸ In its October 1997 report to Congress, the SEC's response expressed uncertainty regarding use of IASC standards and stated that "at this point, it is not clear what the Commission's final decision regarding the core standards project will be."⁶⁹

The problems raised by acceptance of IASC standards were set forth in 1999 by the staff of the FASB, as follows:

If IASC standards were used by foreign issuers without reconciliation to U.S. GAAP, how different would financial reporting in the United States be from that presently required in U.S. capital markets? Would the information provided by IASC standards be higher or lower in quality, more or less extensive, or substantially similar to what investors currently receive and understand?

If IASC standards were accepted without reconciliation to U.S. GAAP for foreign registrants, how would financial reporting by U.S. companies be impacted? Permitting foreign issuers to use IASC standards without reconciliation to U.S. GAAP would increase noncomparability in U.S. capital markets. Is it acceptable for the accounting requirements for foreign registrants and domestic registrants to differ? Would there be pressure on the SEC to accept IASC standards for domestic registrants?⁷⁰

In February of 2000, the SEC announced its plans to undertake an evaluation of IASC standards, stating that it was seeking "input to determine under what conditions we should accept financial statements of foreign private issuers that are prepared using the standards promulgated by the International Accounting Standards Committee."⁷¹

C. The IASC's Restructuring

In 1998, the IASC recognized that its standard setting process needed

⁶⁸ H.R. 3005, 104th Cong. §509(3) (1996). U.S. stock exchanges stand to profit from additional foreign securities listings. They have argued that U.S. disclosure requirements are a major barrier to foreign securities listings and impede the growth of U.S. exchanges. See JAMES L COCHRAN, FOREIGN EQUITIES AND U.S. INVESTORS: BREAKING DOWN THE BARRIERS SEPARATING SUPPLY AND DEMAND (New York Stock Exchange Working Paper No. 95-04, 1995); IASC-US COMPARISON 2ND ED., *supra* note 9, at 17. The argument is that cross border listings will move away unless the SEC eases cross border filings by accepting IASC standards. "Advocates of IASC standards argue that U.S. filing requirements are a major impediment to foreign securities listings in the United States and, thus, requiring use of reconciliation to U.S. GAAP for foreign issuers impedes the growth of U.S. stock exchanges." *Id.*

⁶⁹ SEC Report, *supra* note 64, at Executive Summary.

⁷⁰ IASC-US COMPARISON 2ND ED., *supra* note 9, at 5.

⁷¹ SEC Concept Release on IAS, *supra* note 4.

to be improved if its standards were to be accepted worldwide, particularly in the United States. It formed the Strategy Working Party (SWP) to evaluate the IASC's structure, invite comments, and propose an improved structure. In December of 1998, the SWP issued a Discussion Paper, "Shaping IASC for the Future" (December 1998 SWP Paper), which proposed a plan to restructure the IASC and converge national accounting standards and practices into high quality global accounting standards.⁷² In November of 1999, it issued "Recommendations on Shaping IASC for the Future" (November 1999 SWP Paper) to the IASC Board.⁷³ The reports, comments, and discussion that followed these two papers presented two different views, a standard setting approach based on independence and a standard setting approach based on representativeness.

1. *The SWP December 1998 Paper – A Bicameral Structure*

The December 1998 SWP Paper proposed that the IASC be organized using a bicameral structure composed of an independent Standards Development Committee charged with drafting standards and a representative IASC Standards Board given power of final approval over standards.

Under the bicameral structure proposed in the December 1998 SWP Paper, the major work for setting IASC standards would be accomplished by an eleven member Standards Development Committee (SDC), composed primarily of committee members from various national standard setters, with the remaining members chosen from other groups such as preparers and users of financial statements, public accountants, academics, and regulators.⁷⁴ The December 1998 SWP Paper proposed a partnership between national standard setters and the IASC in order to accelerate convergence between national standards and IASC standards.⁷⁵ It also recognized that acceptance of IASC standards as national standards would take place on a country by country basis, preserving sovereignty for each participating nation.⁷⁶

Under the proposal, the SDC would have had responsibility for drafting the IASC standards. It would prepare exposure drafts and final drafts of international accounting standards in coordination with standard setters of the various countries.⁷⁷

⁷² December 1998 SWP Paper, *supra* note 55.

⁷³ International Accounting Standards Committee, Recommendations on Shaping IASC for the Future (November 1999), available at http://www.iasb.org/uploaded_files/documents/8_210_swp_rep.pdf [hereinafter November 1999 SWP Paper].

⁷⁴ December 1998 SWP Paper, *supra* note 55, ¶ 126.

⁷⁵ *Id.* ¶ 216.

⁷⁶ *Id.* ¶¶ 216-18.

⁷⁷ *Id.* ¶ 154-59.

Regarding the make-up of the SDC, the SWP proposed that at least seven of its eleven members be from more developed countries and at least two be from emerging market economies.⁷⁸ The SWP proposed that special consideration be given to countries likely to make extensive use of IASC standards, or that have a high proportion of foreign trade or enterprises with foreign operations. It proposed a reasonable geographical spread of SDC members.⁷⁹

As a key element in preserving representativeness, the December 1998 SWP Paper proposed a broad-based IASC Standards Board that would approve SDC generated IASC standards. The proposal was for a twenty-five member Board with twenty country seats for professional accountancy bodies, and five seats for organizations with an interest in financial reporting.⁸⁰ Regarding the makeup of the Standards Board, the SWP proposed that there be a reasonable geographic spread of Board members.⁸¹

2. Trustee Oversight

The SWP proposed that oversight of the standard setting process be placed in a Board of Trustees made up of twelve Trustees.⁸² Six Trustees would be appointed by various organizations, such as the International Federation of Accountants.⁸³ A Nominating Committee composed of former IASC and IFAC officials would appoint six other at large members.⁸⁴ The SWP believed that most of the Trustees should be from developed countries, but found it desirable to have some from emerging market economies, with special consideration given for countries likely to make use of IASC standards or with a high proportion of foreign trade or enterprises with foreign operations.⁸⁵ The SWP Report provided that there should be a reasonable geographic diversity of Trustees and a diversity of backgrounds, including Trustees with experience in senior positions as users and preparers of financial reports, public accountants, academics, regulators and others who could make active contributions.⁸⁶

3. Improved Due Process

The SWP recognized that better due process in the deliberations of the

⁷⁸ December 1998 SWP Paper, *supra* note 55, ¶ 128.

⁷⁹ *Id.*

⁸⁰ *Id.* ¶ 137(a).

⁸¹ *Id.*

⁸² *Id.* ¶ 148.

⁸³ *Id.* ¶ 149(a).

⁸⁴ December 1998 SWP Paper, *supra* note 55, ¶ 149(b).

⁸⁵ *Id.* ¶¶ 150(c)-(d).

⁸⁶ *Id.* ¶¶ 150(e)-(g).

SDC and the Standards Board would increase the quality and acceptability of IASC standards.⁸⁷ Improved due process would involve increased open meetings of the SDC, Standards Board, and Trustees;⁸⁸ advanced publications of the agendas for meetings of the SDC, Board and Trustees;⁸⁹ publication of a Basis for Conclusions;⁹⁰ optional public hearings and field tests for all projects;⁹¹ and publication of Exposure Drafts and other documents for public comment.⁹²

4. Reaction to the SWP Proposal

The IASC received more than eighty-five letters of comment to the December 1998 SWP Paper. Major opposing positions related to the role of the IASC Standards Board. Regarding the legitimacy of the standard setting body, comments referred mostly to two attributes: (1) representativeness of the decision making body; and (2) independence of its members.⁹³ The most controversial recommendation made by the SWP was that the Standards Board have the final power to approve IASC standards. The Invitation to Comment portion of the draft indicated that some members of the SWP preferred that final approval power should rest with the SDC.⁹⁴

Most letters supported the reorganization project in principle. Widespread support was expressed for the improvements in due process.⁹⁵ The European Commission and many other European observers advocated control over standard setting by a geographically diverse, large Standards Board. Their view of "representativeness" was that legitimacy should come through approval by a relatively large and geographically diverse group of carefully selected and informed persons.⁹⁶

U.S. observers did not support the structure set forth in the December 1998 Paper because the structure did not adequately insure the IASC's

⁸⁷ See generally *id.* ¶¶ 203-04.

⁸⁸ *Id.* ¶ 204(a).

⁸⁹ *Id.* ¶ 204(c).

⁹⁰ December 1998 SWP Paper, *supra* note 55, ¶ 204(d).

⁹¹ *Id.* ¶¶ 205(a)-(b).

⁹² *Id.* ¶ 206(d).

⁹³ See, e.g., Comment Letter from the European Commission to Sir Bryan Carsberg (Apr. 28, 1999) (on file with Professor Ruder) (advocating representativeness); Comment Letter from the U.S. Securities and Exchange Commission to Sir Bryan Carsberg (May 14, 1999) (on file with Professor Ruder) (advocating independence).

⁹⁴ See December 1998 SWP Paper, *supra* note 55, Invitation to Comment, Question 4.

⁹⁵ See, e.g., Comment Letter from the European Commission, *supra* note 93; Letter from the U.S. Securities and Exchange Commission, *supra* note 93. Additional comment letters responding to the 1998 paper's Invitation to Comment are on file with Professor Ruder.

⁹⁶ Comment Letter from the European Commission, *supra* note 93.

independence.⁹⁷ Based in part on the past failings of the CAP and the APB, the FASB, the AICPA, and the SEC advocated a small, highly qualified independent Board and opposed control by a “representative group.” The FASB stated that the SDC “should be an autonomous and independent decision making body.”⁹⁸ The AICPA stated that its vision “contemplates an independent standard setting board, not directly associated with any professional organization, country or national standard setter.”⁹⁹ The SEC agreed.¹⁰⁰

5. *The Compromise*

In November 1999, the SWP adopted a compromise position in “Recommendations on Shaping IASC for the Future” made to the IASC Board.¹⁰¹ The November 1999 SWP Paper emerged after extensive negotiations and conversations between IASC Board members, members of the accounting profession, securities regulators, and the other regulatory authorities. The debate was resolved in favor of the independent board model, with geographic representation at the Trustee level. On March 17, 2000, the IASC Board unanimously approved a new Constitution for the restructured IASC based on the November 1999 SWP Paper.¹⁰² The new Constitution was approved by the members of the IASC on May 24, 2000 and became effective on that date.¹⁰³ The stated objectives of the newly constituted IASCF were to develop a “single set of high quality, understandable and enforceable global accounting standards” and “to bring about convergence” of national and international accounting standards to “high quality solutions.”¹⁰⁴ The convergence objective was thus clearly set forth in the Constitution.

⁹⁷ See, e.g., Comment Letter from the Financial Accounting Standards Board and the Financial Accounting Foundation to Sir Bryan Carsberg 2 (Mar. 10, 1999) (on file with Professor Ruder). The FASB disagreed with a bicameral system because SDC proposals would be subject to Board approval. *Id.* at 17.

⁹⁸ *Id.* at 17.

⁹⁹ Comment Letter from the AICPA to Sir Bryan Carsberg, IASC 3 (Apr. 21, 1999) (on file with Professor Ruder).

¹⁰⁰ See Comment Letters, *supra* note 93.

¹⁰¹ November 1999 SWP Paper, *supra* note 76.

¹⁰² Press Release, International Accounting Standards Committee, Shaping IASC for the Future: IASC Board Approves New Constitution (Mar. 17, 2000), available at <http://www.iasb.org/docs/press/2000pr07.pdf>.

¹⁰³ Press Release, International Accounting Standards Committee, Shaping IASC for the Future: IASC Members Approve Restructuring (May 24, 2000), available at <http://www.iasb.org/docs/press/2000pr16.pdf>.

¹⁰⁴ IASCF Constitution, *supra* note 7, ¶ 2(a).

D. The New Structure of the IASCF

In the new structure, the IASCF was established as an independent organization with:

1. oversight by a representative IASCF Board of Trustees;
2. standard setting by an independent International Accounting Standards Board;
3. interpretations and advice by the International Financial Reporting Interpretations Committee (IFRIC); and
4. advice by the Standards Advisory Council (SAC).¹⁰⁵

1. IASCF Board of Trustees

The Constitution of the IASCF places governance responsibility in a Board of Trustees of the Foundation. The governance pattern is not designed to provide geographical balance in the Trustees, but to preserve the ability of an independent FASB to set accounting standards. The Trustees are given power to appoint the members of the IASB, IFRIC and SAC,¹⁰⁶ to review board strategic issues affecting accounting standards, and to establish “operating procedures” for IASB, IFRIC and SAC. However, the Trustees are excluded from involvement in technical issues relating to accounting standards.¹⁰⁷

2. Geographical Distribution and Qualification for Trustees

The composition of the Foundation Board of Trustees reflects the compromise between independence and representativeness recommended by the SWP. Although the IASB is composed of independent members, the Trustees are representatives of the world’s capital markets. The Constitution provides that the “Trustees shall comprise nineteen individuals”¹⁰⁸ and that “the mix of Trustees shall be representative of the world’s capital markets and a diversity of geographical and professional backgrounds.”¹⁰⁹ The Constitution states that:

In order to ensure a broad international basis, there shall be:
Six Trustees appointed from North America
Six Trustees appointed from Europe

¹⁰⁵ IASCF Constitution, *supra* note 7; *see also* Press Release, International Accounting Standards Committee, IASB Board Reaches Momentous Decision on Its Future Structure (Nov. 19, 1999), available at <http://www.iasb.org/docs/press/99pr1119.pdf>.

¹⁰⁶ IASCF Constitution, *supra* note 7, ¶¶ 16(a)-(b).

¹⁰⁷ *Id.* ¶ 32(a) (giving the Board “complete responsibility for all IASB technical matters”).

¹⁰⁸ *Id.* ¶ 4.

¹⁰⁹ *Id.* ¶ 6.

Four Trustees appointed from the Asia/Pacific Region; and
Three Trustees appointed from any area, subject to establishing
geographic balance.¹¹⁰

Concern regarding Trustee geographic balance was further expressed in a paragraph requiring a constitutional review to be completed five years after adoption of the Constitution, as follows: “such review to include consideration of changing the geographical distribution of Trustees in response to changing global economic conditions.”¹¹¹

3. *Appointment of the Trustees*

In December 1999, even before the new structure was approved, the IASC Board appointed a high level seven-person Nominating Committee to select the Board of Trustees to govern the restructured IASC.¹¹² Members of the Committee included the chairs of the securities regulatory bodies of France, Germany, Hong Kong, and the United States, the deputy chairman of the German accounting standards board, and the President of the World Bank.¹¹³ SEC Chairman Arthur Levitt was chosen by the Nominating Committee members to chair the Committee.¹¹⁴

The Nominating Committee was charged with appointing nineteen Trustees to oversee the new IASC standards board. It was successful in recruiting Trustees of prominence¹¹⁵ and persuaded Paul Volcker, former

¹¹⁰ *Id.*

¹¹¹ *Id.* ¶ 18(b).

¹¹² Press Release, International Accounting Standards Committee, Shaping IASC for the Future: Board Takes First Step in Implementing Proposed Structure – Nominating Committee Approved (Dec. 17, 1999), available at <http://www.iasb.org/docs/press/99pr1217.pdf> [hereinafter Nominating Committee Press Release].

¹¹³ *Id.* The members were: Dr. Karl H. Buamann, Chairman of the Supervisory Board, Siemens AG, Deputy Chairman DRSC (the German national accounting standards setter); Mr. James E. Copeland, Jr., Chief Executive Officer, Deloitte Touche Tohmatsu; Mr. Howard Davies, Chairman, UK Financial Services Authority; Mr. Arthur Levitt, Jr., Chairman, U.S. Securities and Exchange Commission; M. Michel Prada, Chairman, French Commission des Operations de Bourse; Mr. Andrew Sheng, Chairman, Hong Kong Securities and Futures Commission; and Mr. James D. Wolfensohn, President, The World Bank.

¹¹⁴ International Accounting Standards Board, Restructuring IASC (1997-2001), available at http://www.iasb.org/about/history_restructure.asp (last visited Mar. 10, 2005).

¹¹⁵ On May 22, 2000 the IASC Nominating Committee announced the selection of the initial nineteen Trustees of the restructured IASC, including the Chairman. They were selected in accordance with the geographical standards required by Section 6 of the Constitution, as follows:

North America (6): The Hon Paul A Volcker, *Chairman*, Former Chairman, U.S. Federal Reserve Board; John H Biggs, Chairman, TIAA-CREF; L Yves Fortier, Chairman, Ogilvy Renault, Barristers and Solicitors; Former Ambassador of Canada to the United Nations;

Chairman of the United States Federal Reserve Board, to serve as Chairman of the Board of Trustees.¹¹⁶

4. *International Accounting Standards Board*

a. IASB – Establishment and Powers

The new Constitution established the International Accounting Standards Board, with “responsibility for all IASB technical matters including the preparation and issuing of International Accounting Standards,”¹¹⁷ thus indicating the Board’s independence. It also added that the Board would “have full discretion over the technical agenda of the IASB and over project assignments on technical matters.”¹¹⁸

b. IASB – Combining Skills and Independence

The IASB is comprised of fourteen members, two of whom are part-time.¹¹⁹ Although foremost qualification for membership of the IASB is “technical expertise,”¹²⁰ other criteria also apply. The Trustees are charged with

Philip A Laskawy, Chairman, Ernst & Young International; David S Ruder, Professor of Law, Northwestern University School of Law and Former Chairman, U.S. Securities & Exchange Commission; William C Steere, Jr., Chairman and CEO, Pfizer Inc.

Europe (6): Guido A Ferrarini, Professor of Law, University of Genoa; Cornelius Herkströter, Former President, Royal Dutch Petroleum; Hilmar Kopper, Chairman of the Supervisory Board, Deutsche Bank; Sir Sydney Lipworth, Chairman, UK Financial Reporting Council; Didier Pineau-Valencienne, Chairman, Association Française des Entreprises Privées; Jens Røder, Senior Partner, PricewaterhouseCoopers, Denmark

Asia-Pacific (4): Toshikatsu Fukuma, Chief Financial Officer, Mitsui & Co., Ltd.; Charles Yeh Kwong Lee, Chairman, Hong Kong Exchange and Clearing Ltd.; Kenneth H Spencer, Former Chairman, Australian Accounting Standards Board; company director; Koji Tajika, Co-Chairman, Deloitte Touche Tohmatsu;

Other (3): Roy Andersen, Deputy Chairman and CEO, The Liberty Life Group (South Africa); Andrew Crockett, General Manager, Bank for International Settlements; Roberto Teixeira da Costa, Former Chairman, Brazilian Comissão de Valores Mobiliários.

Press Release, International Accounting Standards Committee, Shaping IASC for the Future: IASC Nominating Committee Selects Initial Trustees of Restructured IASC (May 22, 2000), available at <http://www.iasb.org/docs/press/2000pr15.pdf> [hereinafter Initial Trustees Press Release].

¹¹⁶ *Id.*

¹¹⁷ IASCF Constitution, *supra* note 7, ¶ 32(a).

¹¹⁸ *Id.* ¶ 32(c).

¹¹⁹ *See id.* ¶ 19.

¹²⁰ IASCF Constitution, *supra* note 7, ¶ 20.

selecting a group of people representing “the best available combination of technical skills and background experiences of relevant international business and market conditions.”¹²¹ The latter clause was added so that some of the board members would have practical experience in applying accounting principles. To further the objectives of assuring broad backgrounds, the Constitution requires that there be minimum numbers of members with the following backgrounds: three practicing auditors; three preparers of financial statements; three users of financial statements; and one academic. No background was specified for the other four Board members.¹²²

Independence was emphasized in the provisions stating that “[t]he foremost qualification for membership shall be technical expertise,”¹²³ and that “[t]he selection of members of the IASB shall not be based on geographic representation. The Trustees shall ensure that the IASB is not dominated by any particular constituency or geographical interest.”¹²⁴

The Constitution accepted the SWP theory that IASB standards should be promulgated in cooperation with the standard setters of various countries. In order to facilitate that cooperation and to help achieve convergence, the Constitution specifies that “seven of the full-time members of the IASB will be expected to have formed liaison responsibilities with national standard-setters in order to promote” convergence.¹²⁵

IASB cooperation with the standard setters of the various countries is the core of the plan for successful convergence of accounting standards. Although the IASB’s International Financial Reporting Standards (IFRSs) will not in most cases be binding on national standard setters, the theory of establishing liaison relationships is that national standard setters and the IASB will adopt nearly identical standards at the same time. The plan is that standard setting agendas will be coordinated, draft standards proposals will be similar, and the national standard setters will provide expertise and staff to assist in IASB projects.

c. Board Appointments

Sir David Tweedie, formerly Chairman of the United Kingdom’s Accounting Standards Board (ASB), was selected to chair the new Board on January 28, 2000. Sir David was a well-respected representative to the IASC Board, was an experienced standard setter at both the IASC and the

¹²¹ *Id.*

¹²² *Id.* ¶ 22.

¹²³ *Id.* ¶ 20.

¹²⁴ *Id.* ¶ 21.

¹²⁵ *Id.* ¶ 23.

ASB, had a fine record as administrator of the ASB, and had been an active member of the Strategy Working Party. His unanimous selection by the Trustees provided a vigorous start for the administration of the IASB.

Following Sir David's appointment, the Trustees advertised for IASB Board positions, considered more than 200 applicants, and chose the fourteen Board members. The requirements that there be three auditors, three preparers, three users, and one academic posed difficult selection problems for the Trustees because the well qualified candidates did not fit neatly into required categories.¹²⁶

5. *The International Financial Reporting Interpretations Committee*

The Constitution also established an International Financial Reporting Interpretations Committee (IFRIC), modeled after the Emerging Issues Task Force of the FASB.¹²⁷ IFRIC's role is to interpret the application of IFRSs and to provide timely guidance on financial reporting issues not otherwise addressed.¹²⁸ It is required to report its final interpretations to the IASB and obtain its approval.¹²⁹

Selection of IFRIC members is not subject to constitutional provisions requiring either independence or full-time service, prohibiting geographical representation, or requiring a balance of auditors, preparers, users, or academics. However, the Constitution does impose independence standards by requiring that IFRIC members "vote in accordance with their own independent views not as representatives voting according to the views of any firm, organization or constituency with which they may be associated."¹³⁰

IFRIC is currently composed of eleven members, including six audit firm partners, two preparers, two analysts, and two academics. The European Commission and IOSCO are observers.¹³¹

¹²⁶ In their Constitution Review, the Trustees' Constitution Committee proposed to relax these requirements, stating that "the present system (when combined with liaison requirements) may be unduly restrictive and may inhibit the recruitment of qualified candidates." International Accounting Standards Committee Foundation, *Review of the Constitution: Proposals for change* (Nov. 2004), available at http://www.iasb.org/uploaded_files/documents/8_949_2004-cons-itc.pdf, ¶¶ 80, 97, 98 [hereinafter *Proposals for Change*]. See also Part III.E.5, *infra*.

¹²⁷ IASCF Constitution, *supra* note 7, ¶ 34. IFRIC was established in its current form following a revision of the Constitution effective March 2, 2002. The Constitution was also revised by the Trustees on July 8, 2002 to reflect changes considered to be minor variations pertinent to paragraph 15 of the Constitution.

¹²⁸ *Id.* ¶ 37 (a).

¹²⁹ *Id.* ¶ 37 (d).

¹³⁰ *Id.* ¶ 36.

¹³¹ International Accounting Standards Board, IFRIC Members, available at <http://www.iasb.org/about/ifricmembers.asp> (last visited Mar. 10, 2005).

6. *The Standards Advisory Council*

Geographical diversity at the advisory level was established by creating a Standards Advisory Council (SAC) that:

provides a forum for participation of organizations and individuals with an interest in international financial reporting, having diverse geographical and functional backgrounds, with the objective of (a) giving advice to the IASB on agenda decisions and priorities in the IASB's work, (b) informing the IASB of the views of organizations and individuals of the Council on major standard-setting projects and (c) giving other advice to the IASB or the Trustees.¹³²

Members of the SAC are appointed by the Trustees and are expected to provide the IASB with practical advice regarding the impact of proposed standards on business operations. Although the Constitution states that the "Council shall comprise 30 or more members,"¹³³ the interest in service on the SAC was so large that when establishing the Council the Trustees chose 50 persons to serve as members of the Council.¹³⁴

7. *IASB Voting*

The voting process at a standard setter can affect outcome. The IASCF Constitution requires that IFRSs and IFRIC interpretations be approved by eight of the fourteen members of the IASB, but requires approval only by a majority of the members present at a meeting for other matters.¹³⁵

8. *IASB Due Process*

In answer to criticisms that IASC standard setting was not sufficiently open, the SWP recommendations for IASB due process were included in the Constitution. The Constitution contains requirements that the IASB publish exposure drafts on all projects,¹³⁶ establish procedures for reviewing comments,¹³⁷ and consult the Standards Advisory Council on major

¹³² IASCF Constitution, *supra* note 7, ¶ 38.

¹³³ *Id.* ¶ 39.

¹³⁴ Press Release, International Accounting Standards Board, Trustees Name Standards Interpretation Committee (Dec. 13, 2001).

¹³⁵ IASCF Constitution, *supra* note 7, ¶ 31. On the other matters, including publication of drafts, a simple majority of the members present at a meeting is required, provided that the meeting is attended by at least 60% of IASB members. *Id.* The Chairman is given a casting vote at such meetings. *Id.* ¶ 30.

¹³⁶ *Id.* ¶ 32(b).

¹³⁷ *Id.* ¶ 32(d)(i).

projects, agenda decisions, and work papers.¹³⁸ On other due process matters the IASB is given discretion. It is advised “normally” to form Steering Committees or other advisory groups¹³⁹ and to issue “bases for conclusions.”¹⁴⁰ It is advised to “consider” holding hearings¹⁴¹ and undertaking field tests.¹⁴²

III. CONSTITUTIONAL REVIEW

A. Procedures for Review

The Trustees have the power to amend the Constitution¹⁴³ by a 75% majority vote.¹⁴⁴ They are required to review the entire structure of the IASC Foundation and its effectiveness with the objective of implementing any agreed changes five years after the coming into force of the Constitution.¹⁴⁵ They are required to undertake “a similar review subsequently every five years.”¹⁴⁶

As required by the IASC Constitution,¹⁴⁷ the Trustees initiated a “Constitution Review” in November of 2003 with the objective of implementing changes by February 6, 2006, five years after the incorporation of the IASC Foundation.¹⁴⁸ The Trustees formed a Constitution Committee, which has published consultation papers, held hearings, received comments, and made recommendations to the Trustees. After discussing the recommendations from the Constitution Committee, the Trustees published a final consultation paper. The papers published by the Constitution Committee and the Trustees are:

1. IASCF Constitution Committee, Identifying Issues for the IASC

¹³⁸ *Id.* ¶ 32(d)(iii).

¹³⁹ *Id.* ¶ 32(d)(ii).

¹⁴⁰ IASCF Constitution, *supra* note 7, ¶ 32(d)(iv).

¹⁴¹ *Id.* ¶ 32(e).

¹⁴² *Id.* ¶ 32(f).

¹⁴³ *Id.* ¶ 15.

¹⁴⁴ A 75% majority of Trustees is required for amendments to the Constitution. *Id.* Amendments to the Constitution require a due process, including consultation with the Standards Advisory Council and Publication of an exposure draft for public comment. *Id.* ¶ 16(g).

¹⁴⁵ IASCF Constitution, *supra* note 7, ¶ 18(b).

¹⁴⁶ *Id.* ¶ 18(c).

¹⁴⁷ *Id.* ¶ 18(b).

¹⁴⁸ Press Release, International Accounting Standards Committee Foundation, Trustees Announce the Process for Constitutional Review (Nov. 12, 2003), *available at* http://www.iasb.org/uploaded_files/documents/8_887_IASCFReviewProcess.doc. [hereinafter Process for Constitutional Review]. The following discussion of the Constitution Review process was current as of this Article’s publication date of April 6, 2005.

- Foundation Constitution Review, an Invitation to Comment, November 2003.¹⁴⁹
2. IASB Constitution Committee, Next Steps for the Constitution Review Following Initial Consultations, March 22, 2004.¹⁵⁰
 3. IASCF Constitution Committee, An Update on the Constitution Review and Information Regarding Public Hearings, May 7, 2004.¹⁵¹
 4. IASCF Constitution Committee, An Update on Constitution Review for Hearing in Mexico City, September 28, 2004.¹⁵²
 5. IASCF, Preliminary Recommendation by the Constitution Committee to the IASCF Trustee for Consideration at the October 25 Trustees Meeting, revised October 20, 2004.¹⁵³
 6. IASCF, Review of the Constitution: Proposals for Change, November 2004.¹⁵⁴

The Constitution review process has raised a number of issues that relate to the IASB's independence, and ultimately to the success of the convergence process. The issues were discussed in the various consultation papers, in responses to those papers, and in testimony at various hearings.

B. Issues for consideration

In their November 2004 paper, Proposals for Change, the Trustees made proposals in various areas, most of them affecting independence and convergence.¹⁵⁵ The Trustees identified ten issues for consideration:

¹⁴⁹ International Accounting Standards Committee Foundation, *Identifying Issues for the IASC Foundation Constitution Review* (Nov. 2003), available at <http://www.iasb.org/docs/2003-itc/2003-con-itc.pdf> [hereinafter *Identifying Issues*].

¹⁵⁰ International Accounting Standards Committee Foundation, Next Steps for the Constitution Review Following Initial Consultation (Mar. 22, 2004), available at http://www.iasb.org/uploaded_files/documents/8_887_ConstitutionReviewNextSteps.pdf.

¹⁵¹ International Accounting Standards Committee Foundation, An Update on the Constitution Review and Information Regarding Public Hearings (May 7, 2004), available at http://www.iasb.org/uploaded_files/documents/8_860_anUpdateontheConstitutionReview.pdf.

¹⁵² International Accounting Standards Committee Foundation, An Update on Constitution Review for Hearing in Mexico City (Sept. 28, 2004), available at http://www.iasb.org/uploaded_files/documents/8_887_UpdateforMexico280904.pdf.

¹⁵³ International Accounting Standards Committee Foundation, Preliminary Recommendation by the Constitution Committee to the IASCF Trustee for Consideration at the October 25 Trustees Meeting (rev. Oct. 20, 2004), available at http://www.iasb.org/uploaded_files/documents/latest_update_21_10_04.pdf [hereinafter *Preliminary Constitution Committee Recommendation*].

¹⁵⁴ Proposals for Change, *supra* note 126.

¹⁵⁵ *Id.*

1. Whether the objectives of the IASC Foundation should expressly refer to the challenges facing small and medium-sized entities (SMEs).
2. Number of Trustees and their geographical and professional distribution.
3. The oversight role of the Trustees.
4. Funding of the IASC Foundation.
5. The composition of the IASB.
6. The appropriateness of the IASB's existing formal liaison relationships.
7. Consultative arrangements of the IASB.
8. Voting procedures of the IASB.
9. Resources and effectiveness of the International Financial Reporting Interpretations Committee.
10. The composition, role, and effectiveness of the Standards Advisory Council.¹⁵⁶

The Trustees' proposals regarding each of these topics were made after receiving comments from various interested parties, including companies, standard setters, professional organizations, and other entities. The comments reflected diverse views regarding the importance of having an independent IASB Board.

C. Responses Advocating Decreases in IASB Independence

Some of the responders advocated changes that would reduce the IASB's independence from the influence of business and political interests.

1. *Increased Representation from Countries Using IFRSs*

A number of responders told the Committee that membership selection for either the IASCF Trustees, or the Board members, or both, should favor candidates from countries already using IFRSs. The European Financial Reporting Advisory Group (EFRAG) opined that "the IASB will have greater credibility if trustees and members of the Board come predominantly from countries using IFRSs."¹⁵⁷ Taking this idea a step further, BNP Paribas explained why such a change would improve the IASB's credibility: "[T]he legitimacy of international accounting standards implies that they be prepared and approved by countries that have adopted IFRSs."¹⁵⁸ This was a popular position among European agencies, organizations and corporations,¹⁵⁹ some of whom stated that the IASB was

¹⁵⁶ *Id.* at 12-41.

¹⁵⁷ Comment letter from EFRAG to Tom Seidenstein 2 (Feb. 19, 2004), available at <http://www.iasb.org/docs/2003-itc/cl64.pdf>.

¹⁵⁸ Comment letter from BNP Paribas to Tom Seidenstein 1 (Feb. 11, 2004), available at <http://www.iasb.org/docs/2003-itc/cl66.pdf>.

¹⁵⁹ Responders recommending that Trustee or Board membership favor IFRS-applying

dominated by members from countries with “legalistic”¹⁶⁰ accounting-regulation traditions.¹⁶¹

2. Greater Trustee Oversight

Many responders argued that the Trustees should regularly “review” the Board’s strategy and procedures. BNP Paribas recommended “the board of [T]rustees review regularly the strategy as well as the agenda which can’t be separated from the strategy, and the operating procedures of the IASB.”¹⁶² The Basel Committee on Banking Supervision cited “a need for more active ongoing oversight of the IASB than that currently provided by the Trustees” in order to improve the IASB’s “accountability.”¹⁶³

3. Greater Due Process

A large number of responses to the Trustees’ due process question reflected dissatisfaction with the IASB’s processes of exposure, comment, and deliberation when drafting standards. A number of responders seemed to be faulting the IASB’s due process for failing to produce results to their liking. For instance, Banque de France said:

The use of public comments by IASB could also be improved. In several cases, it was noted that the IASB did not change its mind although convergent comments criticized some proposals in a draft standard. We think it is necessary to clarify such kind of situation and give a more detailed feedback on comment letters received. The Constitution provisions related to due process should also determine how binding public consultations could be, when there is a consensus

countries included EFRAG, RSM Robson Rhodes LLP, BNP Paribas, Banque de France, Deutscher Standardisierungsrat (arguing that “the criterion of experience in applying IFRS” should be used to select Trustees), Compagnie Nationale des Commissaires aux Comptes (“CNCC”), the Association of Chartered Certified Accountants, Ernst & Young Global Limited, the European Commission (“The real question is who are the constituents of the IASC Foundation and the IASB? . . . In the composition of the Board of Trustees, clear weighting should be given to those countries that apply IAS”). For all comment letters, see International Accounting Standards Foundation, IASC Foundation Projects: Comment letters received in first round of consultation (Feb. 2004), *available at* http://www.iasb.org/current/iascf_comment.asp?showPageContent=no&xml=16_96_88_230_82004.htm (last visited Mar. 10, 2005).

¹⁶⁰ Comment Letter from Basel Committee on Banking Supervision to Tom Seidenstein 2 (Feb. 11, 2004), *available at* <http://www.iasb.org/docs/2003-itc/cl133.pdf>.

¹⁶¹ See Comment Letter from Banque de France to Tom Seidenstein ¶ 1.2 (Feb. 23, 2004), *available at* <http://www.iasb.org/docs/2003-itc/cl168.pdf>.

¹⁶² Comment Letter from BNP Paribas, *supra* note 158, at 3.

¹⁶³ Comment Letter from Basel Committee on Banking Supervision, *supra* note 160, at 2.

against a proposal of the IASB.¹⁶⁴

Other critics recommended that the IASB's due process be redirected toward considering the "implementability"¹⁶⁵ and "macroeconomic effects"¹⁶⁶ of accounting standards.

Many of the critics of IASB independence seemed to be concerned with the effect of IASB standards on business interests. Some organizations and companies seemed to consider the short-term economic effects of accounting standards to be more important than the benefits derived from transparency and comparability. For example, the February 2004 comment letter of UNICE, the European organization of employers, complained that "many of the standards adopted are too burdensome for business to comply with . . . an excessive emphasis is being placed on abuse prevention."¹⁶⁷

4. IASB Independence

Opposition to IASB independence was revealed in several ways. BNP Paribas argued that the Trustees should give banks more power as part of the "analyst and investment community".¹⁶⁸

Banks lend money to companies on the basis of their financial statements and insurance companies invest heavily in financial markets. They belong to the users' community and should be involved in the standard-setting process as such.¹⁶⁹

Some responders advocated requiring supermajority votes of the Board to pass standards¹⁷⁰ and increasing the number of part-time Board

¹⁶⁴ Comment Letter from Banque de France, *supra* note 161, ¶ 1.3.

¹⁶⁵ Comment Letter from BNP Paribas, *supra* note 158, at 2.

¹⁶⁶ *Id.*

¹⁶⁷ Comment Letter from UNICE to Tom Seidenstein 2 (Feb. 9, 2004), *available at* <http://www.iasb.org/docs/2003-itc/cl25.pdf>.

¹⁶⁸ *Identifying Issues*, *supra* note 149, at 9.

¹⁶⁹ *Id.* Comment Letter from BNP Paribas, *supra* note 158, at 4. Investors reap the benefits of high quality standards, so they might be expected to support the same reforms that politically powerful economic interests tend to oppose. Despite the expectation, the Constitution Committee admitted that the IASCF "has experienced difficulty" in involving investors in standard setting. *Identifying Issues*, *supra* note 149, at 9. Part of the answer to the question of why investors seem much less interested in supporting high quality accounting standards than economic interests are in opposing them perhaps can be found by analyzing the magnitude of impacts. Each improvement in accounting standards benefits an individual investor only marginally but it may require wrenching changes for a large reporting corporation.

¹⁷⁰ *See, e.g.*, Comment Letter from Federation des Experts Comptables Europeens to Tom Seidenstein 3 (Feb. 11, 2004), *available at* <http://www.iasb.org/docs/2003-itc/cl40.pdf>:

members.¹⁷¹ Both changes might diminish the Board's independence, or the meaningfulness thereof—the former by simply making the passage of standards more difficult and the latter by increasing the odds of having Board members still employed by, or beholden to, economic interests.

D. Responses Advocating Independence

Proponents of the IASB's independence also responded to the paper. One proponent, the United Kingdom's Accounting Standards Board (ASB), advocated widely-based selection of Trustees and Board members: "It is . . . important not only that dominance by any one constituency or group should be avoided but also that it should be widely perceived to have been avoided."¹⁷² The Committee of European Securities Regulators affirmed that any reform must protect the IASB's independence and that "[t]he needs of investors should be paramount." Its discussion of due process issues was oriented towards process, rather than result.¹⁷³

Given the wide implications of new or amended standards and IASB's public interest role and in order to ensure a strong consensus on the Board in respect of new exposure drafts and standards of the highest quality, it is advisable to change these voting rules to qualified majority by requiring approval by ten out of fourteen members.

¹⁷¹ See, e.g., Comment Letter from Ernst & Young to Tom Seidenstein 5 (Feb. 11, 2004), available at <http://www.iasb.org/docs/2003-itc/cl23.pdf>:

A Board that is made up exclusively of professional standard setters is likely to be less accountable to those for whom it is preparing standards than a board that includes members with current or very recent experience as preparers and users . . . they will inevitably tend to promote conceptual purity above practicality In our view, a largely part-time board would bring the necessary practical experience to bear and would therefore be better placed than a largely full-time board to address these issues.

¹⁷² Comment Letter from Accounting Standards Board to Tom Seidenstein ¶ 9 (Feb. 12, 2004), available at <http://www.iasb.org/docs/2003-itc/cl27.pdf>. See also Comment Letter from Accounting Standards Board (Canada) to Paul Volcker 2 (Feb. 10, 2004), available at <http://www.iasb.org/docs/2003-itc/cl16.pdf> ("Independence of the standard-setting process and highest quality of standards must be non-negotiable."); Comment Letter from Deloitte Touche Tomatsu to Tom Seidenstein 2 (Feb. 11, 2004), available at <http://www.iasb.org/docs/2003-itc/cl21.pdf> ("[T]he trustees should [ensure] . . . that Board members are not denominated by any individual characteristic.")

¹⁷³ Comment Letter from Committee of European Securities Regulators to Tom Seidenstein 3 (Feb. 11, 2004), available at <http://www.iasb.org/docs/2003-itc/cl37.pdf>.

E. The Trustees' Proposals

1. *General Support of Independence*

After receiving the Constitution Committee's October 25, 2004¹⁷⁴ recommendations, the Trustees endorsed a set of final proposals in their paper, "Review of the Constitution: Proposals for Change," on November 23, 2004.¹⁷⁵ In their proposals, the Trustees responded to many of the proposals for change and emphasized their support for the independence of the IASB. The Trustees' statement on the "Philosophy of the Constitution Review" expressed clear support for an independent IASB as follows:

The Constitution approved by the former IASC in 2000 established a new structure that recognized the need both to assure the quality of the standards and the accountability of the standard-setting process to the public, which the organization serves. The result is a carefully conceived process, whereby the technical and frequently difficult and controversial decisions in setting accounting standards are the responsibility of an independent expert group with diverse practical and professional backgrounds. The process is overseen by a broadly representative Trustee body. While not opining on technical accounting decisions, the Trustees ensure that decisions of the IASB are taken with due care, only after appropriate and extensive consultation, and using the IASB's best professional judgment. The purpose of this system is to protect the integrity of the standard-setting process from vested interests, political and parochial pressures, and purely national considerations.¹⁷⁶

The Trustees prefaced their proposals for change by emphasizing that they would "continue to protect the independence of the IASC Foundation and the IASB" while ensuring "that the organisation remains responsive to the requirements of the marketplace and the many parties that seek a voice in the development of broadly accepted, high quality international accounting standards."¹⁷⁷ They reaffirmed the organization's basic dichotomy: the Trustees are "widely representative," while the IASB is "independent."¹⁷⁸

¹⁷⁴ Preliminary Constitution Committee Recommendation, *supra* note 153.

¹⁷⁵ Proposals for Change, *supra* note 126. A three-month comment period on Proposals for Change ended on February 23, 2005.

¹⁷⁶ *Id.* ¶ 11.

¹⁷⁷ *Id.* ¶ 13.

¹⁷⁸ *Id.*

2. Number of Trustees and Distribution

Regarding the issue of “Trustee selection and geographic and professional distribution” the Trustees rejected proposals that special recognition be given to countries that have adopted IFRSs. Instead, they recognized that other areas of the world should be encouraged to adopt IFRSs. They proposed increasing the number of Trustees to twenty-two from nineteen, and adding two new Trustees from Asia/Oceania and one new Trustee from any area.¹⁷⁹ The Trustees also proposed increasing the size of the board to twenty-two¹⁸⁰ in recognition “that some large economies outside Europe and North American may be under represented or not represented at all.”¹⁸¹ After noting that the organization’s objectives “call for the organisation to work ‘in the public interest’ towards ‘global accounting standards’ through a process of ‘convergence of national accounting standards’ and IFRSs,”¹⁸² they stated that:

Weighting a particular region because of its current position on IFRSs might impede the objective of developing global standards. First, reducing the relative representation of an area because it has not adopted IFRSs at present might reduce the incentive for it to participate in convergence. Second, to emphasise particular areas that are using IFRSs might focus the IASC Foundation and the IASB on regional or national concerns at the expense of the organisation’s broader international objectives¹⁸³

The Trustees also endorsed changes regarding the background of Trustees by relaxing specificity of professional backgrounds.¹⁸⁴

3. Trustee Oversight

The Proposals for Change supported continued IASB independence by clarifying that, although the Trustees could review the IASB’s agenda, the Trustees would not control the agenda. Under the Proposals for Change, the Trustees would be required to “review annually the strategy of the IASC Foundation and the IASB and its effectiveness, including consideration, but

¹⁷⁹ *Id.* ¶ 40. They proposed changing the phrase “Asia/Pacific” to “Asia/Oceania” to make clear that North and South American countries on the Pacific Ocean are not intended to be treated as part of this grouping. *Id.* ¶ 36.

¹⁸⁰ Proposals for Change, *supra* note 126, ¶ 32.

¹⁸¹ *Id.* ¶ 40.

¹⁸² *Id.* ¶ 43.

¹⁸³ *Id.* ¶ 44.

¹⁸⁴ *Id.* ¶ 47. It removed a provision giving IFAC the right to nominate five Trustees, but included a provision that “two of the Trustees shall normally be senior partners of prominent international accounting firms.” *Id.* ¶¶ 33, 49.

not determination, of the IASB's agenda."¹⁸⁵ The Trustees stated that they continue to believe that the IASB must retain the ability to set its agenda.¹⁸⁶ They specifically rejected Trustee control over the IASB agenda:

Some respondents called for a specific requirement for the Trustees to approve the IASB's agenda. Such a requirement would be inconsistent with the aim of leaving the technical decision-making process to an appointed expert group, the IASB. The consideration of the IASB's agenda should not be interpreted as authority to impose or determine the agenda, which is for the IASB to establish and approve subject to appropriate consultation. The purpose of 'consideration' is to determine, consistently with the Trustees' oversight role, whether the IASB has followed appropriate procedures and criteria for establishing its agenda and has received comment on its agenda from the Trustees.¹⁸⁷

In recognition of proposals that Trustee oversight of the IASB should be increased, the Trustees proposed changing the wording in Paragraph 32(c) dealing with the IASB's power over its agenda from an articulation that the IASB shall have full discretion "over" its technical agenda to a statement that it will have full discretion "in developing and pursuing the technical agenda."¹⁸⁸ The Proposals for Change again indicated that the IASB's independence should be preserved, stating:

The Trustees emphasized that the change in wording should not be interpreted as an intention to undermine the IASB's independence in standard-setting. For that reason, the IASB's sole right to develop and pursue its agenda remains clear.¹⁸⁹

Thus, the final proposal was to give the Trustees an increased oversight role, but not the right to control the IASB's agenda.¹⁹⁰

4. Funding

Regarding funding, the Trustees proposed changing the wording of Section 14(a) of the Constitution dealing with fundraising to require IASCF Trustees to "satisfy themselves that appropriate financing arrangements are

¹⁸⁵ *Id.* ¶ 57.

¹⁸⁶ Proposals for Change, *supra* note 126, ¶ 60.

¹⁸⁷ *Id.* ¶ 61.

¹⁸⁸ *Id.* ¶ 106.

¹⁸⁹ *Id.* ¶ 109.

¹⁹⁰ The Trustees also rejected a proposal that the word "approve" be included in the provision instructing the Trustees to establish and amend the IASB's due process. *Id.* ¶ 57 (proposing, instead, to require the Trustees to "establish and amend the operating procedures, consultative arrangements and due process for the IASB, the International Financial Reporting Interpretations Committee and the Standards Advisory Council").

in place.” The existing language required Trustees to assume “responsibility for fundraising.”¹⁹¹ In proposing the change, the Trustees recognized the possibility of establishing “various fee-based systems,”¹⁹² possibly similar to the fee system established in the United States for the FASB.¹⁹³

They noted independence concerns relating to partial dependence on voluntary contributions, including possible lack of objectivity in an effort to please contributors and possible withdrawal of funding by dissatisfied contributors, leading to disruption of the IASB’s work.¹⁹⁴

5. *IASB Composition*

IASB Board composition is crucial to its independence. The Trustees rejected a possible increase in part-time Board members and instead recommended keeping the number of part-timers at two. They proposed language making clear that “part-time” means a substantial time commitment, as follows:

The remaining two members shall be part-time members (the expression “part-time” meaning that the members concerned commit most of their time in paid employment to the IASC Foundation). . . .¹⁹⁵

The Trustees noted that the proposal to “keep the existing limit of two for part-time members” was favored “by a narrow majority,”¹⁹⁶ and solicited “additional views on the issue” during the final comment period.¹⁹⁷

They added that the issue of representativeness versus independence is raised by the “part-time” requirements. They noted that those favoring increasing part-time members argue that such members would give the IASB “a better understanding of the practical issues related to standard-setting.”¹⁹⁸

The Trustees noted that those opposing the increase had pointed to the potential for increased conflicts of interest, and had expressed concern that part-time members might not be able to handle the workload.¹⁹⁹ The view that part-time members might not be able to handle the workload seems to be bolstered by the Trustees’ proposal that part-time members commit

¹⁹¹ Proposals for Change, *supra* note 126, ¶ 68.

¹⁹² *Id.*

¹⁹³ *Id.* ¶ 71. See Part III.A.6, *supra* (discussing FASB funding).

¹⁹⁴ *Id.* ¶ 69.

¹⁹⁵ *Id.* ¶ 76.

¹⁹⁶ *Id.* ¶ 85.

¹⁹⁷ Proposals for Change, *supra* note 126, ¶ 86.

¹⁹⁸ *Id.* ¶ 83.

¹⁹⁹ *Id.* ¶ 84.

“most” of their time to the FASB rather than “less than all” of their time.²⁰⁰

The Trustees did not accept proposals for geographic balance. They recognized the argument that a geographic basis for membership would assist the board in understanding the impact of IFRSs in particular regions,²⁰¹ but stated that:

[T]he Trustees believe that introducing geographical elements into the IASB’s membership would be inconsistent with the aim of ensuring the independence of judgment and the priority for convergence. The Trustees point out that the logic of the present organizational arrangements is that decision-making is delegated to professional standard-setters, who do not make the decision as representatives of particular countries, but on the basis of the technical merits of a particular argument and the objective of worldwide application of a standard.²⁰²

In one respect the Trustees’ proposals may be seen as reducing IASB independence. The Trustees proposed replacing the phrase “the foremost qualifications” for IASB membership shall be “technical expertise,” with the requirement that the “main qualifications” be “professional competence and practical experience.”²⁰³ However, in response to contentions that technical expertise would no longer be a criterion, the Trustees expressed the belief that their proposed changes would convey a broader range of skills, but that “technical expertise and substantive knowledge remain key qualifications.”²⁰⁴

The Trustees also recommended abandoning the complex numerical formula for backgrounds as auditors, preparers, users, and academics and proposed substituting a provision that: “The Trustees shall select IASB members so that the IASB as a group provides an appropriate mix of recent practical experience among auditors, preparers, users, and academics.”²⁰⁵ This change will make it easier for Trustees to achieve desirable balance on the IASB.

6. *Liaison Relationships*

The Trustees endorsed suggestions that the IASB’s formal liaison relationships with standard setters be replaced with a non-specific

²⁰⁰ *Id.* ¶ 76 (suggesting changes to Article 19).

²⁰¹ *Id.* ¶ 93.

²⁰² *Id.* ¶ 94.

²⁰³ Proposals for Change, *supra* note 126, ¶ 77 (proposing amendments to Article 21).

²⁰⁴ *Id.* ¶ 87.

²⁰⁵ *Id.* ¶ 80.

expectation of wide ranging liaison activities.²⁰⁶ As more countries adopt IFRSs, this change should provide the IASB with more flexibility in achieving convergence.

7. Consultative Arrangements

Despite calls for changes in due process, the Trustees did not propose making changes to IASB process. Instead, they recognized that the IASB was conducting its own internal review of its due process and endorsed the IASB's efforts to improve due process voluntarily.²⁰⁷ The Trustees declined to propose to "enshrine" more detailed due process requirements in the Constitution than those already present,²⁰⁸ but did propose to add a "comply-or-explain" requirement.²⁰⁹

8. IASB Voting Procedures

Regarding the IASB's voting procedures, the Trustees noted that debate on the issue had produced strongly held views both in favor of and against requiring nine votes for the IASB to publish a standard or exposure draft, or interpretation instead a majority of eight votes.²¹⁰ Proponents argued that larger majorities "would provide more credibility" for standards upon adoption,²¹¹ while opponents countered that the nine vote requirement might "compromise the quality of standards—to get standards approved by the necessary supermajority, the IASB might be forced to add special exceptions and compromises."²¹² The Trustees voted in the end to propose the nine vote supermajority requirement.²¹³

9. The Standards Advisory Committee

In recognition of the desirability of a better advisory role for the Standards Advisory Council, the Trustees asked the SAC members to review the role and function of the SAC. In response, the SAC proposed a revised SAC Charter aimed at enhancing the SAC's effectiveness. The Trustees published the proposed new SAC charter as an attachment to

²⁰⁶ *Id.* ¶ 99.

²⁰⁷ *Id.* ¶ 113. The IASB's plan is described in "Recommendations regarding the IASB's consultative procedures." *Id.* app. C.

²⁰⁸ *Id.* ¶ 111.

²⁰⁹ Proposals for Change, *supra* note 126, ¶ 106 (proposing to add art. 32(g) to require the IASB to "give reasons if it does not follow any of the non-mandatory procedures set out in [this section of the Constitution]").

²¹⁰ *Id.* ¶ 116.

²¹¹ *Id.* ¶ 117.

²¹² *Id.* ¶ 118.

²¹³ *Id.* ¶ 115.

Proposals for Change, but did not advance the new Charter as a Constitutional amendment. A proposal to amend the Constitution to provide that the Chairman of the Council would “not be a member of the IASB or a member of its staff”²¹⁴ was received positively by commentators. Suggestions for improvement in SAC due process were reflected in the proposed new SAC Charter.

F. Support for Independence

With the exception of the new supermajority voting requirement, the Trustees’ proposals were clearly intended to preserve the IASB’s independence. The Trustees emphasized that there is no “intent to undermine the IASB’s independence in standard setting” and that “the IASB’s sole right to set its agenda remains clear.”²¹⁵

The ability of the IASB to avoid the perception and reality of being dominated by any interest will improve its chances of bringing about global convergence, in part because regulators, including the SEC, will be more likely to accept standards created by an independent body and in part because independence will be crucial to the convergence process.

G. Responses to Proposals for Change

Following the IASCF’s publication of Proposals for Change, letter responses were received from sixty-six commentators regarding the Constitution Review.²¹⁶ The responses were favorable to most of the Trustee positions, but some topics continued to receive critical comment, primarily from Europeans.

The European commentators urged: 1) greater European representation in the IASCF and the IASB; 2) greater numbers of part-time members in the IASB; 3) greater oversight of the IASB by the Trustees; and 4) greater Trustee accountability. Some sought delay in adoption of amendments to the IASCF Constitution.

The European Commission expressed concern about the “overall accountability of international standard setters.” It urged “appropriate procedures for the selection and appointment of Trustees,” increased membership in the IASB, IFRIC and the Board of Trustees from countries that use IFRSs, and better monitoring by the Trustees of the IASB, including power to approve “the IASB’s work program.”²¹⁷

²¹⁴ *Id.* ¶ 123.

²¹⁵ Proposals for Change, *supra* note 126, ¶ 109.

²¹⁶ The comment letters were posted on the IASB web site, *available at* http://www.iasb.org/current/iasct_commet.asp (Mar. 31, 2005).

²¹⁷ Comment Letter from Alexander Schaub on the European Commission International Market and Series DG to Tom Seidenstein (Mar. 7, 2005), *available at*

The European Financial Reporting Advisory Group expressed concern about “lack of accountability and public oversight,” including the fact that the IASCF Trustees are “self-perpetuating.” It urged greater Trustee oversight of the IASB, including the “prioritization of the agenda” and greater numbers of appointments of Trustees and Board members from countries applying IFRSs, especially Europe. It particularly recommended “postponing the final decision of the constitutional review and putting forward new proposals to ensure European acceptance.”²¹⁸

A joint letter by FEE, CEA, EBF, UNICE, and EFRAG noted a European debate on the “social and economic implications of IFRSs” and urged extension of the “period of the Constitutional Review.” The letter was supportive of the work of the IASB but urged greater Trustee oversight, including agenda review, additional European membership in IASCF and IASB, and an increased role for EFRAG.²¹⁹

Strong general support for the IASB was offered by both the Committee of European Securities Regulators (CESR) and the International Organization of Securities Regulation (IOSCO)²²⁰ in identical language:

- A. It is important to protect the independence of the IASB.
- B. The needs of investors should be paramount in IFRSs.
- C. Board members should be chosen based on their knowledge and qualifications, as well as their ability to help the Board complete its mission.
- D. A credible authoritative standard setter needs transparent and effective due process.²²¹

H. IASCF Trustee Action

At their meeting on March 18, 2005, the IASCF Trustees considered each of the areas discussed in the Proposals for Change, but agreed to postpone final decisions on revisions of the Constitution for an additional

<http://www.iasb.org/docs/2005-itc/cl66.pdf>.

²¹⁸ Comment Letter from Göran Tidström, Chairman of the Supervisory Board of the European Financial Reporting Advisory Group, and Stig Envoldson, Chairman of the EFRAG Technical Expert Group, to Paul Volker (Mar. 10, 2005), available at <http://www.iasb.org/docs/2005-itc/cl65.pdf>. See discussion of EFRAG, *infra* Part IV.C.2.a.

²¹⁹ Comment Letter from David Deevlin, FEE President; Gérard de la Martinière, CEA President; Michael Pébereau, EBF President; Philippe de Buck, UNICE Secretary General, and Göran Tidström, Chairman of the EFRAG Supervisory Board to Paul Volker (Mar. 7, 2005) (on file with Professor Ruder).

²²⁰ Comment Letter from John Tiner, Chairman of CESR Fin., to Erik Wong (Mar. 2, 2005), available at <http://www.iasb.org/docs/2005-itc/cl62.pdf>; Comment Letter from Andrew Sheng, Chairman of the IOSCO Technical Committee, to Erik Wong (Feb. 26, 2005), available at <http://www.iasb.org/docs/2005-itc/cl8.pdf>.

²²¹ *Id.*

unspecified period of time, with the goal of taking final action on the Constitution by written ballot prior to a planned June Trustees meeting.

Although a final decision on the complete package of proposals was postponed, the Trustees voted upon and approved with minor changes the Constitutional amendments contained in the Proposals for Change with one exception. While indicating general support for their proposal regarding the number and geographical distribution of the Trustees, the Trustees left the matter open for further discussion. On the issue of Trustee accountability, the Trustees agreed to consider whether the advice of various official international organizations should be sought when the Trustees are selected.²²²

Unless unexpected changes in views occur, it appears very likely that the Proposals for Change will be adopted, and that some mechanism for consultation regarding Trustee appointments will be adopted by Trustee resolution.²²³

IV. CONTEMPORARY DEVELOPMENTS DEMONSTRATE THE VALUE OF STANDARD SETTER INDEPENDENCE FOR THE CONVERGENCE OF ACCOUNTING STANDARDS

It appears likely that the Trustees Constitution Review process will reinforce the independence of the IASB. Independence has allowed the FASB and IASB to make significant collaborative strides toward convergence. This part begins by discussing the Norwalk Agreement, which forms the basis for collaboration between the FASB and the IASB, and the combined IASB-FASB project on business combinations, which illustrates the capability of independent standard setters to reach convergence.

The potential damage to independent standard setting will be demonstrated by discussion of attempts by business interests to persuade the U.S. Congress to subvert the FASB's standard setting authority over accounting for stock options expense. This attempted interference in standard setting has threatened to the viability of the FASB.

The European Union's 2002 decision to adopt IFRSs for all of its listed companies was a significant stride toward convergence. The European Union's representative endorsement structure has thus far allowed business interests to prevent certain sections of the IASB standard on

²²² Comment Letter from Andrew Sheng, *supra* note 220, at 1; Comment Letter from John Tiner, *supra* note 220, at 1.

²²³ See Process for Constitutional Review, *supra* note 148. This article bears a publication date of April 6, 2005, at which time final action by the Trustees had not yet occurred. The above comments are based upon Professor Ruder's recollection of events that occurred at the March 18 Trustee meeting, which he attended. The Constitutional Review portion of the meeting was open to the public.

financial instruments from being adopted in the European Union, but since this interference has occurred at the endorsement level and not the standard setting level, it preserves the concept of independent standard setting.

These episodes of attempted interference by business interests with the standard setting of the FASB and the IASB demonstrate the importance of independence. If business interests have direct control over standard setting, convergence will become very difficult to achieve. The European episode demonstrates a distinction between interference at the standard setting level and interference at the endorsement or adoption level. Interference at the adoption level is consistent with the fact that each country retains the right to accept, modify or reject converged standards. Indeed, endorsement or adoption structures that are representative in character, like that of the European Union, may protect convergence in the long run. If business interests seeking to dislodge standards focus their efforts on the endorsement level, instead of attempting to reduce the independence of the IASB, independent standard setting by the IASB will be protected.

A. FASB – IASB Cooperation: Successful Interaction of Independent Standard Setters

1. *The Norwalk Agreement*

As currently constituted, the FASB and the IASB are united by a common philosophy: pursuit of converged high-quality accounting standards. The IASB's independence can be attributed in part to support from the independent FASB,²²⁴ and from the U.S. Securities and Exchange Commission.²²⁵ During the past three years, the FASB and the IASB have made ground breaking strides toward convergence.²²⁶

On September 18, 2002, the FASB and the IASB held a historic joint meeting at the FASB's Norwalk, Connecticut headquarters. At that meeting, the two standard setters, in what has since become known as the

²²⁴ *FASB Expresses Faith in New IASB*, THE ACCT., Feb. 26, 2001 (discussing membership on the IASB of FASB member Anthony Cope and former member James Leisenring); *FASB Has a Responsibility to Participate in IASB Processes*, THE ACCT., June 23, 2001 (discussing the international perception that "U.S. standard setters have an obligation to participate within a process they had a strong hand in developing.")

²²⁵ See *FASB Has a Responsibility to Participate in the IASB Processes*, *supra* note 224 (quoting the chair of the Australian Accounting Standards Board's assessment that the SEC's influence was instrumental in establishing the IASB as a full-time board).

²²⁶ For background information on the relations between the FASB and the IASC prior to the IASC's 2001 restructuring, see, e.g., David S. Ruder, *Reconciling U.S. Disclosure Policy with International Accounting and Disclosure Standards*, 17 NW. J. INT'L L. & BUS 1 (1996).

Norwalk Agreement,²²⁷ acknowledged “their commitment to the development of high quality . . . accounting standards that could be used for both domestic and cross-border financial reporting.”²²⁸ They agreed to move toward convergence between IFRSs and U.S. GAAP by making “their existing financial reporting standards fully compatible as soon as . . . practicable”²²⁹ and by coordinating their future work programs so that compatibility is maintained.²³⁰ The FASB and the IASB published a Memorandum of Understanding in which both boards agreed to:

- a. Undertake a short-term project aimed at removing a variety of individual differences between U.S. GAAP and International Financial Reporting Standards (IFRSs, which include International Accounting Standards, IASs);
- b. Remove other differences between IFRSs and U.S. GAAP that will remain at January 1, 2005, through coordination of their future work programs; that is, through the mutual undertaking of discrete, substantial projects which both Boards would address concurrently;
- c. Continue progress on the joint projects that they are currently undertaking; and
- d. Encourage their respective interpretive bodies to coordinate their activities.²³¹

To accomplish the first point of the Agreement, the FASB and the IASB undertook seven short-term convergence projects. These projects involved comparison between the two boards of corresponding existing standards and the adoption of the higher quality one.²³²

2. *The Business Combinations Project*

The third point of the Norwalk Agreement, referring to joint projects currently being undertaken, is well-illustrated by the successful project on business combinations. This project was successfully completed despite

²²⁷ Financial Accounting Standards Board and International Accounting Standards Board, Memorandum of Understanding, “The Norwalk Agreement” (Sept. 18, 2002), *available at* <http://www.fasb.org/news/memorandum.pdf> [hereinafter The Norwalk Agreement]. *See also* Press Release, Financial Accounting Standards Board and International Accounting Standards Board, FASB and IASB Agree to Work Together toward Convergence of Global Accounting Standards (Oct. 29, 2002), *available at* <http://www.iasb.org/docs/press/2002pr15.pdf> [hereinafter Norwalk Agreement Press Release].

²²⁸ The Norwalk Agreement, *supra* note 227, at 1.

²²⁹ *Id.*

²³⁰ *Id.*

²³¹ *Id.*

²³² *See* Press Release, Financial Accounting Standards Board, FASB Issues Exposure Drafts to Improve Accounting Guidance and Support Convergence of Global Accounting Standards (Dec. 15, 2003), *available at* <http://www.fasb.org/news/nr121503.shtml>.

objections from portions of the U.S. business community. On July 20, 2001, the FASB completed a standard setting project on business combinations by publishing two statements: FAS 141, Business Combinations,²³³ and FAS 142, Goodwill and Other Intangible Assets.²³⁴ FAS 141 required the use of the purchase method of accounting instead of the pooling of assets method of accounting for business combinations. In addition, the FASB decided that a reconsideration of its guidance regarding goodwill would be necessary as a result of FAS 141.²³⁵ Concurrently, the IASB began a project to rewrite its own business combinations standards. In September 2001, the FASB and the IASB decided to establish a joint project to create standards on applying the purchase method that could be used by both standard setters.²³⁶

On December 4, 2002, the IASB issued two exposure drafts—a new International Accounting Standard (IAS) 22, Business Combinations, and changes to IAS 36, Impairment of Assets, and to IAS 38, Intangible Assets.²³⁷ The new IAS 22 required the use of the purchase accounting method for business combinations. The net effect of the replaced IAS 22 and the changes to IAS's 36 and 38 was to converge the IASB's standards with the FASB's new FASs 141 and 142. The convergence was not exact but it gave the sets of standards the following similarities:

The pooling-of-interest method would be prohibited, acquired intangible items would be recognized as assets separately from goodwill, identifiable assets acquired and liabilities assumed would be initially measured at fair value, and there would be no amortization of goodwill or intangible assets with indefinite use-lives.²³⁸

Despite minor dissimilarities, the approval of the exposure drafts' changes brought the IASB substantially into line with the FASB as both boards pursued the joint project on the application of the purchase method. The IASB published the exposure drafts as a full-fledged standard and

²³³ BUSINESS COMBINATIONS, Statement of Financial Accounting Standards No. 141 (Financial Accounting Standards Board 2001) [hereinafter FAS 141].

²³⁴ GOODWILL AND OTHER INTANGIBLE ASSETS, Statement of Financial Accounting Standards No. 142 (Financial Accounting Standards Board 2001) [hereinafter FAS 142].

²³⁵ Hilary K. Krane, *The Death of Pooling of Interest: FAS 141 & 142 & Related Developments*, 1286 PRAC. L. INST./CORP. 623, 627 (2002).

²³⁶ Sylwia Gornik-Tomaszewski & Irene McCarthy, *Cooperation Between FASB and IASB to Achieve Convergence of Accounting Standards*, REV. OF BUS., 52, 55 (Spring 2003).

²³⁷ IAS 22 BUSINESS COMBINATIONS, Exposure Draft, (Int'l Accounting Standards Bd. 2002); AMENDMENTS TO IAS 36 IMPAIRMENTS OF ASSETS AND IAS 38 INTANGIBLE ASSETS, Exposure Draft, (Int'l Accounting Standards Bd. 2002).

²³⁸ Sylwia Gornik-Tomaszewski, *Proposed Standard on Business Combinations Would Conform to FASB Statements*, BANK ACCT. & FIN., June 2003, at 38.

amendments on March 31, 2004.²³⁹ The new IAS 22, Business Combinations, which was issued as International Financial Reporting Standard (IFRS) 3, was “hailed as a prime example of how convergence of currently divergent accounting standards could be satisfactorily concluded.”²⁴⁰

The joint project on the purchase method was expected to result in a common exposure draft, released by both standard setters, during the second quarter of 2005.²⁴¹

The cooperation between the IASB and the FASB on business combinations and the purchase method demonstrates the convergence possibilities of independent standard setting. In only a few years, the two boards have moved to establish high quality standards in the business combination area that have brought U.S. and IASB standards together.

The prohibition of the pooling of interests accounting method in the business combination context was not uncontroversial in the United States. Some members of Congress sought to delay the FASB’s original business combinations project.²⁴² In the fall of 2000, the House of Representatives considered, but never passed, the Financial Accounting for Intangibles Reexamination (FAIR) Act, which would have imposed a moratorium on the FASB’s plan to eliminate the pooling-of-interests method.²⁴³ Simultaneously, a group of Senators sought assurances from the FASB that the project would be postponed.²⁴⁴ However, Congress did not attempt to interfere further with the FASB’s plan after the publication of FAS 141 and

²³⁹ IAS 22 BUSINESS COMBINATIONS, IFRS 3 (Int’l Accounting Standards Bd.); *see also* IASB and FASB Reveal Joint Efforts on Standards Convergence, THE ACCT., Apr. 30, 2004.

²⁴⁰ IASB and FASB Reveal Joint Efforts on Standards Convergence, *supra* note 243.

²⁴¹ The release of combined exposure drafts was originally scheduled for the fourth quarter of 2004, then postponed to the first quarter of 2005. *See* IASB Endorses Forming Joint Proposal with FASB on Business Combinations, BNA’S BANKING REP., Aug. 2, 2004; Robert Willens, *Judgment Call: Mood Swing*, THEDEAL.COM, Sept. 14, 2004. However, the FASB and the IASB decided to delay the drafts, FASB, Project Updates, at http://www.fasb.org/project/bc_purchmethod.shtml (Mar. 8, 2005).

²⁴² *See* Ted Bridis, *Delay in Change on Merger Rules Sought in Congress*, WALL ST. J., Oct. 4, 2000, at A6 (reporting on efforts in both houses of Congress to delay the FASB’s plans to eliminate the use of the pooling method of accounting for business combinations).

²⁴³ Financial Accounting for Intangibles Reexamination Act, H.R. 5365, 106th Cong. (2000) (imposing moratorium on elimination of pooling-of-interests method and establishing a Congressional Commission on Financial Accounting for Intangibles to consider related issues).

²⁴⁴ *See* Letter from Sen. Spencer Abraham and twelve other senators to Edmund Jenkins (Sept. 29, 2000) (on file with Professor Ruder) (urging FASB chair Jenkins for “assurance that FASB will take no conclusive action on its current project on business combinations until Congress has reconvened in 2001”); Letter from Edmund Jenkins to Sen. Spencer Abraham (Oct. 4, 2000) (on file with Professor Ruder) (assuring Sen. Abraham that “[t]he Board will not begin discussion of [the pooling-of-interests issue] until” it has completed the business-combinations project, no earlier than the first quarter of 2001).

FAS 142 in 2001.

B. Stock Options: Political Interference in the United States

This subsection discusses the attempts of business interests in the United States to persuade Congress to overrule the FASB's stock options accounting standard.

1. The FASB's 1995 Retreat

The question whether companies should be required to report compensation expense when they issue stock options to employees has been controversial in the United States for over ten years.²⁴⁵ Until the 1990s, the reporting of stock options was governed by the old Accounting Principles Board's Opinion No. 25 (APB No. 25),²⁴⁶ which instructed companies to report stock options using the "intrinsic value" method.²⁴⁷ The intrinsic value method measures the compensation expense of stock options as "the excess, if any, of the quoted market price of the stock at grant date over the amount an employee must pay to acquire the stock."²⁴⁸ Under the most common type of stock option compensation, fixed stock option plans, there is usually no difference between the two amounts. Stock options of that type usually involve no reportable compensation expense under the intrinsic value method.²⁴⁹

In 1993, the FASB released an exposure draft, *Accounting for Stock-based Compensation*, that would have required companies to report stock-option compensation expense using the fair value method.²⁵⁰ Under the fair value method, "compensation cost is measured at the grant date based on the value of the award and is recognized over the [employee's] service period."²⁵¹ Compared to the intrinsic value method, the fair value method

²⁴⁵ See Gornik-Tomaszewski & McCarthy, *supra* note 236, at 57.

²⁴⁶ ACCOUNTING FOR STOCK ISSUED TO EMPLOYERS, Opinion No. 25 (Acct. Principles Bd. 1972).

²⁴⁷ ACCOUNTING FOR STOCK-BASED COMPENSATION, Summary of Statement No. 123 (Fin. Acct. Standards Bd. 1995), available at <http://www.fasb.org/st/summary/stsum123.shtml> [hereinafter SUMMARY OF STATEMENT NO. 123]; see also Sylwia Gornik-Tomaszewski & Irene McCarthy, *Cooperation Between FASB and IASB to Achieve Convergence of Accounting Standards*, REV. OF BUS., Spring 2003, at 57.

²⁴⁸ SUMMARY OF STATEMENT NO. 123, *supra* note 247.

²⁴⁹ *Id.*

²⁵⁰ ACCOUNTING FOR STOCK-BASED COMPENSATION, Exposure Draft (Financial Accounting Standards Bd. 1993); see also *The FASB Stock Options Proposal: Its Effect on the U.S. Economy and Jobs: Hearing Before Subcomm. on Capital Mkts., Ins. and Gov't Sponsored Enters., House Comm. on Fin. Servs., 108th Cong. 184-85 (2004)* (statement of Robert Herz, Chairman, Fin. Accounting Standards Bd. & George J. Batavick, Member, Fin. Accounting Standards Bd.) [hereinafter Herz & Batavick Statement].

²⁵¹ SUMMARY OF STATEMENT NO. 123, *supra* note 247.

frequently results in large increases in reported compensation expense for companies that make extensive use of stock option compensation, with negative effects on reported earnings.

U.S. companies lobbied Congress to prevent the FASB from maintaining the exposure draft's strict fair value expensing of stock options.²⁵² In the spring of 1994, the Senate passed a non-binding resolution expressing the view that the FASB's proposal would "have grave economic consequences" and the further view that the FASB should not change "the current treatment of stock option plans."²⁵³ In 1995, the FASB reacted to business pressure and the Senate resolution by issuing a compromise stock option compensation standard. Statement No. 123²⁵⁴ set forth the fair value method as the preferred approach but also allowed companies to continue to apply the APB No. 25 intrinsic value method if they disclosed pro forma net income and earnings per share figures calculated using the fair value method in financial statement footnotes.²⁵⁵ Within Statement No. 123, the FASB explained why it had chosen to "encourage, rather than require," the use of the fair value method:

[I]n December 1994, the Board decided that the extent of improvement in financial reporting that was envisioned when this project was added to its technical agenda . . . was not attainable because the deliberate, logical consideration of issues that usually leads to improvement in financial reporting was no longer present The Board chose a disclosure-based solution for stock-based employee compensation to bring closure to the divisive debate on this issue—not because it believes that solution is the best way to improve financial accounting

²⁵² See Christi Harlan, *High Anxiety: Accounting Proposal Stirs Unusual Uproar in Executive Suites: FASB's Stock-Option Plan Threatens Pay Packages; Lobbying Gets Intense*, WALL ST. J., Mar. 7, 1994, at A1 (reporting on the lobbying efforts of business interests, including personal efforts by executives from MCI Communications Corp., Raychem Corp., and Citicorp to persuade Congress to derail FAS No. 123); Calvin Johnson, *The Disloyalty of Stock and Stock Option Compensation*, 11 CONN. INS. L. J. 133, 139 (2004-2005).

²⁵³ S. Amdt. 1668 § 2(a) to S. 783, 103rd Cong. (1994) (enacted) (expressing the non-binding sense of the Senate that "the new accounting treatment of employee stock options . . . proposed by the Financial Accounting Standards Board, will have grave economic consequences, particularly for businesses in new-growth sectors which rely heavily on employee entrepreneurship . . . [and] will diminish rather than expand broad-based employee stock option plans; the Financial Accounting Standards Board should not . . . change the current generally accepted accounting treatment of stock options.")

²⁵⁴ ACCOUNTING FOR STOCK-BASED COMPENSATION, Statement of Financial Accounting Standards No. 123 (Financial Accounting Standards Bd. 1995), available at <http://www.fasb.org/pdf/fas123.pdf> [hereinafter FAS No. 123].

²⁵⁵ *Id.*; see also SUMMARY OF STATEMENT NO. 123, *supra* note 247; *Share Options Debate Looms Again in the US*, THE ACCT., Oct. 26, 2001, at 15; *Legislation Introduced to Overturn FASB Stock Option Proposal*, J. OF ACCT., Oct. 1993, at 15-16.

and reporting.²⁵⁶

2. IASB Action on Stock Options

In July 2000, the IASB produced a discussion paper, *Accounting for Share-Based Payment*, addressing an area in which there was no IASB standard.²⁵⁷ In September 2001, the new IASB asked the public for additional comment on the paper.²⁵⁸ IASB Chairman Sir David Tweedie discussed the need for an international standard on stock options:

The widespread use of share options to pay employees, external advisors, and others; the calls from users of financial statements for improvements in accounting for these transactions; and the differing proposals emanating from national standard-setters demonstrate the importance of developing a high-quality global accounting standard for share-based payment.²⁵⁹

U.S. corporations that had opposed the FASB's attempt to impose fair value expensing of stock options, understanding that the IASB and the FASB were seeking to converge their sets of standards, worried that the IASB's actions might induce the FASB to try again. Some treated the stock option question as permanently resolved in the United States and criticized the IASB's actions as possibly threatening to convergence. Financial Executives International Chairman Phil Livingston said:

The IASB has an historic opportunity to provide leadership in converging accounting standards around the world. Unfortunately, some members of the IASB have insisted on restarting this acrimonious fight with corporations, one that was settled only six years ago. Requiring expense recognition for employee stock options would well undermine any chance that we will see harmonization of accounting standards.²⁶⁰

²⁵⁶ FAS No. 123, *supra* note 254, ¶¶ 61-62, quoted in *Subcommittee on Capital Mkts., Ins. and Gov't Sponsored Enters. Hearing on the FASB Stock Options Proposal: Its Effect on the U.S. Economy and Jobs*, 108th Cong. (2004) (testimony of Robert Herz & George Batavick), available at <http://financialservices.house.gov/media/pdf/050403fasb.pdf>, Full Text of Testimony at p. 5-6 [hereinafter Herz & Batavick Testimony].

²⁵⁷ INT'L ACCT. STANDARDS COMM'N, *G4+1 Position Paper: Accounting for Share-Based Payment* (2000), available at <http://www.iasb.org/docs/g4sp00/g4sp00.pdf>.

²⁵⁸ See Daniel M. Hrisak, *IASB Resurrects Heated Discussion about Stock Options*, IOMA'S REPORT ON MANAGING THE GENERAL LEDGER, at 3-4 (Nov. 2001).

²⁵⁹ *Id.*

²⁶⁰ Press Release, Financial Executives International, *Stock Options Accounting Project Could Undermine March Toward Global Accounting Standards* (Sept. 21, 2001), available

Despite objections, the IASB proposed a stock option expensing requirement,²⁶¹ releasing Exposure Draft (ED) 2, *Share-Based Payment*, on November 7, 2002.²⁶² The proposed standard required the reporting of stock option compensation on a fair value basis similar to FASB Statement No. 123's preferred fair value calculation.²⁶³ The IASB published the final standard, in substantially the same form, in February 2004.²⁶⁴

3. *The Continuing U.S. Controversy*

During the summer of 2002, the appeal of stock option expensing as a corporate governance reform was enhanced in the United States by a perception that "stock option overload contributed to the accounting fiascos at . . . Enron Corp. and Worldcom Inc." and other corporations.²⁶⁵

In March 2003, the FASB announced that it had added a stock option expensing project to its work program.²⁶⁶ The FASB justified this decision on three grounds: a high volume of requests from users of financial statements for improvements in this area of financial accounting; the "complexity and noncomparability" of the different approaches allowed under the 1995 Statement No. 123; and the "opportunity to achieve convergence" with international accounting standards in this area.²⁶⁷ The FASB issued an exposure draft of a new Statement No. 123 on March 31, 2004, with an implementation deadline for corporate fiscal years beginning

at <http://www.prnewswire.com/cgi-bin/stories.pl?ACCT=104&STORY=/www/story/09-21-2001/0001576563&EDATE=>; see also *Share Options Debate Looms Again in the US*, *supra* note 255, at 15.

²⁶¹ Amy Borrus, et al., *To Expense or Not to Expense: In the Debate Over Stock Options, Expensing is Picking up Steam*, *BUS. WK.*, July 29, 2002, at 44.

²⁶² Press Release, Int'l Accounting Standards Bd., IASB Publishes Proposals on Accounting for Share-Based Payment (Nov. 7, 2002), available at <http://www.iasb.org/docs/press/2002pr16.pdf>.

²⁶³ Gornik-Tomaszewski & McCarthy, *supra* note 236, at 58.

²⁶⁴ SHARE-BASED PAYMENT, International Financial Reporting Standard 2 (Int'l Accounting Standards Board- 2004).

²⁶⁵ Amy Borrus, et al., *supra* note 261; see also *The Stock Option Accounting Reform Act: Hearing on H.R. 3574 Before Subcomm. on Capital Mkts., Ins. and Gov't Sponsored Enters., House Comm. on Fin. Servs.*, 108th Cong. 46-47 (2004) (statement of Paul Kanjorski) (noting "[w]e now know that [the failure to require fair value stock-option expensing in the mid-1990s] contributed to the financial storm on Wall Street in 2001 and 2002.")

²⁶⁶ Fin. Accounting Standards Bd., Minutes, available at http://www.fasb.org/board_meeting_minutes/03-12-03_stockcomp.pdf, at 1 (Mar. 12, 2003); see also Press Release, Fin. Accounting Standards Bd., FASB Adds Projects to its Agenda on Employee Stock Options and Pensions (Mar. 3, 2003), available at <http://www.fasb.org/news/nr031203.shtml>.

²⁶⁷ Herz & Batavick Testimony, *supra* note 256, Full Text of Testimony at 11-14.

after December 15, 2004.²⁶⁸ The exposure draft closed the Statement No. 123 loophole, requiring the fair value expensing of stock option compensation for employees.²⁶⁹ During the comment period for the exposure draft, the FASB received over 14,000 comment letters, most of them unfavorable.²⁷⁰

Early in 2003, U.S. companies, particularly in the high tech industries, began lobbying Congress to block the possible imposition of the fair value method on stock option compensation. In the spring of 2003, members of Congress responded to the lobbying effort by introducing, in both houses, a bill called the "Broad-Based Stock Option Plan Transparency Act of 2003."²⁷¹ The bill would have imposed a three-and-a-half year moratorium on the fair value expensing of stock option compensation.²⁷² The bill was referred to the appropriate Senate and House committees, but neither body took any further action on it.²⁷³

The Congressional challenge to the FASB's control over accounting standards continued in the fall of 2003. On November 19, 2003, Senator Michael Enzi (R-Wyoming) introduced the Stock Option Accounting Reform Act,²⁷⁴ a bill that, if enacted, would preempt the FASB's proposed Statement No. 123. Among other provisions, the bill required the use of the fair value method to report stock option compensation—but only for CEOs and the four other highest compensated executive officers.²⁷⁵ It also prohibited the FASB from requiring companies to use the fair value method to account for stock option compensation of any employees other than the five highest paid until after an "economic impact study" had been performed by the Departments of Labor and Commerce.²⁷⁶ In a statement

²⁶⁸ PROPOSED STATEMENT OF FINANCIAL ACCOUNTING STANDARDS: SHARE-BASED PAYMENT, AN AMENDMENT OF FASB STATEMENTS NO. 123 AND 95, Exposure Draft at 23 (Financial Accounting Standards Bd. 2004).

²⁶⁹ For an efficient summary of the provisions of the Exposure Draft, see Herz & Batavick Testimony, *supra* note 256, Full Text of Testimony at 15.

²⁷⁰ *FASB Concedes to Six-Month Delay over U.S. Stock Options*, THE ACCT., Oct. 31, 2004, at 1.

²⁷¹ S. 979, 108th Cong. (2003); H.R. 1372, 108th Cong. (2003).

²⁷² S. 979 § 4; H.R. 1372 § 4.

²⁷³ Bill Summary for S. 979, available at <http://thomas.loc.gov/cgi-bin/bdquery/z?d108:SN00979:@@L&summ2=m&> (last visited Apr. 5, 2005); Bill Summary for H.R. 1372, available at <http://thomas.loc.gov/cgi-bin/bdquery/z?d108:HR01372:@@L&summ2=m&> (last visited Apr. 5, 2005).

²⁷⁴ S. 1890, 108th Cong. (2003).

²⁷⁵ *Id.* § 2. Opponents of the legislation rightly charged that this distinction was nonsensical. See, e.g., *The FASB Stock Options Proposal: Its Effect on the U.S. Economy and Jobs: Hearing Before Subcomm. on Capital Mkts., Ins. and Gov't Sponsored Enters., House Comm. on Fin. Servs.*, 108th Cong. 13 (2004) (statement of Brad Sherman) (noting "[i]f you are number six at GM, you are probably doing pretty good.")

²⁷⁶ S. 1890, *supra* note 274, § 3.

on the Senate floor, Senator Enzi said:

I am very concerned that FASB has repeatedly refused to consider the economic consequences of its decisions. The mandatory expensing of all employee stock options has serious economic, labor, trade and competitiveness implications. These issues fall squarely within the jurisdiction and oversight of Congress.²⁷⁷

Senator Enzi's bill was referred to the Senate Committee on Banking, Housing, and Urban Affairs, which took no action on it.

On November 21, 2003, two days after the introduction of the Stock Option Accounting Reform Act in the Senate, identical legislation was introduced in the House of Representatives by Congressman Richard Baker (R-Louisiana).²⁷⁸ In a hearing on March 3, 2004,²⁷⁹ supporters of the legislation repeatedly argued that the FASB's proposed fair value expensing of stock options would discourage the use of stock options as compensation, and that the decreased use of stock options would hurt U.S. companies' prospects for growth and global competitiveness.²⁸⁰ FASB supporters emphasized the need to keep the FASB independent.²⁸¹

At hearings on the Hill, FASB Chairman Robert Herz and FASB member George Batavick summarized the benefits of the FASB's proposal: "greater transparency, completeness and a more level playing field in the accounting for different forms of equity-based compensation."²⁸² They also presented prepared materials supporting the FASB's need for independence

²⁷⁷ 149 CONG. REC. 15,188 (2003) (statement of Sen. Enzi).

²⁷⁸ H.R. 3574, 108th Cong. (2003). The House legislation was referred to the Committee on Financial Services' Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, chaired by Congressman Baker.

²⁷⁹ *The Stock Option Accounting Reform Act: Hearing on H.R. 3574 Before Subcomm. on Capital Markets, Ins. and Gov't Sponsored Enterprises, House Comm. on Fin. Servs.*, 108th Cong. (2004).

²⁸⁰ *See id.* at 1, 2, 5-7,10-13 (opening statements of Cong. Baker, Crowley, Shadegg, Moore, Scott, Inslee, Bachus, and Israel).

²⁸¹ *See id.* at 2-4, 8-11 (opening statements of Cong. Kanjorski, Gillmor, Emanuel, and Sherman); *see also id.* at 50 (Cong. Sherman noting "[m]y fear is that this bill will be the first step in converting GAAP, generally accepted accounting principles, into GAAP, generally adulterated accounting politics."); *see also The FASB Stock Options Proposal: Its Effect on the U.S. Economy and Jobs: Hearing Before Subcomm. on Capital Markets, Ins. and Gov't Sponsored Enterprises, House Comm. on Fin. Servs.*, 108th Cong. 11-12 (2004) (statement of Joseph Crowley, Member, Subcomm. on Capital Markets, Ins. and Gov't Sponsored Enterprises, House Comm. on Fin. Servs.). This hearing, as its title "Effect on the U.S. Economy and Jobs," suggests, reflected the perception of the Act's supporters that the short-term economic effects of the fair value expensing of stock-option compensation justified Congressional interference with the FASB's proposal.

²⁸² Herz & Batavick Testimony, *supra* note 256, Prepared Statement at 3.

in its standard setting activities.²⁸³

Despite the testimony from Herz and Batavick, the subcommittee, on May 12, 2004,²⁸⁴ and the full Committee on Financial Services, on June 15, 2004,²⁸⁵ approved H.R. 3574. The bill passed the House of Representatives on July 20, 2004, by a vote of 312 to 111, with the support of a wide majority of Republicans and a narrow majority of Democrats.²⁸⁶ H.R. 3574 was received in the Senate and referred to the Senate Committee on Banking, Housing, and Urban Affairs, but the committee took no action on it or the Enzi bill throughout the rest of 2004.²⁸⁷

4. *The FASB Publishes Statement 123 (Revised)*

On October 13, 2004, the FASB postponed the new Statement 123's effective date.²⁸⁸ This gave business interests hope that the FASB planned to reconsider its decision to require the fair value expensing of stock options. But the final standard, Statement 123 (Revised 2004), *Share-Based Payment*,²⁸⁹ maintained the same posture toward expensing. The delayed effective date was in part attributable to SEC concerns about the ability of companies to comply with new Sarbanes-Oxley rules and the FASB's new statement simultaneously.²⁹⁰

In 2005, the opponents of expensing continued lobbying Congress

²⁸³ *Id.* at attachment 2. Herz and Batavick also noted the increasing number of companies that had elected voluntarily to expense their stock options using the fair-value method. *Id.* at attachment 3. They presented a compilation of authorities disagreeing with the contention that the fair-value expensing of stock-option compensation would hurt the U.S. economy. *Id.* at attachment 5.

²⁸⁴ H.R. REP. NO. 109-609, pt. 1, at 7 (2004), available at http://thomas.loc.gov/cgi-bin/cpquery/?&db_id=cp108&r_n=hr609p1.108&sel=TOC_24685&.

²⁸⁵ *Id.*

²⁸⁶ H.R. 3574, 108th Cong. (2004).

²⁸⁷ See, e.g., Donna Block, *FASB Rules Defended, Global Regulators Defend Financial Accounting Standards Board's Efforts on Protecting Employee Stock Options*, THEDEAL.COM, at <http://banking.senate.gov/index.cfm?FuseAction=Articles.Detail&Articleid=65&Month=9&Year=2004> (Sept. 10, 2004).

²⁸⁸ See Floyd Norris, *New Options Accounting Rule is Delayed for U.S. Companies*, INT'L HERALD TRIB., Oct. 15, 2004, available at <http://www.iht.com/articles/2004/10/14/business/option15.html>.

²⁸⁹ SHARE-BASED PAYMENT, Statement of Financial Accounting Standards No. 123 (Financial Accounting Standards Bd. 2004).

²⁹⁰ Floyd Norris, *Audit Board Delays Rule on Options as Expenses*, N.Y. TIMES, Oct. 14, 2004, at C1; *FASB Concedes to Six-Month Delay Over U.S. Stock Options*, THE ACCT., Oct. 31, 2004, at 1. See also *Memo to Feds: Let the FASB do its Job*, INV. NEWS, Oct. 25, 2004, at 10 (citing FASB chairman Robert Herz as saying that the delay's purpose was to strike a balance between the needs of companies' auditing processes and investors); David Wang & Mark von Bergen, *Changes to FASB Stock Option Expensing Proposal*, Holland + Knight, Public Companies Alert, Aug. 24, 2004 (quoting Herz as anticipating possible delays, saying, "We are hearing people say they are stretched to the maximum.")

regarding stock options.²⁹¹ On February 17, 2005, Congresswoman Anna Eshoo (D-CA) and Congressman David Dreier (R-CA) introduced the "Broad-Based Stock Option Plan Transparency Act."²⁹² The new bill dropped the Stock Options Accounting Reform Act's requirement of expensing for each corporation's top five highest paid employees. Instead, it directed the SEC to require companies to provide "a summary of the stock options granted to the five most highly compensated executive officers."²⁹³ Like the Stock Options Accounting Reform Act, it would have imposed a moratorium on new stock option accounting rules until the completion of a lengthy study.²⁹⁴

In a statement released the day she introduced the bill, Congresswoman Eshoo dismissed the argument that the FASB's need for independence suggested Congressional restraint:

Some have . . . argued that FASB's independence must be protected and accounting standards, like other technical rules, should not be set by Congress. While in general this is the case, there are many occasions when expert bodies fail to fully protect the public interest and it's essential that Congress steps in. For example, the Securities and Exchange Commission, an independent, expert agency, failed to adequately protect investors and the public from the corporate scandals of recent years: Congress stepped in to enact the reforms of the Sarbanes-Oxley Act.²⁹⁵

5. Outlook for Convergence

Because Congress has so far refused to subvert the FASB's authority, convergence between U.S. standards and IASB standards on the subject of stock options has thus far been achieved. If Congress had blocked the

²⁹¹ Donna Block, *Stock Options Fight Rages On*, THEDEAL.COM, Jan. 14, 2005; Press Release, National Venture Capital Association, FASB Final Stock Option Ruling Lacks Real World Application, at <http://www.nvca.org/pdf/FASBFinalRulingFinal.pdf> (Dec. 16, 2004).

²⁹² H.R. 913, 109th Cong. (2005). As of late March 2005, the bill had been referred to the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises.

²⁹³ *Id.* §3(a)(4).

²⁹⁴ *Id.* §4(a)-(b). The study required by the Broad-Based Stock Option Plan Transparency Act differed significantly from the study contemplated by the Stock Options Accounting Reform Act. The new bill directed the SEC (rather than the Departments of Labor and Commerce) to perform a study. Moreover, the study was to cover only the effects of the minimal new disclosure requirements of the Broad-Based Stock Option Plan Transparency Act, rather than covering "the economic impact of the mandatory expensing of *all* employee stock options." Stock Options Accounting Reform Act, *supra* note 271, §3(b) (emphasis added).

²⁹⁵ Press Release, Congresswoman Anna G. Eshoo, Eshoo, Drier Introduce Stock Options Bill: Legislation would protect employee stock options from accounting rule (Feb. 17, 2005).

FASB from requiring the expensing of stock options, business interests would have demonstrated their influence on Congress regarding future standard setting. Instead, the FASB's independence as a standard setter has so far been protected and it is free to pursue convergence in other areas of accounting.²⁹⁶

C. Adoption of International Accounting Standards in the European Union

The next two subsections discuss the opposition of some European business interests to the imposition of the IASB's rules on derivatives. As will be noted in greater detail below, the European Union has decided to adopt IFRSs for mandatory use by listed companies. This requirement is a giant leap toward convergence, since it gives validity to IASB standards and the IASB standard setting process. As part of the adoption process the European Union has created a complex endorsement mechanism involving the European Commission.²⁹⁷ The endorsement mechanism allows businesses significant influence on whether specific IASB standards are endorsed for use in the European Union.

When the IASB proposed its derivatives standards, significant opposition from business interests developed and pressure was exerted on the IASB to change those rules to meet the needs of European companies. The IASB made significant changes, but adhered to the central principles embodied in its derivatives proposals. Business interests, acting through the endorsement mechanism, succeeded in preventing the adoption of

²⁹⁶ Opponents of expensing have also attempted to persuade the SEC to refrain from enforcing Statement 123. This effort has not been successful. See Kevin Drawbaugh, *SEC Chief Firm on Option Expensing Timing Unclear*, REUTERS, Feb. 10, 2005.

²⁹⁷ The European Commission, which will sometimes be referred to in this section as "the Commission," is one of the three bodies that make up the European Union's governing "institutional triangle." The European Commission's role is to propose legislation to the other two bodies, the European Parliament and the European Council, and to implement the decisions of those bodies. A new European Commission is selected every five years. The member governments of the European Union select a European Commission President, who then appoints the other members of the European Commission, subject to the approval of the European Parliament. The number of Commissioners is determined by treaty and has fluctuated between twenty and thirty. Each Commissioner is responsible for predetermined areas of E.U. policy. The Commission's policy staff is composed of departments called Directorates-General headed by Governors-General and each subject to the authority of a particular Commissioner. See European Union, *The European Commission*, at http://europa.eu.int/institutions/comm/index_en.htm (last visited Mar. 1, 2005). Issues involving accounting standards are the responsibility of the Internal Market Directorate-General. Between Sept. 16, 1999 and Nov. 21, 2004, the Internal Market Directorate-General was answerable to European Commissioner Frits Bolkestein. With the selection of a new Commission in 2004, Bolkestein retired. The Commissioner with authority over the Internal Market Directorate-General in the 2004-09 European Commission is Charlie McCreevy. European Union, *European Commission website*, at http://europa.eu.int/comm/index_en.htm (last visited Mar. 1, 2005).

selected sections of one standard, but the IASB's independence was maintained. However, convergence of the derivatives standards with U.S. standards has not occurred and remains subject to further developments.

1. *Listed Company Requirement*

In February 2001, in the "Proposal for a Regulation of the European Parliament and of the Council on the Application of International Accounting Standards" (the Commission Proposal), the European Commission proposed the adoption of international accounting standards created by the IASB for all securities admitted to trading in a regulated market of any member state of the European Union for each fiscal year starting on or after January 1, 2005.²⁹⁸ It cited the importance of a single set of standards as the reason to impose international accounting standards in Europe:

The lack of comparability in financial reporting has adverse effects for stake-holders. Adaptation of financial statements to take account of local conventions was understandable when investors and other stakeholders were of the same nationality as the company. However, with the emergence of an integrated financial market, the securities of any one company are often held by an internationally diverse group of investors [T]he most effective basis for ensuring this objective of comparability is a requirement for listed companies to publish financial statements that conform to a single set of standards.²⁹⁹

The Commission Proposal was approved by the European Parliament and Council and published on July 19, 2002 (IAS Regulation).³⁰⁰ The regulation made approval of "international accounting standards" conditional, stating that international accounting standards can only be

²⁹⁸ Commission Proposal for a Regulation of the European Parliament and of the Council on the Application of International Accounting Standards, 2001 O.J. (C 154 E) 285 [hereinafter Commission Proposal]; see also Draft Commission Proposal for a Regulation of the European Parliament and of the Council on the Application of International Accounting Standards, Draft, December 2000, available at <http://www.iasplus.com/resource/ec0102.pdf> [hereinafter Draft Commission Proposal].

²⁹⁹ Draft Commission Proposal, *supra* note 298, Explanatory Memorandum at 2-3.

³⁰⁰ IAS Regulation, *supra* note 2. The regulation provides that "for each year starting on or after 1 January 2005, companies governed by the law of a member state shall prepare their consolidated accounts in conformity with the international accounting standards adopted in accordance with the procedure laid down in Article 6(2) if, at their balance sheet date, their securities are admitted to trading on a regulated market of any member state. . . ." *Id.* at art. 4. In Article 2, "International Accounting Standards" are defined as: "International Accounting Standards (IAS), International Financial Reporting Standards (IFRS) and related Interpretations (SIC-IRIC)" and subsequent amendments "issued or adopted by the International Accounting Standard Board (IASB)." *Id.* at art. 2.

adopted if they “are conducive to the European public good and meet the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.”³⁰¹

The European Union’s adoption of IFRSs assumed that IASB standards would converge with U.S. standards. The IAS Regulation allows E.U. member states to delay the imposition of IFRSs for companies that were already using “internationally accepted standards,” such as U.S. GAAP, but even these companies—including U.S. corporations with European listings—are required to use IFRSs by 2007.³⁰² This extension offered the possibility that convergence would be achieved by 2007, so that the SEC would allow European companies using IFRSs to list on U.S. exchanges without reconciling their financial statements to U.S. GAAP.³⁰³

The adoption of IASB standards for use in the European Union is a strong positive step towards the convergence goal of common accounting standards that can be used in cross-border trading. This adoption gives recognition to IASB standards by a very important capital market. Converged FASB and IASB standards would offer tremendous opportunities for securities trading and capital raising in both the United States and the European Union.

2. *The European Endorsement Mechanism*

The IAS Regulation provided that each IASB standard had to be endorsed individually in order to be enforced in the European Union. The Regulation delegated to the European Commission the authority to decide whether to endorse each standard.³⁰⁴

The IAS Regulation required the Commission to take into account three minimum criteria when deciding whether to endorse each IASB standard.³⁰⁵ Standards must not be contrary to the “true and fair value principle” set forth in previous E.U. legislation; must be “conducive to the European public good”; and must “meet the criteria of understandability, relevance, reliability and comparability.”

The procedure chosen for endorsement, called “comitology,” allows the Commission to endorse or reject IASB standards, but not to

³⁰¹ *Id.* at art. 3(2).

³⁰² *Id.* at art. 9.

³⁰³ See, e.g., *Interview with Internal Markets Commissioner Frits Bolkestein*, FIN. TIMES, Feb. 21, 2002.

³⁰⁴ IAS Regulation, *supra* note 2, at arts. 3(1), and 6(2). See also KPMG, *IFRS and the E.U. endorsement process: a status report*, IFRS Briefing Sheet, Issue 18 (2005); Schaub, *supra* note 3, at 618.

³⁰⁵ IAS Regulation, *supra* note 2, at art. 3(2).

amend them, and gives the European Parliament power to review the Commission's decisions.³⁰⁶ Under the comitology procedure the European Commission is directed to consult with two other bodies while making decisions on the applicability of standards. First, the IAS Regulation provides that "[a]n accounting technical committee should provide support and expertise to the Commission in the assessment of international accounting standards."³⁰⁷ Second, the Commission is to "be assisted" by an Accounting Regulatory Committee (ARC).³⁰⁸

The Accounting Technical Committee and the Accounting Regulatory Committee had been discussed in the Commission Proposal.³⁰⁹ The Proposal had characterized the two bodies as a two-tier "endorsement mechanism" that would "oversee the adoption of new standards and interpretations, intervening only when these contain material deficiencies or have failed to cater for features specific to the E.U. economic or legal environment."³¹⁰

The comitology procedure as it applies to IASB standards is conducted as follows:

[A]fter an IAS has been adopted by the IASB, the endorsement process will start with the Commission formally asking EFRAG [the technical committee] for its view on whether an IAS should be endorsed. Once the opinion of EFRAG has been received, the Commission will, where appropriate, draft a proposal for the adoption of the standard. This proposal will then be discussed by the Accounting Regulatory Committee . . . Once the ARC has voted in favour of a proposal, the Commission takes a formal decision to adopt the IAS on the basis of the text voted by the ARC. It has no right to change the standard. Once a standard has been adopted by the Commission, it is then published in full in each of the official languages of the Community as a Commission regulation in the Official Journal of the European Union. The standards

³⁰⁶ The procedure is more fully described in Schaub, *supra* note 4, at 620. Although usual "comitology" procedure does not allow the European Parliament to review the Commission endorsement decision, the IAS Regulation sets up a procedure that provided a period during which the European Parliament may review draft commission proposals and a one month period in which it could pass a resolution preventing the Commission's final review from prevailing. *Id.* at 621. IAS Regulation, *supra* note 2, Recital (8), arts. 3(1) and 6(2), referring to arts. 5 and 7 of Decisions 1999/468/EC and specifying a three month period under art. 5(6) of that decision.

³⁰⁷ *Id.* at recitation (10).

³⁰⁸ *Id.* at art. 6(1).

³⁰⁹ See Commission Proposal, *supra* note 298, Explanatory Memorandum at ¶ 3.3.

³¹⁰ *Id.*, Explanatory Memorandum at ¶ 4.

thus become part of Community law.³¹¹

a. EFRAG's Technical Expert Group Serves as the Accounting Technical Committee

In its proposal the European Commission had suggested forming an “accounting technical committee” that would “provide the support and expertise needed to assess the standards on a timely basis.”³¹² The Commission believed that the technical committee should be responsible for involving both “users and preparers” of financial statements in technical assessments.³¹³ The technical committee was mentioned in the recitals of both the Commission’s proposed regulation³¹⁴ and, as noted above, the final E.U. regulation,³¹⁵ but was not provided for in the text of either version.

In March 2001 a group of European business and accountancy organizations, acting at the invitation of the Commission,³¹⁶ proposed the establishment of a new entity that would provide the technical support function for the Commission.³¹⁷ This entity, the European Financial Reporting Advisory Group (EFRAG), was officially established in June 2001.³¹⁸ It is made up of two bodies: a Technical Expert Group and a Supervisory Board of European Organizations.³¹⁹

The Technical Expert Group serves as the Commission’s accounting technical committee.³²⁰ It is composed of “highly qualified experts with proper knowledge of the European and international financial reporting scene” with “experience in standard setting.”³²¹ The Supervisory Board’s purpose is “to guarantee representation of the full European interest

³¹¹ Schaub, *supra* note 3, at 621 (internal citation omitted).

³¹² Commission Proposal, *supra* note 298, Explanatory Memorandum at 5.

³¹³ *Id.*

³¹⁴ *Id.* at recital 8.

³¹⁵ IAS Regulation, *supra* note 2, Recital 10.

³¹⁶ Press Release, Private Sector Organizes Itself for the Adoption of IAS by 2005 in Europe: EFRAG, (Mar. 20, 2001), available at <http://www.iasplus.com/resource/efrag.pdf> (discussing the Commission’s invitation to form EFRAG, accepted by the accountancy organization Federation des Experts Comptables Europeens (FEE) on July 31, 2000) [hereinafter EFRAG Proposal].

³¹⁷ *Id.*

³¹⁸ See Press Release, Europe Organizes Itself in the Field of Accounting, (June 26, 2001), available at <http://www.iasplus.com/resource/efragorg.pdf> [hereinafter EFRAG Establishment Press Release].

³¹⁹ *Id.* at Notes to Editors, item 2.

³²⁰ *Id.*

³²¹ *Id.*

and to enhance the legitimacy and credibility of EFRAG.”³²² It is composed of individuals who represent EFRAG’s founding organizations, called EFRAG’s “founding fathers.”

The organizations that founded EFRAG represent business interests as well as the accounting profession. EFRAG’s “founding fathers” include UNICE, the organization of European employers; the European Banking Federation (EBF); the European Association of Cooperative Banks (GEBC); the Comité Européen des Assurances (CEA), the Continental Insurers’ Organization; and representatives of small businesses, accountants and stock exchanges.³²³

EFRAG characterizes its own function as twofold—first, “[p]roactive contribution to IASB” by providing comment on IASB proposals; and second, “endorsement advice” to the Commission on specific IASB standards.³²⁴ In fulfilling the second function—the one ordained by the IAS Regulation—EFRAG “is committed to give its endorsement advice to the Commission within two months” of the publication of an IASB standard.³²⁵ The Technical Expert Group’s practice is first to issue a “tentative view,” then invite comment and give consideration before issuing its final recommendation.³²⁶ It can recommend in favor of or against endorsement of an IASB standard or do neither. There is no provision for the number of members of the Technical Expert Group who must vote in favor of a standard in order to recommend endorsement. In practice, EFRAG only issues such a recommendation if a majority of the Technical Expert Group

³²² *Id.*

³²³ *Id.* at 2. The other founding fathers are the Fédération des Experts Comptables Européens (FEE), the European Savings Banks Group (ESBG), the European Association of Craft, Small and Medium-Sized Enterprises (UEAPME), the European Federation of Accountants and Auditors for SMEs (EFAA), the Federation of European Securities Exchanges (FESE), and the European Federation of Financial Analysts Societies (EFFAS). *Id.* As of February 2004, the members of the Supervisory Board were chairman Göran Tidström; deputy chairman John Glen, representing UNICE; Philippe Crouzet, representing UNICE; Peter Sampers, representing UNICE; Maije Torkko, representing UNICE; David Devlin, representing FEE; Hans van Damme, representing FEE; Klaus-Günter Klein, representing FEE; David Lindsell, representing FEE; Jos Streppel, representing CEA; Hervé Guider, representing GEBC; Paul Chisnall, representing FBE; Chris de Noose, representing ESBG; Paul Arlman, representing FESE; Javier de Frutos, representing EFFAS; Jan Verhoeve, representing UEAPME and EFAA; and Jürgen Tiedje, representing the European Commission as a non-voting observer. EFRAG website, at <http://www.efrag.org> (last visited Feb. 14, 2005).

³²⁴ EFRAG, EFRAG Due Process, Explanatory Memorandum at ¶ 10, available at http://www.efrag.org/doc/53_EFRAG%20Due%Process.pdf (last visited Apr. 6, 2005).

³²⁵ *Id.* at ¶ 3.1.

³²⁶ *Id.* at Explanatory Memorandum, ¶¶ 12, 15.

supports a standard.³²⁷ Two-thirds of the Technical Expert Group must vote against a standard in order for EFRAG to issue a recommendation against endorsement.³²⁸ When this happens, the Supervisory Board submits “a separate statement directly to the Commission to provide its commentary.”³²⁹ An abstaining vote by a member of the Technical Expert Group is “counted as a vote in favor of the endorsement.”³³⁰

The members of the Technical Expert Group are experienced European standard setters, accounting firm partners, preparers, and academics.³³¹ When EFRAG appointed the first members of the Technical Expert Group in June 2001,³³² Jean den Hoed, the EFRAG Supervisory Board’s first Deputy Chairman, stated that the Technical Expert Group would be an independent body: “It is important that the experts appointed have been selected because of their technical excellence. They have agreed to work independently in the European interest. This aspect will be closely monitored by the EFRAG Supervisory Board.”³³³

b. The Establishment of the ARC

The Accounting Regulatory Committee (ARC) was established by the European Commission in 2002³³⁴ and is governed by the Commission’s

³²⁷ See Comment Letter from EFRAG to the European Commission (July 8, 2004) (Recommendation on the Adoption of the Amended IAS 39 *Financial Instruments: Recognition and Measurement*), available at http://europa.eu.int/comm/internal_market/accounting/docs/ias/efrag/efrag-2004-07-a-endorsement-letter_en.pdf (noting that EFRAG has “decided only to issue a positive endorsement advice if there is a majority supporting endorsement.”) [hereinafter EFRAG IAS 39 Recommendation].

³²⁸ EFRAG, Due Process, *supra* note 324, at ¶ 3.7.

³²⁹ *Id.* at Explanatory Memorandum, ¶ 13.

³³⁰ *Id.*

³³¹ The current members of the Technical Expert Group are Stig Enevoldsen, a partner at Deloitte in Denmark; Allan Cook, a Technical Director of the United Kingdom’s Accounting Standards Board; Françoise Flores, a member of multiple steering committees of CNC, the French standard-setter; Begoña Giner Inchausti, Professor in Accounting and Finance at the University of Valencia; French Deloitte partner Catherine Guttman; Hans Leeuwerik, member of the preparers delegation of CAR, the Dutch standard-setter; Ugo Marinelli, Professor of Auditing at Rome University; Thomas Naumann, Senior General Manager and Chief Financial Officer at the Institutional Restructuring Unit of Dresdner Bank; Friedrich Spandl, co-head of the rating / consulting division of Vienna’s Bank für Arbeit und Wirtschaft AG (BAWAG); and Dominique Thouvenin, Director of Accounting at Ernst & Young, France. EFRAG website, at <http://www.efrag.org> (last visited Feb. 13, 2005).

³³² EFRAG, Establishment Press Release, *supra* note 318.

³³³ *Id.* at 2.

³³⁴ European Commission, Rules of Procedure for the Accounting Regulatory Committee, available at http://europa.eu.int/comm/internal_market/accounting/docs/arc/arc-rules_en.pdf (last visited Feb. 8, 2005) [hereinafter ARC Rules of Procedure].

standard committee operating rules.³³⁵ It is made up of delegations from each E.U. Member State. The delegations are made up of representatives of Member States' "administrations responsible for accounting issues."³³⁶ As of December 2004, organizations sending representatives included a wide range of agencies, ministries, national banks and non-governmental organizations.³³⁷ A procedure called Qualified Majority Voting (QMV) assigns a different number of votes to each Member State's delegation, so that the voting strength of the delegations varies. For example, the U.K. delegation has 29 votes and Latvia has 4. The total number of votes is 321.³³⁸

The ARC's function, according to the European Commission, "consists in providing an opinion" when the Commission has proposed to endorse an IASB standard.³³⁹ To approve a standard, at least thirteen

³³⁵ Council Decision 1999/468/EC, Rules of Procedure for the . . . Committee, 2001 O.J. (C 38) 3-5 (setting forth generic rules of procedure for European Commission committees).

³³⁶ European Commission, E.U. Accounting Regulatory Committee Opinion on IAS 39, available at http://europa.eu.int/comm/internal_market/accounting/docs/ias/2004-10-arc-opinion_en.pdf (last visited Feb. 8, 2005).

³³⁷ See Accounting Regulatory Committee, Summary Report, Meeting of the Accounting Regulatory Committee (Dec. 20, 2004), available at http://europa.eu.int/comm/internal_market/accounting/docs/arc/2004-12-20-summary-record_en.pdf (last visited February 8, 2005), Participants' List, 9. Participating in the December 20, 2004 meeting of the ARC were representatives of the following entities: from Austria, the Justizministerium, the Finanzministerium, and the Finanzmarktaufsicht; from Belgium, the Fod. Economie; from Cyprus, the Ministry of Finance; from the Czech Republic, the Ministry of Finance; from Denmark, the Danish Ministry of Economic and Business Affairs, the Danish Commerce and Companies Agency, and the Danish FSA; from Estonia, the Permanent Representation to the European Union; from France, the Conseil National de la Compatibilité (CNC), the Ministère de l'Économie, des Finances et de l'Industrie (Trésor), and the SGCI/Premier Ministre; from Finland, the Permanent Representation to the European Union; from Germany, the Permanent Representation to the European Union; from Greece, the Ministry of Economy and Finance; from Hungary, the Permanent Representation to the European Union; from Ireland, the Institute of Chartered Accountants in Ireland and the Department of Enterprise, Trade and Employment; from Italy, CONSOB, ISVAP, the Ministry of Economy and Finance, and Banca d'Italia; from Latvia, the Ministry of Finance; from Lithuania, the Ministry of Finance and the Accounting Institute; from Luxembourg, the Commission de Surveillance du Secteur Financier and the Ministère de la Justice; from Malta, the Accountancy Board; from The Netherlands, the Ministerie van Justitie and the Ministry of Finance; from Poland, the Ministry of Finance; from Portugal, CMVM and CNC; from Slovakia, no representative; from Slovenia, the Slovenian Institute of Auditors and the Ministry of Finance; from Spain, Banco de España and ICAC; from Sweden, the Ministry of Justice; and from the United Kingdom, the Department of Trade and Industry.

³³⁸ See Schaub, *supra* note 3, at 621; *id.* at Annex 3. The number of votes is not precisely proportional to each Member State's population. Germany, with a population of over eighty million, has the same number of votes as France, with a population of just under sixty million.

³³⁹ European Commission, Committees at E.U. Level, Accounting Regulatory

Member States' delegations, wielding at least 232 QMV votes, must vote in favor of it.³⁴⁰ The Commission is encouraged by the IAS Regulation to "take into account" such opinions "to the maximum possible extent."³⁴¹ The ARC not only provides advice, but under the comitology procedures³⁴² its vote has significance. According to Dr. Schaub: "If the ARC does not vote in favor of a Commission proposal or has no opinion, the Commission's proposal is sent to the Council of Ministers, which may approve or reject a proposal within three months."³⁴³

c. The Representative Character of the Endorsement Mechanism

The European endorsement mechanism is representative in character. The ARC's membership includes many entities that represent the interests of European companies.³⁴⁴ Although EFRAG's Technical Expert Group is expected to work independently, it is expected to do so "in the European interest," and the EFRAG Supervisory Board of European Organizations is designed to give business interests influence in the endorsement process. Thus, both EFRAG, particularly through its Supervisory Board, and the ARC offer E.U. business interests a voice in the adoption of IFRSs in the European Union.

The existence of the E.U. endorsement mechanism is consistent with the principles underlying international standard setting. Since international accounting standards are being created by the IASB, a private, independent standard setting body that has no authority to impose its standards on any country, the European Union quite properly has established a mechanism for assuring that IASB standards fulfill E.U. goals. The European Union, as a sovereign body, has the right and authority to consider business interests when deciding whether to adopt IFRSs. Of course, the European Union also needs to consider the market effects of a decision not to adopt IFRSs, since failure to adopt IASB standards that have been converged with U.S. and other national standards may deprive E.U. companies of access to foreign securities markets.

The combined sovereignty and market approach to convergence of national accounting standards was explicitly recognized by the IASC

Committee, available at http://europa.eu.int/comm/internal_market/accounting/committees_en.htm (last visited Feb. 8, 2005).

³⁴⁰ Schaub, *supra* note 3, at 621. Any Member State may also "request confirmation that Member States representing at least 62 percent of the E.U. population have voted in favour of the proposal." *Id.*

³⁴¹ IAS Regulation, *supra* note 2, at recital 15.

³⁴² Comitology procedures described, *supra* Part IV.C.2.

³⁴³ Schaub, *supra* note 3, at 621.

³⁴⁴ See Accounting Regulatory Committee, Summary Report, *supra* note 337.

Strategy Working Party when it stated that “there are many roads which may lead sovereign authorities to converge on a single set of global standards.”³⁴⁵ The SWP anticipated that “market pressures will encourage convergence,”³⁴⁶ but recognized that “countries may either reject solutions required by IAS and require different accounting for these items, or may not require certain IASC standards to be followed.”³⁴⁷ The concept that each sovereign nation should have the right to decide whether to adopt IASB standards is consistent with the SEC approach to the regulation of international securities markets set forth in a 1988 Policy Statement as follows:

In seeking solutions to common problems, securities regulators should be sensitive to cultural differences and national sovereignty concerns. As regulators seek to minimize differences between systems, the goal of investor protection should be balanced with the need to be responsive to the realities of each marketplace.³⁴⁸

The members of the EFRAG Technical Expert Group appropriately should cooperate with the IASB to inform the IASB about ways in which proposed standards will interfere with business operations. However, if the IASB ultimately disagrees with EFRAG, business and political interests should not threaten the IASB’s independent standard setting structure, but instead should give their advice to the European Commission in the context of the endorsement process.

D. European Business Interference with Adoption of IAS Derivatives Standards

In the IASB agenda, the most controversial standards have been those dealing with the measurement and reporting of financial instruments, especially derivatives contracts. In the United States, under FAS 133, adopted by the FASB in 1998, derivatives contracts, with some exceptions, must be recorded at fair market value.³⁴⁹ Gains and losses in the value of a derivative are immediately recorded in financial statements, even though no transaction has occurred. In general, the European practice has been to

³⁴⁵ November 1999 SWP Paper, *supra* note 73, ¶ 12.

³⁴⁶ *Id.*

³⁴⁷ *Id.*

³⁴⁸ Policy Statement of the Securities and Exchange Commission on the Regulation of International Securities Markets (Nov. 1988) Commerce Clearing House Inc. Federal Securities Law Reports (1988 Transfer Binder) at I.

³⁴⁹ ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES, Statement of Financial Accounting Standards No. 133 (Financial Accounting Standards Bd. 1998) [hereinafter FAS 133].

keep unrealized fluctuations in market value off of financial statements.³⁵⁰

1. Background

During the late 1990s, at the end of its core standards project, the IASC, under great pressure to complete its program, adopted most of U.S. Standard 133 on derivatives. At that time, European companies were not required to use IASC standards and few did so. In 2001, when the adoption of IASB standards in the European Union was anticipated, the IASB turned its attention to its financial instruments standards and undertook projects to improve the impact on business of IAS 32 and IAS 39. The IASB released an exposure draft in June 2002³⁵¹ that set forth improvements for both standards, IAS 32 (*Financial Instruments: Disclosure and Presentation*)³⁵² and IAS 39 (*Financial Instruments: Recognition and Measurement*).³⁵³ As envisioned by the IASB, IAS 39 dictated fair value accounting for derivatives, with a few exceptions.³⁵⁴ IAS 39 did not extend fair value to loans, which still would be measured at historic cost.³⁵⁵

As the European Union began to move toward the wholesale adoption of IASB international accounting standards, the prospect of fair value accounting of derivatives alarmed some European companies, particularly banks, who charged that the change would introduce unnecessary volatility in their financial reporting.³⁵⁶ European banks make extensive use of derivatives to hedge interest rate risks on loans.³⁵⁷ IAS 39 confronted these institutions with the choice of accounting for most derivatives by using fair value methods and or by conforming to strict new criteria for hedges.³⁵⁸

³⁵⁰ See, e.g., *Shining a Light on Company Accounts: 'Fair value' accounting for all financial assets and liabilities is on its way. Banks hate the idea.*, ECONOMIST, Aug. 18, 2001.

³⁵¹ PROPOSED AMENDMENTS TO IAS 32, FINANCIAL INSTRUMENTS: DISCLOSURE AND PRESENTATION, AND IAS 39, FINANCIAL INSTRUMENTS: RECOGNITION AND MANAGEMENT, Exposure Draft (Int'l Accounting Standards Bd. 2002) [hereinafter June 2002 Exposure Draft]. See also Press Release, Int'l. Accounting Standards Bd., International Accounting Standards Board Proposes Improvements of Financial Instrument Standards (June 20, 2002).

³⁵² FINANCIAL INSTRUMENTS: DISCLOSURE AND PRESENTATION, International Accounting Standard No. 32 (International Accounting Standards Bd. 2002), available at <http://www.iasc.org/> (last visited Mar. 1, 2005).

³⁵³ FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT, International Accounting Standard No. 39 (International Accounting Standards Bd. 2002), available at <http://www.iasc.org/> (last visited Mar. 1, 2005).

³⁵⁴ June 2002 Exposure Draft, *supra* note 351

³⁵⁵ *Id.*

³⁵⁶ See, e.g., Andrew Parker, *Regulators Push for Tougher Accounting Rules*, FIN. TIMES, Mar. 9, 2003 (Barclays pre-tax profits of £3.6B in 2001 would have been inflated by £449M in derivatives gains under U.S. GAAP).

³⁵⁷ *Id.*

³⁵⁸ Sean Togher, *IAS 39: Making Securitization Transparent*, RISK MGMT., Aug. 1, 2003.

For a derivative to be held as a hedge, IAS 39 required a demonstration of effectiveness—that it would mitigate or eliminate the risk inherent in a particular asset.³⁵⁹ Making the demonstration would be difficult because of the number and complexity of the derivatives-based financial structures in use.³⁶⁰ The application of IAS 39 to European banks raised the possibility that derivatives used as macro hedges—that is, used to hedge entire portfolios, rather than matched to specific risks—would not be treated as effective hedges and would be denied hedge accounting treatment.³⁶¹ The central complaint was that IAS 39 would have a negative effect on the risk management strategies of European companies, particularly banks.³⁶²

When similar rules had been introduced in the United States in June 2000,³⁶³ most U.S. banks had abandoned macro hedging and instituted focused and specific hedges. Accounting staffs were expanded in order to comply with stringent, complicated new hedging rules.³⁶⁴

2. *The Case for Fair Value Accounting for Derivatives*

The IASB believed fair value accounting for derivatives necessary both to improve standard quality and to promote convergence. IAS 39 itself explained that “derivative contracts create rights and obligations that meet the definition of assets and liabilities and, as a result, should be valued as assets and liabilities in a bank’s accounts using fair value or mark to market calculations.”³⁶⁵ The IASB also saw the changes of IAS 39 as necessary to make IFRSs acceptable to the SEC. Without fair value accounting for derivatives, the IASB believed the SEC would not drop its requirement that non-U.S. companies provide financial statements using U.S. GAAP and would not allow IASB standards to be used for registration of securities in the United States.³⁶⁶

³⁵⁹ June 2002 Exposure Draft, *supra* note 351.

³⁶⁰ See Adriana Arai, *E.U. Companies Forced to Swallow New Derivatives Rule Book*, Dow Jones Indus. News, June 19, 2003 (quoting PriceWaterhouseCoopers partner Peter Holgate, noting that even “pretty simple structures” would not qualify as hedges under IAS 39).

³⁶¹ See Andrew Peuple, *European Banks Face Daunting Derivatives Rules*, WALL ST. J. EUROPE, June 12, 2003.

³⁶² See Francisco Guerrero, Andrew Parker and Charles Pretzlik, *Brussels Sticks to its Guns*, FIN. TIMES, Mar. 10, 2003.

³⁶³ Introduction, FAS 133, *supra* note 349.

³⁶⁴ See Adriana Arai, *E.U. Companies Forced to Swallow New Derivatives Rule Book*, *supra* note 360.

³⁶⁵ *European Banks Hopeful of Deal with IASB on Derivatives*, Market News Int’l, Apr. 25, 2003.

³⁶⁶ See Andrew Parker, *Regulators Push for Tougher Accounting Rules*, FIN. TIMES, Mar. 9, 2003 (citing IASB chair Sir David Tweedie’s claim that the United States would not drop its requirement for E.U. companies to produce accounts under U.S. GAAP if Europe failed

3. Endorsement Problems and IASB Responses

In June 2002, EFRAG's Technical Expert Group recommended to the European Commission the adoption of the IASB's entire body of standards as it stood.³⁶⁷ It observed that IAS 39 "gives rise to . . . difficulties," but noted that the IASB was rewriting the standard.³⁶⁸ Corporate opposition to IASs 32 and 39 began to surface in the fall of 2002.³⁶⁹ It was matched by opposition to IASs 32 and 39 among the delegations of the Accounting Regulatory Committee.³⁷⁰ The Commission missed its self-imposed deadline—the end of 2002—for endorsing the entire set of standards. It announced that it would delay the endorsement until the following June.³⁷¹ In response, the IASB decided to hold public hearings on IAS 39.³⁷² When the hearings began in the late winter of 2003, it became clear that European banks strongly opposed fair value accounting for derivatives.³⁷³

In April 2003, the IASB's position on hedging was that "hedge accounting should be possible only where a clear link is established between derivatives and particular assets or liabilities."³⁷⁴ On April 28, the IASB met in London with senior banking executives and representatives of the European Banking Federation (EBF).³⁷⁵ The EBF asked the IASB to modify IAS 39, relaxing hedge definition rules to allow macro hedging—

to adopt IAS 39).

³⁶⁷ Comment letter from EFRAG to John F. Mogg, Director-General of the Internal Market (June 19, 2002), available at <http://www.iasplus.com/resource/efrg0206.pdf> [hereinafter EFRAG endorsement letter].

³⁶⁸ *Id.*

³⁶⁹ See Andrew Parker, *Regulators push for tougher accounting rules*, *supra* note 366 (reporting that French finance minister Francis Mer had voiced skepticism about fair-value accounting to Sir David Tweedie during a September 2002 meeting).

³⁷⁰ See Accounting Regulatory Committee, Summary Record, Meeting of the Accounting Regulatory Committee (Nov. 6, 2002), available at http://www.europa.eu.int/comm/internal_market/accounting/docs/arc/200211-summary-record_en.pdf, at Agenda Point 3 (reporting that "[a]ll Member States agreed that it was essential to send a clear message to the IASB on the need to thoroughly reconsider IAS 39 beyond the proposed improvements project.")

³⁷¹ See Andrew Parker, *EU Plans on Accounting Under Threat*, *FIN. TIMES*, Jan. 2, 2003.

³⁷² See Andrew Parker, *Regulators Push for Tougher Accounting Rules*, *supra* note 366.

³⁷³ See *id.* (characterizing banks as "leading the fight" against fair-value accounting for derivatives); Francesco Guerrera and Andrew Parker, *EU is Warned not to Reject Derivatives Rule*, *FIN. TIMES*, Mar. 11, 2003 (quoting IASB vice-chair Tom Jones, at the Brussels hearing, as claiming that convergence would be undermined if the European Union did not adopt IAS 39); Andrew Parker, *European Banks Slam Derivatives Proposals*, *FIN. TIMES*, Mar. 12, 2003 (reporting that BNP Paribas CFO had suggested that perhaps the fair-value measurements of hedge derivatives could be reported in the footnotes of financial statements, but that the idea had been rejected by IASB research director Wayne Upton).

³⁷⁴ Andrew Parker, *Bankers Set for IASB Talks*, *FIN. TIMES*, Apr. 28, 2003.

³⁷⁵ See *European Banks Hopeful of Deal with IASB on Derivatives*, *MARKET NEWS INT'L*, Apr. 25, 2003.

the hedging of entire portfolios of assets and liabilities.³⁷⁶ In a mid-June vote the IASB accepted this idea.³⁷⁷ Citing its discussion with the EBF, the IASB announced that it would produce an exposure draft of changes to IAS 39 that would allow macro hedging.³⁷⁸ On August 21, 2003, the IASB published Exposure Draft 6 (ED 6) on macro hedging, as promised.³⁷⁹

The proposals in ED 6 regarding the availability of hedge accounting and the standards used to judge the effectiveness of hedges were still not acceptable to some European economic interests.³⁸⁰ Moreover, banks still complained that fair value accounting would create too much volatility. The meetings between the IASB and representatives of the banking industry, which had been ongoing since February 2003, were broken off shortly after the announcement of the IASB's compromise on macro hedging.³⁸¹

On July 4, 2003, French President Jacques Chirac weighed in on the controversy. In a letter to Commission President Romano Prodi, he charged that fair value accounting for derivatives would have "nefarious consequences for financial stability."³⁸²

On July 16, 2003, the Accounting Regulatory Committee voted to recommend all IFRSs except IASs 32 and IAS 39.³⁸³ The chair of the meeting "insisted on the need for the IASB and the banking and insurance industries to find an acceptable solution for IASs 32 and 39 as soon as possible."³⁸⁴

³⁷⁶ *Id.* (quoting Wilfried Wilms of the EBF: "The problem is the current Standard [IAS 39] doesn't have any room for macro hedging, because you're hedging either assets or liabilities, but not a combination of both and that is the tricky part. The IASB does not see a solution that will fit with its principles, but we say our solution can.")

³⁷⁷ IASB, *IASB Insight*, June 2003, at 5 (reporting that the IASB had adopted "an approach that has been developed largely as a result of meetings between representatives of the IASB and representatives of the European Banking Federation (FBE).")

³⁷⁸ See *EC remains unyielding on IASB's proposed derivatives standards*, THE ACCOUNTANT, July 22, 2003.

³⁷⁹ IAS 39 MACRO HEDGING, Exposure Draft 6 (Int'l Accounting Standards Bd., 2003); see also Andrew Parker, *IASB to Ease Draft Rules for EU banks*, FIN. TIMES, Aug. 20, 2003.

³⁸⁰ See Paul Chisnall, *Financial reporting – Financial instruments: Financial – A final opportunity on IAS 32 and IAS 39*, ACCOUNTANCY, Oct. 1, 2003 at 83 (explaining remaining areas of conflict between IASB and economic interests after ED 6 had been issued); Andrew Parker, *IASB to Ease Draft Rules for EU Banks*, *supra* note 379.

³⁸¹ See Simon Clow and Andrew Peaple, *Banks' Talks with IASB Break Down*, WALL ST. J. EUROPE, June 26, 2003.

³⁸² Daniel Dombey, Andrew Parker and Bettina Wassener, *IASB to 'Stand Firm' Following French Attack*, FIN. TIMES, July 12, 2003.

³⁸³ Accounting Regulatory Committee, Summary Record, Meeting of the Accounting Regulatory Committee of 16 July 2003, available at <http://www.iasplus.com/resource/0307arc.pdf> (last visited Mar. 1, 2005).

³⁸⁴ *Id.* at 2. See also *Financial Reporting—IFRS Countdown—Burning Issues*,

The European Commission, following the ARC's recommendation, adopted a regulation endorsing all of the IASB's then-existing standards except IAS 32 and IAS 39.³⁸⁵ IAS 32 and IAS 39, explained the European Commission, were "not included because they are currently in the process of being revised by the International Accounting Standards Board . . . in cooperation with European accounting experts."³⁸⁶ Commissioner Frits Bolkestein, who was responsible for accounting issues in his position as the Commissioner charged with supervising the European Commission's Internal Markets Directorate-General, said: "I encourage the IASB and interested parties to continue their dialogue on IASs 32 and 39, so that the Commission will then be in a position to consider these standards too, in time for 2005."³⁸⁷

During the fall of 2003, European economic interests waged an extensive lobbying campaign in the European Parliament, advocating that the Parliament pressure the Commission to reject IASs 32 and 39.³⁸⁸ The IASB was criticized for failure to yield to the demands of European companies.³⁸⁹

By this time the European failure to endorse the standards had begun to have effects beyond the derivatives standards. Some observers feared that the time-consuming consultation and standard revision the IASB had performed regarding the derivatives standards might cause it to miss its deadline for finalizing other standards.³⁹⁰

On December 17, 2003, the IASB released definitive versions of IASs 32 and 39—definitive except for the macro hedging portion of IAS 39.³⁹¹ The standards remained largely unchanged. Sir David Tweedie warned that

ACCOUNTANCY, Oct. 20, 2003 (reporting that the ARC asked the Commission to "request the IASB to continue its dialogue with representatives of European industries in order to find a satisfactory and timely solution for the revised IAS 32 and IAS 39.")

³⁸⁵ Press Release, European Commission, Financial reporting: Commission adopts Regulation endorsing International Accounting Standards (Sept. 29, 2003), available at <http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/03/1297?format=HTML&ag ed=0&language=EN&guiLanguage=en>.

³⁸⁶ *Id.*

³⁸⁷ *Id.*

³⁸⁸ See John House, *Financial Reporting—IASB—Ready or not?*, ACCOUNTANCY, Aug. 31, 2003.

³⁸⁹ See, e.g., Peter Williams, *Accounting—Making Enemies in High Places*, AccountancyAge.com, at <http://www.accountancyage.com/features/1135899> (Dec. 17, 2003) (reporting that a French insurance executive had termed Sir David Tweedie and the IASB staff "Ayatollah accountants").

³⁹⁰ *See id.*

³⁹¹ FINANCIAL INSTRUMENTS: PRESENTATION AND DISCLOSURE, International Accounting Standard 32 (Int'l Accounting Standards Board, 2003); INT'L ACCT. STANDARDS BD., IAS 39: FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT, International Accounting Standard 32 (Int'l Accounting Standards Bd. 2003).

if the European Union failed to adopt the derivatives standards the attractiveness of European corporations to investors would suffer, as would prospects for convergence.³⁹²

On January 19, 2004, Commissioner Bolkestein told the IASB to omit the “remaining conflictual issues” from its final and complete version (incorporating the macro hedging rules) of IAS 39, which was scheduled for release in March, unless it could reach “broad agreement” with bank representatives.³⁹³ E.U. finance ministers voiced their approval of Commissioner Bolkestein’s statement on January 20, 2004.³⁹⁴ But at its January 2004 meeting the IASB voted against further changes to IAS 39.³⁹⁵

On February 10, 2004, at the European Commission’s request, the European Consultative Group on Accounting Issues was formed.³⁹⁶ The Consultative Group was to include representatives of the European Central Bank, the European banking and insurance industries, and European regulators of those industries.³⁹⁷ Commissioner Bolkestein said that the Consultative Group would examine the disputed sections of IAS 39 that could not be resolved by March.³⁹⁸

At its February meeting, the IASB voted to change IAS 39’s application of fair value accounting in another significant way. As an effort to allow companies to use fair values other than in hedging transactions, IAS 39 had permitted fair value accounting for any financial instrument, whether an asset or a liability, if a company wished. In response to suggestions from Commissioner Bolkestein, the IASB voted to prepare an amendment to restrict this permissiveness.³⁹⁹

Despite the IASB’s offer to abandon IAS 39’s permissive fair value

³⁹² Andrew Parker, *Warning to Opponents of Derivatives Rules*, FIN. TIMES, Dec. 17, 2003 (quoting Sir David: “The big danger for Europe is if IASB and FASB have the same standards—which we hope in just a few years we will—for someone having something different the big question the market is going to ask is ‘why?’ That is something that scares people. If you are a multinational and you have to do something – a watered down version – people are going to ask the question: ‘What is in there that we cannot see?’”)

³⁹³ Daniel Dombey, *IASB set to Rebuff Brussels on Rules*, FIN. TIMES, Jan. 21, 2004.

³⁹⁴ *Id.*

³⁹⁵ IASB, *IASB Update*, Jan. 2004, at 4.

³⁹⁶ Press Release, IASB, European Consultative Group on Accounting Issues Affecting Financial Institutions to be Created (Feb. 10, 2004). See also Andrew Parker, *IASB Creates Advisory Group at EC’s Request*, FIN. TIMES, Feb. 3, 2004; Patrick Tracey, *New IASB Advisory Forum Created to Strengthen European Bankers’ Input*, BNA’S BANKING REP., Feb. 16, 2004.

³⁹⁷ *Id.*

³⁹⁸ Parker, *supra* note 396.

³⁹⁹ IASB, *IASB Update*, Feb. 2004, at 1 (reporting the IASB’s decision that “whilst preserving the key benefits of the [fair value] option it would explicitly limit the use of the option to specified situations.”) See also Patrick Tracey, *IASB Bends to European Pressures to Scale Back Fair Value for Derivatives*, BNA’S BANKING REP., Feb. 23, 2004.

provision, Commissioner Bolkestein insisted on further changes in IAS 39. On March 2, he said, "I am still convinced that temporary solutions can be found in the short term, pending longer-term work by the IASB. I have urged Sir David Tweedie to continue working in the short term with technical experts – around the clock if necessary – to try to find such appropriate solutions."⁴⁰⁰

On March 31, the IASB incorporated the macro hedging amendment contained in ED 6 into IAS 39.⁴⁰¹ In response, the European Commission called for further concessions.⁴⁰² It imposed a new deadline, June 2004, for the resolution of the disagreements between the IASB and the banking industry.⁴⁰³ On March 31, the IASB announced that it would form a working party including representatives of the EBF to review IAS 39.⁴⁰⁴

True to its February suggestion, on April 21, 2004, the IASB published an exposure draft containing a fair value limitation amendment to IAS 39.⁴⁰⁵

4. The European Commission's Carve-Out

Beginning on June 9, 2004, a body called the "High Level Group on IAS 39," made up of representatives of the European Commission, the IASB, and business interests, began trilateral negotiations.⁴⁰⁶ The IASB agreed in principle to presentational changes.⁴⁰⁷ Under the compromise, companies would report equity values the traditional way, with a special disclosure for changes in values of derivatives. The IASB also agreed to consider a bank-sponsored proposal for the expansion of hedging.⁴⁰⁸

Even after the IASB agreed to presentational changes, banking

⁴⁰⁰ Andrew Parker, *Bolkestein Urges Solutions on Standards*, FIN. TIMES, Mar. 3, 2004.

⁴⁰¹ IASB, *IASB Insight*, Apr./May 2004, at 1. See also *IASB Sets Derivatives Accounting Rules Despite Firms' Doubts*, THE ACCOUNTANT, Apr. 30, 2004.

⁴⁰² Andrew Parker, *Brussels Delivers Standards Deadline*, FIN. TIMES, Apr. 1, 2004.

⁴⁰³ *European Banks and IAS 39: Time to Settle the Account*, EUROPEAN BANKER, Apr. 30, 2004.

⁴⁰⁴ Andrew Parker, *Bankers Change Tone with IASB*, FIN. TIMES, Apr. 2, 2004.

⁴⁰⁵ IAS 39: THE FAIR VALUE OPTION, Exposure Draft (Int'l Accounting Standards Bd. 2004); See also *Still not Tallying – Accounting Standards*, ECONOMIST, Apr. 3, 2004, at 69.

⁴⁰⁶ See *Banking Experts Meet to Hammer Out Derivatives Compromise*, DOW JONES INT'L NEWS, June 9, 2004.

⁴⁰⁷ Juliane Von Reppert-Bismark, *EU Derivatives Vote is Delayed*, THE WALL ST. J. EUR., July 12, 2004.

⁴⁰⁸ See Accounting Regulatory Committee, Summary Record, Meeting of the Accounting Regulatory Committee of 14 June 2004, available at http://europa.eu.int/comm/internal_market/accounting/docs/arc/2004-06-14-summary-record_en.pdf, at 2-3. See also *EU Commission: Outlook on Derivatives Rule 'Hopeful,'* DOW JONES INT'L NEWS, June 9, 2004 [hereinafter *Outlook on Derivatives Rule*].

interests wanted to stall the endorsement process.⁴⁰⁹ In a June 11 letter, the EBF asked the Commission to postpone its decision until more progress had been made in the negotiations. The letter argued that “[t]he strengthening of the European capital markets resulting from the application of international accounting standards can only be achieved if Europe ensures that the standards developed by the IASB are suited to European market conditions.”⁴¹⁰

On June 14, 2004, the Accounting Regulatory Committee met to consider whether to endorse IAS 39. After members had been briefed on the proposed presentational changes, fifteen countries voted yes, six stated no opinion, and four—France, Italy, Spain and Belgium—voted no.⁴¹¹ In response, the European Commission chose to delay its final decision on standard endorsement still further, asking the national governments represented in the ARC to submit formal opinions by the end of June.⁴¹²

In July 2004, EFRAG’s Technical Expert Group voted on whether to endorse IAS 32 and IAS 39. The Technical Expert Group issued an endorsement of IAS 32.⁴¹³ Five of the eleven members voted in favor of endorsing IAS 39 and six against.⁴¹⁴ Since EFRAG’s due process requires the approval of a majority of the Technical Expert Group to endorse a standard, IAS 39 was neither approved nor rejected.

The European Commission next proposed what became known as a “carve-out”—endorsing portions of IAS 39 and not endorsing other portions.⁴¹⁵ The carve-out involved two issues: the fair value option and the

⁴⁰⁹ See *EU Set to Miss Deadline for New Derivative Accounting Rule*, DOW JONES INT’L NEWS, June 11, 2004.

⁴¹⁰ See *EU Veto on Derivatives Standard Threatens Move to IAS by 2005*, THE ACCOUNTANT, June 30, 2004.

⁴¹¹ *Outlook on Derivatives Rule*, *supra* note 408. Their weighted votes were sufficient to block the endorsement. See *France and Three Others Veto Derivatives Accounting Deal*, DOW JONES INT’L NEWS, June 14, 2004.

⁴¹² Floyd Norris, *4 European Nations Object to Bank Accounting Shift*, N.Y. TIMES, June 15, 2004, at C12.

⁴¹³ Letter from EFRAG to Dr. Alexander Schaub, Director General, European Commission Directorate for the Internal Market (July 8, 2004) (endorsement of IAS 32) available at http://europa.eu.int/comm/internal_market/accounting/ias_en.htm#efrag-advice.

⁴¹⁴ Letter from EFRAG to Dr. Alexander Schaub, Director General, European Commission Directorate for the Internal Market (July 8, 2004) (non-endorsement of IAS 39) available at http://europa.eu.int/comm/internal_market/accounting/ias_en.htm#efrag-advice.

⁴¹⁵ European Commission, Proposal for a Draft Commission Regulation, available at http://europa.eu.int/comm/internal_market/accounting/docs/ias/2004-09-ias39-proposal_en.pdf (Sept. 7, 2004); European Commission, Revised Proposal for a Draft Commission Regulation, available at http://europa.eu.int/comm/internal_market/accounting/docs/ias/revised-2004-09-ias39-proposal_en.pdf (Sept. 28, 2004); Accounting Regulatory Committee, Summary Report, Meeting of the Accounting Regulatory Committee, Jul. 9, 2004, available at http://www.europa.eu.int/comm/internal_market/accounting/docs/arc/2004-07-09-

portfolio hedging of core deposits. The Commission proposed a non-endorsement of the portions of IAS 39 dealing with the fair value option because it felt that a final version of the IASB's proposed elimination of the fair value option⁴¹⁶ would not be incorporated into IAS 39 before the end of 2004.⁴¹⁷ With regard to hedging, the Commission felt that the IASB's concession on macro hedging had been insufficient and that the hedge effectiveness testing requirements of IAS 39 were too restrictive and difficult to meet. It therefore proposed not to endorse the portions of IAS 39 that dealt with effectiveness testing.⁴¹⁸ The ARC approved the carve-out on October 10.⁴¹⁹

The Commission formally endorsed the carved-out IAS 39 by regulation on November 19, 2004.⁴²⁰ The regulation stated that

[I]t is the objective of the Commission to have a stable platform of international accounting standards in place as from 1 January 2005. However, certain important provisions in IAS 39 are still the subject of unfinished discussions between the IASB, the European Central Bank, prudential supervisors and the banking industry. These provisions relate to the option to fair value all financial assets and liabilities and to hedge accounting. Each of these provisions concern areas which are completely autonomous, distinct and separate from the rest of the standard. In order to respect the date of 1 January 2005, it is necessary to introduce IAS 39 with the exception of these provisions.⁴²¹

The Commission characterized the carve-out as a temporary solution to be revisited when the IASB came to agreement with the European banking industry, and stressed the "exceptional nature" of the situation.⁴²² According to Director-General Schaub,

summary-record_en.pdf, at 1 (reporting that the Commission was exploring the possibility of the carve-out because "the [European] Union had to remedy the inability of both the International Accounting Standards Board and the European banking industry, after 2 years of long and painful discussions, to come to a mutually satisfactory solution on portfolio hedging of core deposits.")

⁴¹⁶ Discussed *supra* Part IV.D.3.

⁴¹⁷ Accounting Regulatory Committee, Summary Report, *supra* note 415, at 2.

⁴¹⁸ *Id.*

⁴¹⁹ Accounting Regulatory Committee, Opinion on IAS 39, Oct. 10, 2004, available at http://www.europa.eu.int/comm/internal_market/accounting/docs/ias/2004-10-arc-opinion_en.pdf. See also Tobias Buck, *EU Backs Move to Sweeten Derivatives Proposal*, FIN. TIMES, Sept. 9, 2004.

⁴²⁰ Commission Regulation No. 2086/2004, O.J. L 363/1 (Nov. 19, 2004). See Floyd Norris, *Europe Closer to Adopting Uniform Accounting Rules*, N.Y. TIMES, Nov. 22, 2004, at C2.

⁴²¹ *Id.* at Recital (4).

⁴²² Accounting Regulatory Committee, Summary Report, *supra* note 415, at 1-2.

In carving-out a few positionings of IAS 39 the Commission was scrupulous to ensure that no additional text was inserted into the carved-out standard. On the other hand, it did not wish to postpone IAS 39 until the IASB was able to resolve the issue . . . It is the Commission's hope that after discussion the IASB will be able to come forward very quickly with a revised standard for IAS 39 that is acceptable to parties concerned.⁴²³

Meanwhile, IAS 32 was approved by the ARC⁴²⁴ and endorsed by the Commission⁴²⁵ without further difficulty.

5. Outlook for Convergence

European business interests seem temporarily to have succeeded in dislodging a standard that was not to their liking, and they have done so by utilizing the representativeness mode of the E.U. endorsement process. Despite intense pressure, the IASB has not changed the basic principles that underlie its derivatives rules. Its IASs 32 and 39 are still internally consistent and consistent with fair value accounting for derivatives. Notably the differences between the official IASB versions and the Commission-endorsed IAS 39 carve-out have resulted from the E.U. endorsement process and not pressure-induced changes in IASB standards.

The IASB's refusal to succumb to political pressure from business interests to change its derivatives standard bodes well for the functioning of international standard setting in the future. Companies that oppose particular changes in financial reporting standards have been given substantial opportunity to attempt to persuade the IASB to make changes. Having failed in that attempt they appropriately have sought instead to seek modifications through the European Commission endorsement mechanism. As a result, the IASB's legitimacy as an independent standard setter has been preserved.

V. CONCLUSION

The events of the past four years suggest that the IASCF Trustees have been correct in conducting the IASCF's Constitution Review in a manner that reinforces the IASB's independence. Standard setter independence is crucial for the international convergence of accounting

⁴²³ Schaub, *supra* note 3, at 622.

⁴²⁴ Accounting Regulatory Committee, Summary Report, Meeting of the Accounting Regulatory Committee, Nov. 30, 2004, available at http://europa.eu.int/comm/internal_market/accounting/docs/arc/2004-11-30-summary-record_en.pdf, at 1.

⁴²⁵ Commission Regulation No 2337/2004, O.J. L 393/1 (Dec. 31, 2004).

standards. If business interests can control the standard setting process, opposition from business interests is likely to prevent convergence.⁴²⁶ The FASB and the IASB have made tremendous progress in converging IASB standards and U.S. GAAP precisely because neither standards board is subject to control by business interests. Their independence bodes well for the success of the worldwide accounting convergence process with its attendant economic benefits.

Companies that fear the economic effects of particular standards should have the opportunity to be heard by an independent standard setter. Both the FASB and the IASB have instituted extensive due process procedures designed to ensure they receive extensive information about the real world effects of their standard setting. However, giving business interests the opportunity to be heard is very different from giving them the power to control. If, despite opposition from business interests, an independent standard setter determines that a change in standards is necessary, it must be allowed to institute the change.

The European derivatives episode suggests that business interest successes in influencing endorsement or adoption of accounting standards are likely to delay or impede convergence. Nevertheless, even if businesses are successful in the short run, in a longer period they are likely to be subject to market pressure toward convergence from constituencies that insist on comparable, high-quality accounting standards. Business interests in Europe succeeded in persuading the European Commission to endorse a carved-out IAS 39, but the carved-out provisions were not stricken from that standard by the IASB. As a result, the IASB standards endorsed by the European Union do not meet the convergence goal. Since IAS 39 as endorsed in the European Union does not meet the convergence goal, it seems unlikely that the E.U. standards will be able to be used for cross-border trading without reconciliation in the derivatives area. As a result, it can be expected that market pressure will be brought on the European

⁴²⁶ It should also be noted that convergence may eliminate some of the motivation for business interests to oppose particular accounting standards:

Constituents often complain that a 'tough' standard would put local companies at a competitive disadvantage relative to companies outside their jurisdiction. Local political pressures and policies may work against individual national standard setters. An international standard setting process, independent of political pressures, can establish financial reporting standards that would apply to all companies in all jurisdictions, thus eliminating perceived disadvantages.

Sir David Tweedie, *Setting a Global Standard: A Case for Accounting Convergence*, 25 Nw. J. INT'L. L. & BUS. 589, 594 (2005).

Commission to recommend full endorsement, or at least to seek further compromises with the IASB.⁴²⁷

This article applauds the convergence efforts of the IASB and the FASB as well as the IASCF's Trustees determination to maintain the IASB's independence. By remaining independent, the IASB and the FASB can vigorously continue their effective campaign for the international convergence of accounting standards. Independent standard setters of the world working with each other offer great hope for convergence and for the enormous economic benefits from widespread cross-border trading.

⁴²⁷ This result is made especially likely by the adoption of IFRSs by an increasing number of jurisdictions outside the E.U. For current statistics on the application of IFRSs, see Deloitte, *Use of IFRSs for Reporting by Domestic Listed Companies, by Country* at http://www.iasplus.com/country/useias.htm#* (last visited Mar. 30, 2005).