

**THE INTERNATIONAL DIMENSION OF THE HARMONIZATION
OF ACCOUNTING STANDARDS IN THE EU**

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Abstract

Starting in January 2005, all companies located in the European Union (EU) have to use the accounting standards promulgated by the International Accounting Standards Board (IASB). At a stroke, accounting standards for the consolidated accounts of companies whose shares are listed on an EU stock exchange have been harmonized across the Union. This is quite an achievement. Although IASB standards have existed for more than 30 years, this is the first time that they will become directly and solely applicable within a state, let alone 25 states.

This situation raises two interesting questions. Why are accounting standards being harmonized now? Why are the IASB's standards being adopted as opposed to other accounting standards (American, British or European)? The answer to the first question is best found in neofunctionalism's concept of functional spillover, whereby the integration of capital markets in the EU requires common financial reporting standards. The answer to the second question is best dealt with by liberal intergovernmentalism, whereby the decision to standardize accounting standards across the EU is the ultimate responsibility of the member state governments, whose preferences are determined by domestic politics. However, in the present case, and this is the novel contribution of this paper, it is the external (i.e. international) environment that shapes member states' domestic politics. The globalization of capital markets as a result of the international mobility of capital structures member state governments' preferences vis-à-vis making IASB standards applicable throughout the EU. To have a complete understanding of the EU's policy-making choice regarding accounting standards and possibly other areas of European integration and policy-making, EU scholars need to incorporate (some might bring back) the external environment in their analytical toolbox.

The paper also provides support for more recent theoretical approaches to the EU, notably delegation and multi-level governance, by showing that a recent decision by the European Commission to Europeanize somewhat the IASB's standards may undermine (continental) member states' ultimate goal of restoring the competitiveness of their capital markets in the global economy.

Finally, this paper adds to the emerging literature on the international political economy of standard setting by offering a case study in support of recently proposed theoretical approaches to the topic.

INTRODUCTION

Since January 1, 2005, all companies whose shares are listed on a stock exchange in the European Union (EU) have to produce their consolidated financial statements according to the rules promulgated by the International Accounting Standards Board (IASB) rather than according to national rules.¹ This means that at once accounting rules (for listed companies) have been standardized across 25 member states. This is quite an achievement, especially since it took less than five years to do so from the time the European Commission made its official recommendations to the European Parliament (EP) and the Council of Ministers in the context of the Lisbon Summit of June 2000 (Commission of the European Communities 2000). The EU is now the first jurisdiction to make the IASB's International Financial Reporting Standards (IFRS) and International Accounting Standards (IAS) the only applicable financial reporting rules for publicly-listed companies.

In Lisbon in 2000, EU member states agreed to devise a strategy of economic reforms that would make the EU the most productive economy by 2010. One important element of the Lisbon Strategy is to fully integrate the EU's financial markets, as it was envisaged at Maastricht in 1991 when the member states agreed to economic and monetary union. An integrated financial market would ensure that capital would be allocated to the most productive investment projects across the EU. It would also reduce the cost of capital as transaction costs to move capital across the EU would be

¹ In order to avoid any confusion, we use the term European Union when referring to the region now composed of 25 member states as well as the institutions where supranational policy decisions are made even though it would be more accurate to refer to the European Community (EC) when discussing the legal institutions in which decisions regarding the economic and monetary union (including common accounting standards) are made. Before the Maastricht Treaty on European Union, which came into force in November 1993, the EC was separated into three Communities, of which the main one was the European Economic Community (EEC). Accounting standards fell within the purview of the EEC before Maastricht.

significantly reduced, if not eliminated. In return, a lower cost of capital would make more investment projects economically feasible, which would boost economic growth and employment. EU-wide standards of financial reporting represent a fundamental element of such an integrated financial market. This is because they provide the common language through which investors can assess companies' performance and, therefore, allocate their precious capital most effectively.

This is the economic rationale behind the need for a single set of European accounting standards. As such, it is in line with the neofunctionalist theory of integration and its concept of functional spillover. A common financial market cannot function optimally without easily available and comparable information. At the international level, the same argument is made regarding the need to have common standards for the proper functioning of the global economy. For example, Mattli (2003) argues that globalization "has changed the technical needs and preferences of an ever-growing number of international producers and traders and has magnified the opportunity cost of incompatible national standards" (199). As such, market integration, whether regional or global, requires compatible product, service and information standards across states.

Although the rationale for EU-wide common accounting standards is clear, it still leaves unexplained the choice of standards. Why did the EU choose IASB's accounting standards over "European" or even American standards? How do we explain the policy choice made by the EU's governing institutions? The answer lies with the international context in which the integration of European financial markets takes place, particularly the central role played by the UK and the US in global financial markets. Here, the international mobility of capital and its impact on continental European capital markets

structured (continental) EU member states' preferences. This finding points to the importance of the external (political and economic) environment for our understanding of EU policy-making as well as institutional change (e.g., Knodt 2004). Unfortunately, it has traditionally been neglected by EU scholars.

The case of common accounting standards in the EU also shows that once the decision to adopt IASB standards has been made, the implementation of these standards into EU (i.e. EC) law is influenced by the multi-level governance nature of the EU and the delegation of standard setting to an independent private international organization. Powerful national and transnational economic actors managed to force the Commission to leave aside some contentious provisions of an IASB standard (IAS 39) in order for the latter to be applicable in the EU by January 2005. This "Europeanization" of IASB standards runs the risk of undermining the (continental European) member states' ultimate goal of restoring the global competitiveness of their capital markets.

To develop this argument fully, the paper is organized as follows. The next section deals with theoretical explanations of EU policy-making as well as international standard setting. The third section describes the process leading to current policy of IASB accounting standards being applicable in the EU for publicly-listed companies as well as the recent controversy about the implementation of IASB standards in the EU. The final section concludes on the lessons that the harmonization of accounting standards in the EU has for theoretical approaches to the study of European integration and policy-making.

EXPLAINING POLICY CHOICES IN THE EU

The creation of integrated financial markets for equity and corporate bond trading in the EU requires accurate and easily comparable financial information that investors can use in order to make their investment decisions. Otherwise, the markets will remain fragmented as investors will tend to favour companies of the same nationality, whose economic performance is easier to assess because of their use of national accounting standards with which investors are familiar. In such a case, investors do not have to incur the non-negligible cost of familiarizing themselves with financial reporting standards in other member states as well as the cost of translating financial results from one standard to the other in order to make them comparable. As a result of the existence of these informational (transaction) costs, investors will not allocate their capital optimally across the EU. In other words, they will prefer investing in national companies rather than in companies located in other member states, even though the latter may provide superior expected financial returns. This bias makes it hard to create integrated financial markets, even if capital is free to circulate across the EU. The ultimate consequence is that the EU economy will fail to become more productive as potentially lucrative investment projects do not see the light of day or are only partially realized, owing to a lack of adequate funding.

If investors could more easily compare companies' performance across the EU because common accounting standards for financial reporting would apply across the region, then they could feel confident that their decisions would be more accurate. Furthermore, this confidence would also grow if investors believed that the common accounting standards are superior to national rules in reflecting companies' true

economic performance. As a result of this increased confidence in financial reporting, investors would spend less time and money on analysing and comparing companies' performance. This reduction in transaction costs would translate in a lower cost of capital demanded by investors. Only then would it be possible for an integrated financial market to emerge across the EU.

The need to reduce information (or transaction) costs with respect to investment decisions across the EU represents the economic rationale for having common financial reporting (i.e. accounting standards) for the EU. As such, it fits with the neofunctionalist explanation of European integration originally developed by Haas (1958), whose central concept of spillover provides the dynamic mechanism explaining why integration takes place. In the case of functional spillover, which is the one of concern here, the integration of one economic policy domain at the supranational level requires the integration of another in order to internalize the externalities created by the interdependence between policy domains (George 1991). For example, a common market can not function optimally without a common currency (Eichengreen 1993). Similarly, a common financial market cannot function optimally without easily available and comparable information.

Although useful to explain why integration at the supranational level takes place, neofunctionalism does not explain the policy choices that are made within the integration process. In the present case, it tells us why accounting standards must be the same across the EU. However, it tells nothing about the choice of standards that the EU's governing institutions have made. Moravcsik's (1993 and 1997) liberal-intergovernmentalist analytical framework may be useful here as it argues that governments' policy

preferences are determined in good part by the pressures exercised by domestic socio-economic constituencies on policy-makers. Bargaining at the EU level, taking into account states' power resources as well as the EU's institutional context, then explains the policy outcome. In the case of accounting standards, it means that investors should favour supranational rules that are as close as possible to the national rules with which they are most familiar. This is because investors want to minimize the cost of learning the new, common standards. As for companies, those whose shares or bonds are listed in only one country should also favour financial reporting standards that are as close as possible to the national ones they are most familiar with. Companies with listings in more than one EU member state should favour common standards that are as close as possible to the rules applicable in one of the member states where their shares or bonds are listed. Finally, European companies that are also (or planning to be) listed in the United States (New York Stock Exchange or Nasdaq) should prefer EU accounting standards that are as close as possible to US rules. The problem with Moravcsik's liberal framework is that it does not tell us how these different preferences get aggregated at the government level. In the present case, it seems reasonable to assume that the majority of investors and companies support European accounting standards that are as close as possible to the national standards they are most familiar with. If national standards are relatively far apart from each other, then even under qualified-majority voting in the Council we can expect either stalemate (i.e. the status quo) or rules that are so flexible that they are of little use in terms of facilitating comparability across EU member states. In a sense, this explains the results of earlier attempts by the EU (then EEC) to harmonize accounting standards (see next section for details).

As we will see in the next section, the international nature of financial markets and the dominant role played by the United States in this context exerted strong pressures on EU member states to harmonize their financial reporting standards with those of the US in the late 1990s and early 2000s. This unilateral harmonization paved the way for the adoption of a Council regulation in 2002 that would make IASB standards applicable in the EU for companies with shares listed on European stock exchanges from 2005 and on (2007 for companies with only bonds listed). As such, the argument presented herein about the choice of accounting standards for the EU is of the second-image-reversed type, whereby the international system affects domestic actors' preferences with regards to international cooperation (see Gourevitch 1978). Because the international mobility of capital constrains EU member states' accounting standards policy, our explanation is similar to Andrews's (1994) structuralist argument about states' monetary policies being severely constrained by international capital mobility.

Another possible explanation of the choice of common accounting standards in the EU is the role played by epistemic communities (Haas 1992). Such communities of politically-independent individuals with recognized expertise in a given field can play an important role in influencing decision-making, especially when governments hesitate between different policy options. For example, the Delors Committee, which was composed mainly of central bankers, played a determinant role in setting the institutional framework of the EU's monetary union (Verdun 1999). In the case of financial reporting standards, a forum of European accounting experts could have influenced the EU's choice by arguing that the IASB's standards were better than any of the accounting standards found in the member states and the US. This is what Mattli and Büthe (2003)

call the “technical rationality” approach,² whereby “standards are primarily a function of science and technical considerations rather than a function of the distribution of power between national, regional and nonstate actors” (13). Because it is devoid of politics as Mattli and Büthe (2003) correctly point out, we will see in the next section that this approach cannot explain the EU’s policy choice in the case of accounting standards; international economic pressures and politics do.

THE HARMONIZATION OF ACCOUNTING STANDARDS IN THE EU

Thorell and Whittington (1994) make a distinction between the international harmonization and standardization of accounting standards. They define the former as bringing “the accounting standards of different countries into closer harmony with one another” (216). In terms of the latter, they note that it is the limiting case of the harmonization process, whereby all countries share identical accounting standards. Thus, in the case of the EU, the adoption of IASB standards throughout the region can be considered in terms of international (i.e. European) standardization. However, this does not mean that there were no previous attempts to harmonize accounting standards in the EU.

Earlier attempts to harmonize financial reporting standards in the EU took the form of two Council directives on company law harmonization: the Fourth Directive on the annual accounts of companies (Council of the European Communities 1978) and the Seventh Directive on consolidated accounts (Council of the European Communities 1983). Before the Fourth Directive, there was a great diversity in accounting and reporting rules across the EU (then EEC).

² They actually refer to this approach as the world society approach of sociological institutionalism.

This [ranged] from systems dominated by taxation considerations and by closely defined statutory prescription in company law (such as Germany and France) to systems which allow a greater freedom of choice of accounting method in order to meet the need of communicating relevant information to investors. Examples of the latter are the UK, Ireland and the Netherlands in Europe and the USA in the wider world economy (Thorell and Whittington 1994, 218).

The key difference between accounting standards in Europe was with respect to their primary intent. They were geared towards the needs of either national taxation or financial investors. This reflected in some way the different corporate governance (or capitalist) systems in place throughout Europe: those based primarily on arms-length shareholder capital and those based primarily on closely-involved bank capital. Consequently, the Fourth Directive aimed to create greater harmony between the different financial reporting standards for individual companies within the EU (EEC). However, the objective was greater comparability and equivalence of financial information rather than uniformity (Haller 2002, 155). Given the great disparity between national rules, the end result for the Fourth Directive was a compromise between the highly prescriptive German and French approaches regarding format, disclosure and valuation, and the “true and fair view” approach of Ireland and the UK regarding the need for financial statements to reflect as well as possible the true economic state and performance of companies (Thorell and Whittington 1994, 218). In spite of the compromise between different approaches to accounting standards between member states, the Fourth Directive did increase the consistency of financial reporting practices across the EU; however, Thorell and Whittington (1994, 219) note that it was much more effective in the areas of format and disclosure than in measurement.

The Seventh Directive aimed to extend the Fourth Directive’s application to consolidated accounts of corporate groupings rather than only individual companies

because in many member states consolidated financial statements were poorly regulated, owing to the focus of accounting standards on taxation rather than investors (Haller 2002, 156). However, in order to do so, this new directive had to establish rules for “the identification of groups, scope of groups accounts and obligation to prepare, audit and publish group financial statements as well as consolidation-related methods” (Haller 2002, 155). Like the Fourth Directive, the Seventh Directive was a compromise between the various practices among the member states, whereby it offered a choice between different accounting methods in many cases (Thorell and Whittington 1994, 220). In order to ensure its adoption, the Seventh Directive also exempted most small- and medium-sized groups of companies from producing consolidated financial statements.

The development of the EU’s two accounting directives was essentially a result of a compromise between two approaches to financial reporting: (1) the Anglo-Saxon approach based on a true and fair view of the company or group of companies for the primary use of investors with rules based on general principles (thus allowing for professional judgement) and (2) the continental approach (particularly German) based on detailed legal and prescriptive accounting rules aimed mainly at taxation. The result was two directives with a large number of options in terms of accounting methods: 76 in the case of the Fourth Directive and around 50 in the case of the Seventh Directive (Haller 2002, 157; Thorell and Whittington 1994, 220). Because the member states have selected different options in their implementation of the accounting directives into national law, the EU has not achieved “a satisfactory level of comparability and equivalence between financial statements within Europe, which means that the contents of the accounts and financial figures are often so different that they cannot be compared and analysed

decently on a cross-border basis without taking national particularities into account and subsequently arranging reconciliation” (Haller 2002, 159).

So even if the accounting directives provided the basis for mutual recognition of financial statements for having shares and/or bonds listed on security exchanges throughout the EU (Haller 2002, 159), the degree of harmonization remained insufficient for investors to be indifferent between domestic and foreign companies, for there was an additional information cost to investing in a foreign company’s assets (shares or bonds).³ As Haller (2002, 159) puts it, there was “equality” but not “comparability”.

Given that this situation persisted until only recently, what changed in the 1990s to make greater harmonization (standardization) of accounting standards in the EU acceptable to the member states? Haller (2002) argues that two parallel phenomena took place in the 1990s. First, there was an increase in cross-border mergers and acquisitions (M&As) involving European companies, both inside and outside the EU. Within the EU, the Single Market was a major driver of industry consolidation. This has had for effect to internationalize the investor base of multinational companies (MNCs), thereby creating a greater need for standardization in financial reporting. Second, capital markets became globalized as a result of states removing controls on the cross-border flow of capital.⁴ This made it easier for investors to place their capital in foreign companies. For example, investors could now purchase shares and/or bonds of companies listed on a foreign securities exchange. The globalization of capital markets also made it easier for MNCs to list their shares and bonds on foreign exchanges in addition to their home exchange.

³ Bradshaw et al. (2003) have found a similar pattern for US investors. They found that foreign firms that use accounting standards close to US ones attract more American institutional investors and that this reduces foreign companies’ cost of capital.

⁴ For various explanations of this process, see *inter alia* Bryant (1987), Goodman and Pauly (1993), and Helleiner (1994).

Many companies in continental Europe now also have their shares listed on the London Stock Exchange (LSE) or the New York Stock Exchange (NYSE). For example, in 1990 there were only 26 EU-15 companies listed on the NYSE. In 2001, the number had increased to 146 (Haller 2002, Table 4). The primary motivation for seeking a foreign listing is because home capital markets and banks are not sufficient to provide the financing required by MNCs to pursue their global expansion (both sales and production). Moreover, the cost of capital in continental Europe has been higher than in the UK or the US because of the relatively smaller size and lower liquidity of capital markets. For companies raising hundreds of millions of dollars or euro in financing, a few additional percentage points in the cost of capital can be an important competitive disadvantage in the global marketplace. Those companies that decide to list their shares in London or New York have to report their financial information in accordance with UK or US accounting standards. At the very least, they have to reconcile their “home” financial statements with UK or US standards. This aims to give British and American investors financial information that is easily comparable with that of domestic companies. Otherwise, such investors would either refrain from investing in such foreign companies or they would ask for higher expected returns on investment in order to cover the extra cost of analysing financial statements produced with foreign accounting standards. So instead of asking foreign investors to cover the information cost of dealing with various foreign accounting standards, it is cheaper for companies wishing to attract foreign investors’ capital to provide the latter with financial information they easily understand.

Cross-border M&As and the globalization of capital markets, with New York and London occupying prominent places in the hierarchy, underpin the need for harmonizing

national financial reporting standards internationally. However, according to Hopwood (1994), capital market interests (mainly investors) have not actively demanded that accounting standards be internationally harmonized. He notes that they have been very quiet throughout the history of the International Accounting Standards Committee (IASC), the IASB's precursor. This observation makes sense if one considers that most investors have decided not to incur the cost of learning foreign financial reporting standards. Instead, they have usually waited for foreign companies to translate their own financial information in a language (i.e. standards) that investors understand. Otherwise, investors choose not to invest in foreign companies. Investors' passivity thus transposes itself to the demand for international accounting standards. So if investors themselves are not asking for internationally harmonized financial reporting standards, why did the EU decide to impose the IASB's standards on companies whose shares and bonds are listed on European securities exchanges? Could it be the companies, which bear the cost of preparing more than one set of financial statements?

Although supportive of the Commission's endeavour to introduce standardized financial reporting standards across the EU, European companies did not seem very active in pushing the Commission and the member states in this direction (*get reference or interview*). The Commission was aware that accounting standards in the EU put (continental) European companies at a disadvantage vis-à-vis their Anglo-Saxon counterparts in terms of raising financing. However, the real concern for the Commission and eventually the member states was the increasing marginalization of continental capital markets. Because capital markets in London and New York offered lower costs of capital than in continental Europe, owing to their greater trading volumes and liquidity,

European companies based on the continent were increasingly raising their financing in those markets rather than in the home market. Institutional investors (pension funds, mutual funds, etc.) also focused their energies and capital in the British and American markets (*get reference or interview*). They were attracted by the markets' lower cost of doing business, caused by the higher volume of trades as well as the higher level of liquidity (which makes it easier to find buyers and sellers). Because London and New York offered a larger number of companies to invest in, they made it easier and cheaper for institutional investors to diversify their investment portfolios. Finally, it was cheaper for institutional investors to deal with only a couple of capital markets with similar financial reporting standards, because it reduced the cost of evaluating companies' performance. Analysts only needed to master one or two sets of accounting standards. So the real concern for the EU (bar Ireland and the UK) was the marginalization of its capital markets.

Mattli (2003) notes that there are three traditional modes of standardization: market-driven standardization and standardization conducted through private or public standards-development organizations. Market-driven standardization describes a situation where a standard is adopted *de facto* by the market because of its greater economic value and consumer demand. In this case, "standardization creates a demand-side economy of scale" (Mattli 2003, 202). This means that the cost (value) of using the standard decreases (increases) with number of users. Economists call this positive network effects or network externalities. However, it is important to note that market-driven standardization does not necessarily mean that the socially-optimal standard will prevail. It seems safe to say that the harmonization of international accounting standards is market-driven as

standards increasingly converge towards IASB and US standards, which in any case are closely aligned (see also Simmons 2001).

The marginalization of continental Europe's capital markets was the key driver for greater accounting standards' harmonization. However, given the mitigated success that the EU had experienced with the Fourth and Seventh Directives, it seemed that creating common "European" accounting standards through a European Accounting Standards Committee or Board would most probably prove difficult. Moreover, European standards would not necessarily solve the problem of capital market marginalization, unless they were close to the standards used in the UK and the US. The Securities and Exchange Commission (SEC), the US capital market regulator, had already refused to recognize the validity of European accounting standards as found in the two accounting directives (Haller 2002, 164). Consequently, the EU had three policy options available to it: UK, US or IASB accounting standards. Adopting UK or US standards for the whole of Europe was not justifiable politically, given the amicable geo-political and geo-economic rivalries between continental (West) European states and their Anglo-Saxon counterparts (*get reference or interview*). For continental EU member state governments, either of these two options would be akin to publicly admitting that their accounting standards were inferior to UK or US ones. Adopting IASB standards, even if closely aligned with Anglo-Saxon standards, was a face-saving alternative.⁵ However, it could also be a socially-optimal policy choice if it eventually led to the adoption of IASB standards across the world, whereby international accounting standards would be truly standardized with the same common applicable financial reporting rules across the globe.

⁵ Simmons (2001, 611) makes a similar point but provides no evidence to support it.

By being the first jurisdiction to make IASB standards solely applicable (for publicly-listed companies), the EU could provide the necessary impetus for the standardization of financial reporting rules across the globe. It could even force the United States to harmonize its own accounting standards in line with IASB standards, instead of the other way around. However, in order to do this, the EU needed to have more influence of the standard-making process at the IASB. This position was clearly stated in a communication from the Commission in 1995:

The approach proposed in the present communication consists of putting the Union's weight behind the international harmonization process which is already well under way in the International Accounting Standards Committee (IASC). The objective of this process is to establish a set of standards which will be accepted in capital markets world-wide. The Union must at the same time preserve its own achievements in the direction of harmonization, which are a fundamental part of internal market law. It therefore needs to take steps to ensure that existing international standards (IAS) are consistent with the Community's Directives and that IAS which remain to be formulated remain compatible with Community law.

There needs to be closer cooperation within the Union, through the improved functioning of the existing bodies at the EU level which deal with accounting issues, to reach agreed positions on both international and internal accounting issues. This would strengthen the influence of the EU in the international harmonization debate and help improve consistency of application of agreed standards in the Member States, especially for the consolidated accounts of groups of companies (Commission of the European Community 1995, 2).

The Commission clearly understood that the EU member states' influence on the international harmonization of accounting standards process would be much greater if they could speak with one voice. This way they could avoid the process being driven mainly by Anglo-Saxon countries, with the US in the lead.

In their study of international standard setting, Mattli and Bütte (2003) argue that the outcome is very much influenced by the "institutional structure of the international standardization organizations and the institutional structure of *national* [italic in original] standardization systems" (18-19). The greater the degree institutional complementarities between the national and international institutional structures are, the greater the

influence on the international standards-setting process. The authors point out that Europe usually has much more influence in international product standards-setting organizations than the United States because its national institutional structure is much less fragmented than in the United States. This is because of the role played by European (i.e. supranational or transnational) standard-setting organizations in aggregating the ideas and preferences of firms and other interested actors in the standard-setting process. In contrast, the US system is usually fragmented with several competing standards-setting organizations. As a result, it is difficult for American firms to have their preferences prevail at the international level.

In the case of international accounting standards, the reverse situation has held since the inception of the International Accounting Standards Committee (IASC) in 1973.⁶ Until recently, continental European countries have had little influence on the IASC/IASB.⁷ Anglo-Saxon countries have been able to shape the work of the IASC because they have adopted a common front, owing to the fact that their accounting standards are geared to the needs of investors (which are the same everywhere), not fiscal authorities (which vary from country to country). Simmons (2001) states that the “strategy of U.S. standard setters has been to make as much progress as possible in the Group of 4+1 [Australia, Canada, the United Kingdom, and the United States plus a representative of the IASC] so that the Europeans are persuaded to participate essentially on British-U.S. terms” (611, fn. 93). The end result has been that IASC/IASB standards have been much closer to UK-US standards than to continental European standards.

⁶ The IASC was reorganized into the IASB in 2000.

⁷ The European Commission continues to complain that the IASB fails to take into account the EU’s concerns. It is therefore asking for greater representation in the IASB’s governance (*Financial Times*, February 3, 2005).

This is why the European Commission decided to become a member of the IASC Consultative Group as well as an observer on the IASC board responsible for standard setting in 1990, following a conference on the future of harmonization of accounting standards in the EU (Commission of the European Communities 1995). To advise the Commission, the latter created the Accounting Advisory Forum in 1991, which was composed of independent experts. However, this *rapprochement* with the IASC/IASB seems to have given the EU little leverage in influencing international accounting standards (*confirm with interview*). During the 1990s, EU work on the harmonization of accounting standards was limited to examining the compatibility of IAS with the two accounting directives, in order to determine the extent to which international accounting standards were compatible with EU (EC) law. According to Haller (2002, 165-6), two studies concluded that the EU's accounting directives were generally compatible with IAS. Therefore, adoption of IAS by the EU would not contravene the law.⁸

In response to European MNCs seeking capital outside continental Europe, many EU member states unilaterally decided in the second half of the 1990s to allow companies to report their financial information in accordance with IAS or US accounting standards, but only under specific circumstances (Haller 2002). This was notably the case in Austria, Belgium, France, Germany and Italy. In other member states, there was a serious effort to bring national standards more in line with IAS. As we have already mentioned, pressure for these changes did not really come from investors or even companies. In this case, it came from national stock exchanges, because they are the ones that have most to lose if companies decide to list their shares on another exchange in

⁸ The compromised and flexible nature of the Directives, between British and continental standards, probably made it easier for them to be compatible with IAS.

order to tap a larger pool of (cheaper) capital (*get reference or interview*). Haller (2002, 173-4) shows that a majority of the EU's stock exchanges allow listed companies to submit their financial statements according to IAS or US accounting standards; however, in most cases they require that companies reconcile their published financial information with national standards. Obviously, the unilateral recognition of international accounting standards and convergence of national standards towards them in the late 1990s facilitated the Commission's goal of standardizing European accounting rules in line with IAS.

In the wake of the European Council summit in Lisbon in March 2000, the Commission issued a communication calling on the Council and the EP to support a strategy to require "all listed EU companies to prepare their consolidated accounts in accordance with one single set of accounting standards, namely International Accounting Standards (IAS)" (Commission of the European Communities 2000, 2). The Commission justified its proposal in terms of the need to have an integrated, efficient European capital market in order to foster growth and employment in the EU. In fact, the Lisbon European Council concluded that one of the priority objectives of the Lisbon Strategy, which aimed to make the EU the most productive economy by 2010, was "the need to enhance the comparability of companies' financial statements to benefit companies and investors" (Commission of the European Communities 2000, 3). Thus, standardized financial reporting rules in the EU were one of the principal measures that would implement the Lisbon Strategy. The Commission's proposal was the next logical step in preserving if not enhancing the place held by continental European capital markets in the world economy, given that most member states had already begun to harmonize their national

standards with IAS and that national stock exchanges already allowed listed companies to present financial statements in accordance with IAS or US standards. The Commission's communication emphasized the danger of capital market marginalization if the EU did not adopt common international accounting standards: "Only with such standards will there be a potential to allow the EU securities markets to grow from its present level of around half the size of the US capital markets" (Commission of the European Communities 2000, 3).

The Commission's proposal also gathered wide support from the business and investment community, even though the latter had not actively lobbied the Commission and member state governments in its favour. For example, Haller (2002, 166) mentions a study conducted by PricewaterhouseCoopers in 2000 that indicates that 80 per cent of EU chief financial officers (CFOs) interviewed supported the move to IAS even if relatively few (93) of the 7,000 publicly-listed EU companies made use of IAS. The Commission's "new accounting strategy" was given additional support by the International Organization of Securities Commissions' (IOSCO) recommendation that its members (national securities regulators) allow MNCs that issue equity and bonds in multiple jurisdictions to use IAS for the preparation of their financial statements (Commission of the European Communities 2000, 4).

In February 2001, the Commission issued its proposed regulation making IAS mandatory by 2005 for companies whose shares are listed in an EU stock exchange (Commission of the European Communities 2001a). Regulation (EC) No 1606/2002 was officially adopted by the EP and the Council on July 19, 2002. This regulation is concerned only with the consolidated accounts of companies whose shares are listed on

an EU stock exchange.⁹ Non-listed firms and individual accounts (for tax purposes) can continue using national accounting standards, although the regulation asks member states to allow, if not encourage, the adoption of IAS by all EU companies for both consolidated and individual accounts. The financial reporting rules prepared by the IASB do not have direct effect in the EU, according to the Regulation. Each specific standard (IAS and IFRS) has to be approved by the Accounting Regulatory Committee (ARC), which is chaired by the Commission and composed of representatives from the member states. The ARC's work will be supported by the Technical Expert Group (TEG), which will provide advice regarding the use of IASB standards within the EU's legal environment. The TEG was established by the European Financial Reporting Advisory Group (EFRAG) in June 2001.¹⁰ The Commission indicates that such an approach is necessary because "it is not possible politically, nor legally, to delegate accounting standard setting unconditionally and irrevocably to a private organization [the IASB] over which the EU has no influence" (Commission of the European Communities 2001b, 1).

The unwillingness or inability of the EU to delegate completely the setting of international accounting standards to the IASB has already undermined the EU's "ultimate objective of achieving a single set of global accounting standards" (Regulation [EC] No 1606/2002, par. 2). In the case of IAS 39, which deals with the reporting of financial instruments, the Commission (i.e. the ARC) decided to "carve out" two provisions of the IASB's standard following pressure from many European financial

⁹ Starting in January 2007, all companies issuing securities (whether bonds or equities or other types of financial assets) to the public will be required to prepare their financial statements in accordance with IASB standards.

¹⁰ EFRAG is a private sector grouping of associations representing preparers (firms, banks and insurers), users (stock exchanges and financial analysts) and the accounting profession.

institutions, especially French ones. The first of these provisions deals with the obligation for companies to report investment assets at their “fair” (i.e. market) rather than historical (i.e. purchased) value on the balance sheet. The argument used by financial institutions to oppose this provision is that it would create too much volatility in their accounts, since investments would have to be revalued every time a company publishes financial statements and resulting unrealized gains or losses recorded accordingly. The fear is that such volatility in earnings would push away investors from financial institutions, whose assets are mainly in the form of investments.

It is interesting to note that IAS 39 is modeled after a US accounting standard (FAS 133). So it is in this sense that the EU is coming short of its “ultimate objective” global accounting standards. The other provision carved out by the Commission deals with hedge accounting, meaning that companies can recognize gains and losses on financial derivatives only when they are realized. However, in the case of financial institutions, which use macro hedging (where assets are not directly tied to liabilities but cover only a net risk exposure), IAS 39 would force them to include the assets (i.e. financial instruments) on their balance at their fair value and record the unrealized gains or losses. The end result would also be greater volatility in earnings, which is unacceptable for many European banks and insurers. Frits Bolkestein, the former European commissioner for the internal market, justified the Commission’s decision by saying that it was only a temporary measure to allow the majority of IAS 39 to be adopted in time for January 2005, when the IASB standards came into force. He expected that a planned review of IAS 39 by the IASB would soon resolve the matter (Bolkestein 2004). However, there are concerns by some market participants that the Commission’s

decision undermined the credibility of financial reporting in Europe as well as the EU's leadership in creating one set of global accounting standards under the aegis of the IASB. Unless the conflict between the Commission and the IASB over IAS 39 is soon resolved, those concerns could materialize and hurt the development of European capital markets. It could also hurt the current convergence efforts between the IASB and the US Financial Accounting Standards Board (FASB), the US accounting standard setter. In light of this cooperative effort, the SEC has indicated that it would be ready to recognize IASB standards by 2007, meaning that foreign companies would no longer need to reconcile their financial statements to US standards.

CONCLUSION

Until the second half of the 1990s, there were two main schools of thought about European integration. One, neofunctionalism, saw European integration as a continuous, dynamic process whereby integration in one area led to integration in another with, in addition, a gradual transfer of loyalty and focus to the supranational level by those actors involved in or benefiting from the integration process. The concept of "spillover" (functional and political) characterizes this dynamism (George 1991). The second approach, intergovernmentalism, argued that European integration proceeds only as a result of bargains between the member states. This second approach was modified in the early 1990s by incorporating the liberal notion that domestic politics influences the preferences of the member states when it comes to integration, whereby the black box of the state was pried open to see what was going on (Moravcsik 1991; 1993; 1997). In the first half of the 1990s, neofunctionalism, which was brought back to life with the drive to

complete the Single Market as well as create a common currency (see Tranholm-Mikkelsen 1991), and liberal intergovernmentalism fought a theoretical battle that resembled World War I's never-ending trench warfare.

In the second half of the 1990s, a truce was called between the two approaches, which were now considered to be more or less two sides of the same coin (e.g., Moravcsik 1998). Although it was clear that the member state governments were in charge of the integration process, by delegating the implementation of their "grand bargains" to supranational institutions they would sometime end up with results that would not have been achieved had they kept all decision-making at the intergovernmental level. This was the insight brought about by the application of notions and tools from comparative and American politics literature to the study of EU policy-making: e.g., delegation, institutionalism (whether rational, sociological or historical) and multi-level governance (see, *inter alia*, Hix 1994; Marks *et al.* 1996; Pollack 1997; Sandholtz and Stone-Sweet 1998). With the multi-level governance approach, there was also greater focus on the role of transnational actors in European integration and policy-making (see also Risse-Kappen 1995).

In the above-described evolution of the theoretical approaches to the study of European integration and policy-making, there is one element that has generally been neglected: the EU's external (or international) environment. Stanley Hoffmann (1966) was one of the early scholars advocating the importance of the international context in the study of the European integration. However, he concluded that the external environment would tend to favour divisions and disintegration rather than the opposite as it would elicit different responses from the member states.

In the case of the standardization of financial reporting rules in the EU, the international environment favoured integration rather than disintegration. Although the notion of functional spillover from neofunctionalism explains why the EU sought to harmonize accounting standards across the member states, the latter's response to the globalization of capital markets is what ultimately allowed the Commission to propose adopting the IASB's standards for the consolidated accounts of publicly-listed companies in the EU. By unilaterally harmonizing their national accounting standards with those of the IASB and the United States, the member states provided the necessary consensus for the adoption of Regulation (EC) No 1606/2002 on the application of IAS in the EU. Interestingly, the pressure on member state governments to unilaterally bring their national accounting standards in line with IASB and US ones came from national securities exchanges, which were increasingly seeing national companies and investors move their financial activities to New York or London. To compete with New York and London, continental European capital markets needed to be integrated in order to gain scale. However, in order to do so, they needed common accounting standards so that the financial information produced by European companies could be easily compared by investors, regardless of where they were based. However, because New York and London dominate global capital markets, continental member states had no choice but to adopt standards that were in line with UK-US standards, which was the case of the IASB's standards. Only in this way could continental European capital markets become better integrated as well as retain national investors while attracting foreign ones. So here the external environment in terms of the international mobility of capital structures EU policy-making towards greater integration but also the policy choice of IASB standards

through its impact on national capital markets, to which EU member states were very responsive. The external environment also played a role in that the EU favoured adopting IASB standards rather than UK or US ones for purely political reasons: not admit that their standards were not competitive but at the same time hope to force British and American standards to move closer to IASB standards, which the EU hoped to be able to influence much more as a result of its decision to apply them.

In sum, the present story fits well within the evolution of the theoretical approaches to the study of European integration and policy-making. Neofunctionalism provides the explanation for the need to harmonize accounting standards in the EU. Liberal intergovernmentalism augmented (or completed) by the role of the external environment and its structural impact on domestic politics explains the choice of accounting standards (IASB rather than those of the US or the UK). Finally, the implementation of IASB standards in the EU is a clear instance of transnational multi-level governance involving delegation. And the case of the standardization of financial reporting rules in the EU shows that, as indicated above, it sometimes, if not often, happens that the actual policy outcome does not correspond to the member state governments' original objectives. In the present case, the carve-outs from IAS 39, following intense lobbying by transnational financial institutions and their representative associations, raise serious doubts about the member states' "ultimate" objective to bring about a single set of global accounting standards under the aegis of the IASB. Failure to achieve this objective as a result of the "Europeanization" of IASB standards will probably mean that Europe's capital markets will become marginalized globally. This is the member states' truly ultimate fear but the multi-level governance of accounting

standards in the EU may in the end make this fear a reality. It is still too early in the process to tell but it is worth monitoring, for both theoretical and public policy reasons.

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