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## International Financial Reporting Standards and banking regulation: A comeback of the state?

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# TranState Working Papers

INTERNATIONAL FINANCIAL REPORTING  
STANDARDS AND BANKING REGULATION  
– A COMEBACK OF THE STATE?

MAXIMILIAN GRASL

No. 158

Universität Bremen • University of Bremen  
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Staatlichkeit im Wandel • Transformations of the State  
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## ***International Financial Reporting Standards and Banking Regulation – A Comeback of the State?***

### **ABSTRACT**

The European Union began using accounting rules defined by an independent private sector regime as compulsory norms in 2005. Is the incorporation of these International Financial Reporting Standards (IFRS) into European law a viable solution to combine external technical expertise with principles of democratic governance?

The current financial crisis has shown that the technical expertise of this standard-setting body alone does not sufficiently guarantee satisfactory policy outcomes: The pro-cyclical IFRS-accounting standards have come to be accused of exacerbating the extent of the financial write-offs, which cost an enormous amount of taxpayers' money. In consequence, these standards have lost their output legitimacy. Abandoning public competences and legitimate decision-making have not paid off.

What does the global public do about this? As early as 2007 the three most important financial jurisdictions (U.S., EU, Japan) and the International Organization of Securities Commissions (IOSCO) urged the IASC Foundation to alter its governance structure in order to enhance public accountability of the International Accounting Standards Board (IASB).

How has the relationship of independent but widely influential standard-setters and public authorities developed? While public authorities (especially from the EU) bemoan a loss of public governance in accounting-policy the IASB shows little will to abandon obtained competencies. Public authorities rather have to act strategically in order to retrieve competencies within the interwoven field of international financial regulation.

The analysis has implications for regime theory, European governance and global political economy of financial regulations.

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## **International Financial Reporting Standards and Banking Regulation – A Comeback of the State?**

### **INTRODUCTION<sup>1</sup>**

The role of the state has been changing, and a major debate in Political Science has evolved over this hypothesis. Regardless of whether this hypothesis can be confirmed or disproved, it is important to note that a field is studied here on which private authorities (Cutler et al. 1999) have assumed a significant role beside state authorities: the regulation of financial markets. Especially in this field the nation-state has become a “manager of governance” who activates, completes and synchronises non-state governance (Genschel/Zangl 2008: 431). In this manner, regulation is conducted by nation-states (primarily the U.S.), regional supranational institutions such as the European Union and non-state forms of governance (e.g. by transnational regulatory networks) side by side. At the same time a comprehensive regime comparable to the WTO in the area of international trade does not yet exist. This coexistence of different forms of governance along with the absence of a comprehensive regime has produced a high number of organizations with partially overlapping competences, a phenomenon that has been referred to as a “regime complex” (Raustiala/Victor 2004). The causes of such a maze are well known (Keohane/Victor 2010). One very important reason for the appearance of a set of different regulatory institutions is disagreement among nation-states about a common regime.

Considering the fact that little is known about the effects of varying forms of governance on outcomes so far (Mosley 2009: 135), the present study focuses not on the origins of the regime complex of international financial regulation but on the strategic actions taking place between the different forms of governance. As this case-study will show, the competences of an important transnational regime are now contested by nation-states (i.e. the G20). As private sector regimes persist on competences they have acquired, serious difficulties for nation-states become obvious to manage the governance of a policy freely. Particular attention will therefore be given to the strategies nation-states use in order to re-assume competences from a transnational regime.

This contribution is primarily concerned with setting international accounting standards as an important sector of financial market regulation. This issue is fundamental for the functioning of economic systems in general and has special importance for financial markets. Since the drawbacks of the existing regime have become obvious

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<sup>1</sup> The author is grateful for very helpful comments by Dr. Markus König (University of Munich) und Dr. Volker Mohr (University of Heidelberg) and two anonymous referees.



through the current financial crisis, accounting standards have moved into the centre of public attention. Over the past ten years the private order International Accounting Standards Board (IASB) has become a very important actor in the field of accounting standard setting. As some major difficulties have attended this success, accounting standards policy is under reconsideration by those nation-states and jurisdictions that are home to the most relevant financial markets. However, as the IASB does not easily agree to relinquish the competences it has acquired, the nation-states have to apply strategic measures in order to re-assume them.

The problem to be analysed is whether the complexity of the current regulatory structures is an advantage for the nation-states that promoted its emergence or whether this very complexity guards the status of the private order organization from public authorities' interference.

The article starts with a short overview of the current regulatory structure on financial markets in order to show its character of a regime complex (1). The most important insights into regime complexes will be briefly reviewed.

Section (2) provides a detailed introduction of what the most important regimes from the perspective of this study are with a view to showing how they could gain the significant role they currently play. The third section (3) refers to the current financial crisis and investigates the strategic interactions between nation-states and both transgovernmental standard-setting bodies in the regime complex of financial markets regulation. Section four (4) compares empirical findings with stated hypotheses and sums up the obtained findings.

The relevance of the object of this study—governance by transnational actors—is emphasised by the European Commission's considerations to expand the experiment (Véron 2007) of applying privately set standards in the area of accounting also to the field of auditing (European Commission: Press release IP/09/975 from 22 June 2009).

## **1. REGULATION OF INTERNATIONAL FINANCIAL MARKETS – A REGIME COMPLEX**

In comparison with the regulation of international trade in goods and services, trade with financial instruments shows a very different form of international governance that can be described as a “regime complex”. With this term Raustiala and Victor denominate “an array of partially overlapping and nonhierarchical institutions governing a particular issue-area” (Raustiala/Victor 2004: 279). The causes of regime complexes lie in diverging interests (shaped by beliefs, constrained by information and weighted by power) of the most powerful actors in one issue area (Keohane/Victor 2010: 4). Four conjectures have been made about the effects they have on policy outcomes (Raustiala/Victor 2004: 279):

- (1) Path-dependence: New regimes are channelized and constrained by existing regimes.
- (2) Forum-shopping: An actor will seek the forum which is most favourable to its interests (in terms of bargaining entry, membership and the linkage of issues).
- (3) Legal inconsistencies: Because the multitude of forums with overlapping competences may lead to legal inconsistencies, actors try to establish demarcation boundaries and disentangle events in one forum from another.
- (4) Importance of implementation: As negotiating detailed rules *ex ante* is difficult, the implementation stage of international rules gives leeway for diverging implementation and therefore raises concerns about compliance.

In this section a short overview of the various organizations in the field of financial regulation will support the attribution of financial market regulation as a regime complex and will therefore allow assuming these conjectures on policy outcomes. The character of a regime complex becomes apparent in comparison with a single regime: The World Trade Organization (WTO) constitutes a comprehensive regime with clear and widely uncontested competences in the area of international trade. This regime is supported by not less than 153 member states<sup>2</sup> and 30 observer governments, and has therefore true global scope.

While in the area of financial markets no single comprehensive regime has evolved, attempts have been made on a national rather than an international scale to improve the governance of financial markets. The idea behind this development is the principle of 'home country control' (Kapstein 1994: 47), which assumes that if every single country safeguarded the financial stability in its own realm, international stability would also be guaranteed. This practice has permitted another two advantages to be realized: Neither have competences to be shared, nor has a country to become a lender of last resort for foreign banks operating on its market. This rationale has impeded the development of a common financial market regime and has led to the foundation of less powerful international coordination forums. Such forums qualify for the exchange of best practices between public authorities and typically comprise private stakeholders (i.e. representatives of the financial industry) as well. However, they have no competence to take decisions that are binding to national authorities. An example of such a forum is the Financial Stability Forum (FSF), which was created after the Asian crisis in 1998 (cf. Davies/Green 2008: 112), and has then been renamed and empowered with some more competences as the Financial Stability Board (FSB) shortly after the current crisis. While the newly created FSB only conducts surveillance and gathers information that is reported to the G20 leaders, it has no formal decision-making or enforcement compe-

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<sup>2</sup> Since 23 July 2008.

tences of its own. Besides the nation-states that still play the most significant role in the regulation of financial markets, other forms of governance have also developed. The nation-states have come to be “accompanied” (SFB 597 2006: 12) by additional forms of governance. Although the international organizations that were created in order to supervise international financial markets (World Bank and International Monetary Fund (IMF)) have stayed weak for the above reason, another international organization, the European Union (EU), has gained major influence on—at least—regional markets. Here, the same pattern can be identified: So far, the integration of the European financial market also relies on the same idea as the integration of the global financial market: Every member country is in charge of controlling its own financial realm without having a common authority implemented. National supervisory authorities therefore meet in forums to exchange information and best practices but have no competence to take binding decisions and to enforce those (CEBS, CESR, CEIOPS).

Besides these more formal institutions, a confusing set of less formal institutions and organizations has emerged for the organization of the financial markets. As a consequence of the need to coordinate trans-border activities of market actors, some institutions provide solutions for specific sectors of financial markets: Central banks coordinate in the G10 Group and have also initiated the Basel Committee on Banking Supervision (BCBS) (Genschel/Plümper 1997), which is discussed in more detail in the next section. With regard to securities markets, the responsible supervisory authorities have organized in IOSCO, while insurance supervisors meet in the International Association of Insurance Supervisors (IAIS), as do auditing regulators in the International Forum of Independent Audit Regulators (IFIAR). For a full assessment of the current international financial architecture, cf. Sloan/Fitzpatrick 2007. Inversely the respective industries too have their global federations, which participate in financial market regulation at least by contributing their knowledge and expertise.

As a first result it has to be noted here that the sectorized structure of regulatory efforts is detrimental to their effectiveness: As the segmentation of financial markets is blurred by the advancement of the financial industry (financial conglomerates, for example, offer products from different sectors, new innovative products themselves can no longer be assorted to one of the conventional categories), the segmentation of regulatory structures becomes a burdensome and somehow inadequate task as it needs reconciliation among regulators of different sectors. These examples point to another difficulty in the regulation of the highly innovative global financial business: The pace at which new products are provided poses a challenge for the regulators to keep up with. The demand of public regulators for expertise and update information about market practices might be an explanation for the close cooperation with private sector representatives that can be observed in the field of financial regulation.

The case of accounting standard setting is an extraordinary example of close cooperation with the private sector. In view of the complexity and therefore high costs for the public authorities to exercise, some scholars suggest that the regulation of more technical issues might lead to greater direct private participation (Mosley 2009: 136). More than 100 states and jurisdictions (among them the EU) have de-facto delegated the norm-setting in the field of accounting rules to a strictly private organization, the IASB. Currently the European Commission is considering to do the same in the field of auditing, and to follow auditing-rules set by the private International Auditing and Assurance Standards Board (IAASB). This sketch of the current global regulatory structure should be sufficient to substantiate the view that the regulation of global financial markets can justly be characterized as an accumulation of different forms of governance with varying and overlapping scopes.

The conjectures introduced above suggest that even under the conditions of crisis and the pressure exerted on politicians, path-dependence will make it difficult for nation-states to change the existing regulatory structure. What does this mean for the forms of government under which financial market regulation is conducted? Although nation-states continue to play a dominating role in regulating financial markets, they are now accompanied by a set of relatively well-established international institutions (Porter 2009: 3). Are nation-states able to simply choose whether to improve existing public and private authorities or to create new ones? The hypothesis answering this question stated here is that the leeway of nation-states to alter regulatory environment, depends on the institutional structure it has. Notably private-sector actors are more difficult to affect. Depending on the amount of formal influence nation-states have, two strategy options can be identified:

- Strategy option I: Policy adaptation: New regulatory standards are created, or existing standards are modified.
- Strategy option II: Polity adaptation: New standard-setting agencies are created, or existing ones are modified.

However, under the conditions of regime complexes a third option occurs:

- Strategy option III: Strategic inconsistency: Inconsistencies between different regimes can be provoked in order to exact adaption in one particular regime.

This argument is based on the lack of clean slate, which is typical of regime complexes. Therefore, when new rules are negotiated in order to avoid conflicts, actors usually seek demarcation boundaries between existing regimes. However, according to Raustiala/Victor, “we observe explicit efforts to create conflicts to force change in another regime—what we term “strategic inconsistency” (Raustiala/Victor 2004: 298).

The following empirical analysis intended to confirm the above theoretical expectations and attempts to find out through which strategic provisions states try to circumvent

the persistent forces and establish an adjusted regulatory structure. The case of financial market regulation is chosen as it shows three important pre-conditions for the analysis of nation-states acting in regime complexes: First, it is a very heterogeneous regime complex involving various (in particular private) forms of governance; second, due to the financial crisis it is a very salient issue with high priority for efficient solutions; and third, major players (i.e. U.S. and EU) have different views on them. In order to compare the relevance of institutional factors on the strategies chosen, two antithetical organizations are analysed: The Basel committee with stronger public influence as it represents public authorities, and the IASB which emphasises its independence. For an adequate understanding it is essential to introduce these two organisations in more detail.

## **2. INFORMAL AND PRIVATE GOVERNANCE BODIES IN THE REGULATION OF FINANCIAL MARKETS**

This section is devoted to a comparison of two standard-setting organizations, both of which have been highly involved in the current financial crisis and have been accused of suffering from the same deficiency: The Basel II framework on banking supervision and the International Financial Reporting Standards (IFRS) should have had a pro-cyclical effect on banks write-offs and therefore have exacerbated the current crisis. Therefore, both standards ought to be adjusted. They have also a second characteristic in common: Both standards are voluntary in the attitude they are usually applied by countries, no country can—initially—be forced to use them. This raises the question how these standards, whose faultiness has now been proved, could have become so widely implemented.

In spite of all their similarities, there seems to be one major difference between these two standards that lies in their organizational structure: While IFRS are created independently of public authorities by a private sector body, the Basel II standards are elaborated by representatives of public authorities—as informal as this process may be.

In the following account the two organizations will be compared with special emphasis on their organizational structure, which accounts for the variation among both organizations.

### **2.1 Basel Committee on Banking Supervision (BCBS)**

The BCBS was established in December 1974, after the international consequences of national banking failures had become obvious by the collapses of Herstatt-Bank in Germany and Franklin National Bank in the U.S. during the same year (cf. further Kapstein 1994: 44; Wood 2005: 43). The central bank governors of the world's leading fi-

nancial markets, the Group of Ten (G-10)<sup>3</sup> plus Luxembourg, therefore decided to establish a consultation forum in order to facilitate the continuous exchange of information relevant for the supervision of cross-border active banks. However, since it is not central banks that are in charge of banking supervision in all countries, they set up a committee which assembles central banks and national supervisory authorities where they existed. This committee came to be known as the BCBS, because this committee is hosted at the Bank for International Settlements (BIS) in Basel, which also provides a small staff to manage the BCBS's secretariat. A review of the BCBS's foundation shows that it lacks any formal legitimacy: There is neither a founding treaty nor even delegation of competences. The BCBS itself outlines its objectives as follows:

“to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. It seeks to do so by exchanging information on national supervisory issues, approaches and techniques, with a view to promoting common understanding. At times, the Committee uses this common understanding to develop guidelines and supervisory standards in areas where they are considered desirable” (<http://www.bis.org/bcbs/>, last accessed 23 April 2010).

The BCBS does not claim to take any mandatory decisions. As there is no formal decision-making procedure, it passes unanimous decisions and adopts texts that have the status of “recommendations”. Neither the wording of these guidelines is very broad, avoiding any legalistic accuracy and is thus leaving much space for implementation into specific national contexts (Slaughter 2004: 183). Harmonisation of national rules is based on principles rather than commonly agreed detailed new rules.

The most important guidelines the BCBS issued are the concordat on cross-border banking supervision, the core principles for banking supervision, and the standards on capital adequacy.

The concordat on cross-border banking supervision was the first recommendation the BCBS issued shortly after its establishment. It constitutes an agreement on the exchange of information about cross-border active banks between the host country authorities and the home country of the parent bank (BCBS 1975: 4).

Agreed on in 1997, the principles for banking supervision defined the projected relationship between private banks and public authorities.

The most important recommendation the BCBS issued is the framework on banking supervision, which is also known as the 'Basel Accord'. The first Basel Accord (Basel I) was made in 1988 under American and British efforts to reach an agreement with global reach in order to avoid competitive disadvantages to their banks by an uneven level-playing field in international markets (Genschel/Plümper 1997: 628). The core element

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<sup>3</sup> Founding members of the G-10 are Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom and the United States. Later Switzerland joined.

of the first Basel Accord was a simple categorization of bank loans into five risk-categories. As banks were obliged to hold a minimum capital reserve of 8% of their risk-weighted loans, they had an incentive to lend capital to the most risky creditors within any category in order to earn the highest risk premium.

This deficit was to be overcome by the second Basel Accord (Basel II), concluded in 2004, through an advanced risk-measurement that allows a more precise attribution of equity to the risks incurred. Basel II rests on three pillars: This new accord was intended to provide more comprehensive coverage of risks and to make the related risk weights more precise (pillar one). Therefore credit risks are now measured on the basis of any individual creditor, with credit-rating agencies playing a very important role. The calculation of a bank's aggregated risks is based on a formula which can be drafted by a bank on its own according to its individual needs but has to be approved by the responsible supervisory authority. These measures should allow substituting the minimum capital requirements by precisely risk-adjusted capital requirements, thus reducing the average amount of a bank's equity obliged by prudential supervision. The fine-tuning of supervisory requirements is intended to expand the amount of credit that banks are able to grant and thereby boost the development of whole economies. In order to guarantee the financial soundness of banks, domestic supervisors are expected to determine whether the banks' own risk assessment and management practices are adequate (pillar two). As a further innovation, Basel II prescribes the publication of relevant information to enable other market participants to assess a bank's risk situation; prompting market forces to participate in the task of supervision by keeping actors responsible (pillar three).<sup>4</sup>

This agreement was very successful in terms of proliferation. Although it was originally drafted by no more than 13 countries before 2004 and now over 100 countries already apply or plan to apply this standard.<sup>5</sup> According to the eStandardsForum—a private sector organization monitoring the implementation of the 12 key standards on financial markets—53 out of 93 countries studied show at least a high compliance with these standards.

Despite the wide use of the Basel II standard the current financial crisis has also revealed some deficiencies of these norms: In particular, the soundness of financial markets is now highly dependent on estimations by rating-agencies, which have proved to be sometimes misleading. Likewise, the risk models that banks are allowed to apply are

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<sup>4</sup> For an in-depth analysis of the Basel II Accord, see Tarullo (2008: 139); Wood (2005: 123).

<sup>5</sup> In a World Bank survey on bank regulation and supervision in 2008 113 countries had already adopted the Basel II standard or were planning to do so. [http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTRESEARCH/0,,contentMDK:20345037~pagePK:64214825~piPK:64214943~theSitePK:469382,00.html#Survey\\_II\\_I](http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTRESEARCH/0,,contentMDK:20345037~pagePK:64214825~piPK:64214943~theSitePK:469382,00.html#Survey_II_I), last accessed on 3 March 2010)

rather imperfect in terms that they leave much room for designing favourable results. The amount of equity that banks are required to hold has decreased dramatically to roughly 4% of their risk-weighted loans since the implementation of Basel II.

The issue that has become obvious throughout the crisis is the pro-cyclical effect of the equity rules: Credit defaults increase during a downturn, which leads to a heightened risk assessment. This arithmetic reduction of bank's equity produces a shortening of available credit. It is these shortcomings which are addressed by the G20 global leaders in their attempt to improve the global financial regulations.

As the governance structure is of most importance, it is summed up here briefly: The BCBS comprises representatives of public authorities (i.e. central banks and bank-supervising authorities) and thus publicly accountable persons. The work of the BCBS is overseen by the Group of Central Bank Governors and Heads of Supervision which also consist of publicly accountable persons (e.g. ECB President Jean-Claude Trichet currently chairs the group).

According to its governance structure, the BCBS has been characterised as a trans-governmental regulatory organization (Slaughter 2000: 181) in order to indicate the cooperation of authorities of nation-states (i.e. banking supervisory institutions and central banks) beyond states' borders. While its decisions lack any formal legitimacy (Underhill/Zhang 2008: 542), the influence of public will through public authorities and a publicly accountable oversight board is still obvious. Still its legitimacy is not that essential as its decisions are not formally binding but only suggestions of best practice with the status of a gentlemen's agreement.

As any opinion can be discussed and decisions taken unanimously, this form of decision making is highly deliberative. Who ever is concerned that the recommendations are appropriate is free to apply them; otherwise they do not have to be implemented.

## **2.2 IASB – The emergence of the International Financial Reporting Standards**

To evaluate the importance of the International Financial Reporting Standards (IFRS) it is necessary to recall the emergence of these standards and the circumstances under which they have gained the huge amount of global relevance they have come to enjoy.

The origins of the institution formulating IFRS can be traced back more than three decades. By 1973 Sir Henry Benson, President of the Institute of Chartered Accountants in England & Wales—the association of the English accountancy profession—had founded an international non-governmental organization to establish a network of accounting occupational unions. Beside its role as a platform for regular consultations the International Accounting Standards Committee (IASC) proposed solutions to common accounting problems, which—as proposals for best practice—should lead to a common set



of accounting principles. It may be interesting to note the moment of the IASC's foundation: In Hopwood's opinion (1994: 243) founding the IASC was a reaction to UK's membership in the European Communities in the same year. As the British accounting profession mistrusted European statutory law, company law and continental European accounting principles, its members tried to strengthen the Anglo-American accounting basis by affiliating with other Anglo-American accountants.<sup>6</sup> In this regard the IASC was to become the stronghold of Anglo-American accounting tradition.

At this point it becomes sensible that fundamental differences between the British/Anglo-American and the continental European (i.e. mainly German) accounting tradition exist.

The key differences concern the fundamental aims of accounting: It is the orientation towards investor-information in the Anglo-American tradition versus the protection of creditors' interests in the European (i.e. German) tradition. Accordingly, Anglo-American accounting tries to provide a “true and fair view” while the continental European tradition emphasises the “prudence principle”. The fundamental reasons for this difference lie in the varying funding structures of the economies involved. This fact links the question of accounting rules with evolving analysis of Varieties of Capitalism (Hall/Soskice 2001): Financial markets play a much more important role in Liberal Market Economies (LME), where companies constantly have to compete for the money of investors committing themselves only for a relatively short time to an investment. Therefore companies are obliged to report their current financial statements more frequently. By contrast, in Coordinated Market Economies (CME) the relationship between investors and companies is more long-standing and allows investors additional forms of information beside financial statements, for example through their representation on a company's supervisory board. A second difference between the two accounting traditions is the form of standard setting, which is conducted through self-regulation on the part of the interested actors in the Anglo-American world, and through codified law requiring majority decisions in continental Europe.

In many of the current disputes about the IASB's work, these differences are still perceptible and therefore support the incidental evidence of Hopwood's assumption.

For the first twenty years of its existence, the development of IASC remained quite unnoticed in the wider public and was recognized only by accounting professionals. It was not until the early 1990s that the issue of accounting and therefore of setting accounting standards gained wider public recognition:<sup>7</sup> Increasing globalisation boosted

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<sup>6</sup> The IASC's founding members were representatives of the accounting profession of these nine countries: Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, UK and the U.S. (Flower 2004: 133).

<sup>7</sup> Public attention continued to maintain by corporate accounting frauds (e.g. Enron, WorldCom, Parmalat) in the

the interest of major companies to apply widely recognized international accounting standards instead of varying national accounting rules. Many European companies sought access to the largest global capital markets, especially the New York Stock Exchange. However, the U.S. Securities and Exchange Commission (SEC), which is responsible for permitting companies to issue shares on U.S. stock exchanges, requires financial statements prepared according to U.S. generally accepted accounting principles (U.S. GAAP). Many companies all over the world heavily lobbied their governments to accept U.S. GAAP and to abandon national rules in order to release their companies from the obligation to do twofold accounting.

The most famous European example of the results of parallel accounting involves Daimler-Benz: In order to become listed on the New York Stock Exchange in 1994 it filed a financial statement in compliance with U.S. GAAP in addition to one due according to the German commercial code (HGB). Whereas the HGB-statement showed a profit of 615 million German Mark, the reconciliation to U.S. GAAP yielded more than 1,839 million German Mark in losses (Ball 2004: 128).

Accounting policy in Europe shows strong similarities to the case of banking regulation: The challenge to harmonize accounting standards among the EU member states is nested in the endeavour to shape rules for the global financial market and therefore has to cover the U.S. However, in contrast to the case of banking supervision the U.S. has no strong interest in achieving a common solution in new global accounting standards as its standard U.S. GAAP is already de facto the global norm (Simmons 2001: 611).

For European countries—which are focused of this analysis—however complying with the wishes of their industry and accepting accounting according to foreign (i.e. U.S.) standards, was a problem as this would have been a breach of European law: The European Communities had tried to harmonize their member states' accounting rules since their beginning. However, this has proven as a very difficult undertaking. These efforts have led to the adoption of two relevant directives (the 4<sup>th</sup> and 7<sup>th</sup> company law directive<sup>8</sup>) representing the least common denominator between different national accounting rules, with numerous optional rules to the member-states. Therefore, while the European Union can still be regarded as a fragmented accounting area, at least there were some legally binding norms every member state had to accept. By contrast, U.S. GAAP is not compatible with these regulations and therefore cannot be recognised.

Nevertheless, the growing demands of European companies to lower their burden of double accounting costs had become problematic for the European Union, which had to

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early 2000s. For details cf. Véron/Autret/Galichon 2006).

<sup>8</sup> Fourth Council Directive (78/660/EEC) of 25 July 1978 (O.J.No L 222 of 14<sup>th</sup> August 1978) and Seventh Council Directive (86/635/EEC) of 8 December 1986 (O.J.No L 193 of 18<sup>th</sup> July 1986).

reconsider its accounting policy. Harmonizing European standards had not been fruitful up to then and there was no hope for a breakthrough in the near future. Accepting financial statements prepared under U.S. GAAP within the EU would have meant abandoning the minimal consensus of the 4<sup>th</sup> and 7<sup>th</sup> company law directives and giving up control of those accounting standards used by important sectors of European companies such as banks. Due to the attractiveness of U.S.-financial markets, many European transnational corporations would probably have chosen U.S. GAAP as their sole accounting standard.

As a result the European Commission changed its accounting policy in 1995: In a communication issued in November 1995 (COM (1995) 908) it recommended to accept the application of “International Accounting Standards (IAS)”<sup>9</sup>; In return the European Union would try to support the IASC's work in order to gain influence on the IAS.

The above account shows that the success of this private organization was a consequence of the European nation-states' failure to agree on a common standard internally by advancing the accounting directives. The European Commission can be said to have used IFRS in order to harmonize the fragmented accounting policies on European markets. This is in line with the theoretical argument that delegation to the public sector occurs when nation-states are unable to agree among themselves (Mosley 2009: 136). However, there was no clear delegation of competences towards the IASC. Instead, the European Commission suggested using what IASC had already prepared and tried to take part in the subsequent development of standards.

By then, IASC's standards had almost nowhere been in practical use although some important regulators thought about their application. The global association of security supervisors IOSCO (International Organization of Securities Commissions) considered to suggest its member institutions to allow the application of IAS for the same reason for which the European Commission suggested their application: One common set of financial reporting standards should lead to a global financial language, which could improve investors' access to necessary financial information and would thus improve the efficiency of global financial markets. Yet from the viewpoint of the SEC, the supervisor of by far the most important financial market, there was no need to consider the reversal of their U.S. GAAP to an alternative standard, as many foreign issuers were already prepared to apply U.S. GAAP. The dispute within IOSCO about the right time to turn to IFRS was determined by the dominant role the U.S. SEC has in this body: While other IOSCO-members were willing to accept existing IAS immediately, the SEC succeeded in postponing the suggestion to apply IAS until a set of “core IAS” would become available that covered all relevant fields of accounting.

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<sup>9</sup> Until the IASC constitution review of 2000 the IFRS were called IAS.

IASC was therefore working swiftly to issue all relevant core standards by 2000. It was a major success for the IASC to get its IAS-standards recommended by IOSCO. After it had been recommended by the European Commission, this represented its first acknowledgement on a global level. Here again the IASC benefited from the disaccord of the countries involved and became the least common denominator.

This development was contemporaneous with another important European development: In the course of the introduction of the Euro, the European Union enhanced its efforts to establish a common European capital market. One of the 43 measures indicated in the Financial Service Action Plan in 1999<sup>10</sup> consisted in reaching harmonized accounting rules by 2002.

The European Commission identified four options to achieve this objective:

- (1) The conclusion of a mutual recognition agreement with the U.S.
- (2) Exclusion of global players from the scope of application of the accounting directives
- (3) An update of the European accounting directives
- (4) The creation of a European Accounting Standards Board (van Hulle 2004: 355).

Again, the European Commission decided to propose a change in Europe's policy towards IAS (COM (2000) 359): In order to establish a common financial market, it suggested to implement all existing IAS into European law and to make them mandatory to all publicly traded Community companies.

Under the favourably international environment towards the IAS with IOSCO's recommendation to accept financial statements prepared under IAS in May 2000, Europe's ECOFIN Council agreed to follow the Commission's proposal to implement the IAS (ECOFIN conclusions 17 July 2000). However, ECOFIN stated two requirements regarding the IAS-application: IAS should not violate existing EU regulation (i.e. 4<sup>th</sup> and 7<sup>th</sup> company law directives) and the EU would exert stronger influence on the works of the standard-setting organization IASC:

“5. The mechanism for recognising international accounting standards should, as the Commission indicates, be a means to improve the coordination of positions within the European Community in IASC discussions and give more consideration beforehand to the solutions eventually chosen by that body through active European participation in the constituent bodies of the IASC.” (ECOFIN conclusions of 17 July 2000, 10328/00)

By this step the EU de facto delegated norm-setting competence to the IASC but imposed two premises in order to keep control of the process: It would set up the principles for the new standards (by the rules assembled in the directives) and would channel

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<sup>10</sup> [http://ec.europa.eu/internal\\_market/finances/docs/actionplan/index/action\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/actionplan/index/action_en.pdf), last accessed 2 March 2010.

European interests into the polity of the norm-setting agency (through participation of European stakeholders in IASC's bodies).

ECOFIN adopted the IAS regulation (EC No 1606/2002) on 7 June 2002. Accordingly, from 2005 all consolidated accounts of publicly traded European companies had to be drawn up in accordance with IAS.

This decision was a major boost in the development of the IASC's standards. For the first time a major jurisdiction not only recommended, but required its subordinate to apply these standards. This way, the European Union became the first major user of IAS and thereby supported these standards with its market power and financial strength. In this regard it is easy to see why Europe wanted to exert stronger influence on the IASC.

A formal opportunity for the European Union to exercise control over IAS came up by way of endorsing the IAS into European law: In order to require European companies to follow these rules, they had to be incorporated into European law. For this purpose, a specific endorsement procedure was invented: Under Art. 6 of regulation EC No 1606/2002 a new accounting regulatory committee (ARC) was created which—functioning as a comitology committee—assembles national experts from member-states in the field of accounting. The ARC evaluates (beside other committees) every single existing and all new IAS and advises the European Commission whether to endorse a standard into European law or not. If it does not approve to endorse a standard, the council and since 2007 also the European Parliament, is in charge of making the decision. At the time the regulation was being issued, it was assumed that the rejection of a single IAS would never be necessary, and even if it was, the endorsement procedure provide for sufficient scrutiny. Although such a re-examination could only be exercised ex post once the IASB issues a standard, it could only meet with full acceptance or complete refusal of such a text.

However, a test for that mechanism and the first dispute over a standard was not far away: Already the comprehensive endorsement of all existing IAS before the first adaptation of IAS in 2005 gave room to heavy controversy. In 2003 and 2004, the IAS 39 “Financial instruments: Recognition and measurement” was widely criticised (Flower 2004: 189). The dispute was triggered by two issues: The first issue concerns the extent to which IAS users could use the “fair-value” (or “mark-to-market”) principle on their financial assets and liabilities. Beside members of the European banking industry, the European Central bank and the Basel Committee on Banking Supervision (BCBS) too opposed the range of this option. The second highly debated issue was concerned with the provisions regarding possibilities of banks to hedge their financial assets, which in their view would reduce their possibilities to manage risks.

As the IAS 39 had not been fully adjusted to satisfy European demands by the end of 2004, the European Commission decided to endorse IAS 39 only in parts and leave out

the disputed norms. By this decision, the EU created “carve-outs”, which from then on distinguished “IAS as endorsed by the EU” from the “full” IAS as issued by the IASC. Although the carve-outs on the fair-value options became redundant through respective adjustments by the IASB, some carve-outs on hedge accounting still exist. This disputed standard on financial instruments plays an important role in the debate over the current financial crisis.

### **2.3 From IASC to IASB – the organizational structure of the IASCF**

A reform of the standard-setting agencies' structure has led to many unintended side-effects: While the EU as the most important user of its standards aimed at participating in IASC's bodies and controlling their outcomes, the IASC sought to defend its formal independence.

During its advancement the IASC arrived at the conclusion that its organizational structure needed to be readjusted in order to comply with its aspired role as a global financial standard setter. Flower (2004: 134) lists the following deficiencies perceived in the IASCs' old structure:

- (1) The standard-setters found themselves dominated by representatives of the accounting profession and the lack of representatives from preparers and users of financial statements.
- (2) The IASC had no means to control the compliance with IAS companies which claimed to apply IAS but often omitted those parts of the IAS they did not like.
- (3) Important as they were in order to endorse the IAS in their countries, national standard-setters were not formally involved in the IASC standard formulation process.
- (4) Decision-making within the IASC Board became inefficient as by the year 2000 sixteen formal members, observers and IASC staff amounted to of more than 70 persons participating in an IASC Board meeting.
- (5) Finally, there was a lack of resources as well as the problem that IASC's board members were all part-time members preoccupied in their main professions.

To overcome these shortcomings and to prepare for its role as a global standard-setter, two basic orientations are possible: Either all interested parties and stakeholders become involved in the formal decision-making process and are given a voice, or all formal power is ceded to a self-contained and independent body.

The recommendations proposed in 1999 by an IASC working group suggest a decision in favour of an independent standard-setting body. These recommendations became the basis of the reviewed constitution, which came into effect in April 2001. The new constitution emphasises the organization's primary objective—to become a global stan-

dard setter—by changing its name to International Accounting Standards Committee Foundation (IASCF)<sup>11</sup>. Within this organization, the new International Accounting Standards Board (IASB)<sup>12</sup> would solely be responsible for the definition of standards, which from then on have been called International Financial Accounting Standard (IFRS).

In order to ensure the IASB's monopoly in the definition of standards, the dispersion of competences among the organization's different bodies is very important. The IASB comprises fourteen members with a sound practical background in the accounting profession. These members should come from different regions in order to foster representation of different accounting practices which are distributed regionally although the members are not to act as representatives for their home-countries but as members of the IASB. Twelve of the IASB's members are engaged full-time in order to prohibit conflicts of interest with their other occupations. To attain IASB's formal and practical independence, a board of trustees represents the acting body of the IASC foundation. It comprises sixteen trustees selected with regard to a fixed regional proportion. The functions of the board of trustees involve controlling and ensuring the organizations' funding, controlling the IASB's compliance with the established due process when defining new standards and—most importantly—selecting new members for the IASB as well as for the board of trustees themselves. Besides these most important bodies, other bodies such as the Standards Advisory Council (SAC) or the International Financial Reporting Interpretations Committee (IFRIC) advise the IASB or have solely the competence of interpreting IFRS.

A comparison with the organizational structure of the Financial Accounting Standards Board (FASB) reveals that this was the role-model for the IASCF's constitution. FASB is the American accounting standard-setter which issues the widely recognised U.S. GAAP. The IASB follows the same organizational pattern in that both represent the self-regulating model of the Anglo-American accounting tradition according to which the financial industry manages the definition of necessary standards as their own business and at its own cost (Fleckner 2008; Mattli/Büthe 2005). Still, it has to be borne in mind that the SEC can withdraw the competences granted to FASB at any time. The structures of the American and the European accounting system differ in that the EU wanted to take influence on the independently formulated standards (if necessary), whereas the IASB made itself immune through adjustments in its organizational setting. While the U.S. SEC has delegated its standard-setting competence to a similarly structured body, it can effectively control the standards defined there *ex post*. The EU's at-

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<sup>11</sup> The IASC-Foundation is incorporated as a foundation under the commercial law of Delaware.

<sup>12</sup> The IASB is based in London.

tempts to control IAS ex ante have led to a power struggle with the standard-setter, as Flower speculated as early as 1997:

“[The European Commission] is attempting to detach the IASC from its long-standing alliance with the Anglo-Americans and to bring it over to the side of the Europeans. Instead of, as in the past, the IASC and the Anglo-American presenting a united front, against the European Union, the future may be quite different: the IASC and the European Union combining together against the Anglo-Americans” (Flower 1997: 290).

Now, how have things developed after ten years, and boosted by the regulatory impulse as a response to the financial crisis? As will be shown in the analysis of current developments in its governance structure, especially the emphasis on the IASB's independence entails some major difficulties. Before the following section reviews the attempts by public authorities to impose their will on the IASB, table 1 summarises the organizational similarities and differences of both institutions described here. As it has become obvious, both organizations are quite similar in what they do: They both define standards that have gained global appliance although there is no formal enforcement mechanism to them; and their legitimacy is solely based on the expertise of their creators. Yet they differ in the source of the expertise they use: While the members of the Basel Committee are public authorities accountable to the government of nation-states, the IASB is purely private and cannot verify to represent a sufficient spectrum of stakeholders.

*Table 1: Comparison of the BCBS and IASB*

<b>Criterion</b>	<b>BCBS</b>	<b>IASB</b>
standards	Basel II Framework	IFRS
dispersion	global	global
legitimacy	expertise	expertise
assumed impact	pro-cyclical effect	pro-cyclical effect
adaptation (by states)	voluntary	voluntary
legal implementation	compulsory (EU)	voluntary/compulsory (EU)
competence	de facto delegated	de facto delegated
enforcement mechanism	non	non
governance structure	transgovernmental IGO	transnational private order
public accountability	ex ante	ex post
political influence of nation states	high	low
structural adjustment	?	?

Source: Own classification



### **3. FINANCIAL CRISIS AND THE DRAWBACKS OF THE PRIVATE SECTOR REGULATION - NATION-STATES' STRATEGIES TO INFLUENCE PRIVATE STANDARD SETTERS**

The following section refers to the resolutions that G20 leaders have passed since the beginning of the current financial crisis unfolded and analyses the demands they had in regard to the standard-setting in two sectors monitored here.

#### **3.1 Demands on the BCBS by G20**

At the peak of the financial crisis the heads of state demanded the harmonization of capital definitions in order to achieve consistent measures of capital and capital adequacy. The amount of equity that financial institutions are obliged to retain was to be as high as necessary to sustain public confidence in those institutions. Whereas the G20 leaders formulated these expectations with regard to the standards, they left the relevant standard-setters unchanged (G20: Action Plan to Implement Principles for Reform, Washington D.C.: 2).

In addition, at the following G20 meeting in London held on 2 April 2009, the standard-setter's structure remained unchanged. The BCBS was mandated to strengthen standards on prudential regulation of banks. Therefore BCBS was to enhance the demands on the quality of capital and to reconsider the necessary amount of equity capital (G20 Declaration on strengthening the financial system, London: 2). Parallel to these works and largely unrecognised by the public, BCBS's membership was expanded in two rounds: In March 2009 seven new member states became affiliated with the BCBS (Australia, Brazil, China, India, Korea, Mexico, Russia), and another seven countries joined in June 2009 (Argentina, Indonesia, Saudi Arabia, South Africa, Turkey, Hong Kong and Singapore). Through these enlargements all G20 members have become members of the BCBS. Hence, congruence between both arenas of decision-making has been established: The same states that had decided about the principles of further regulation now began to participate in the organization that transforms these principles into more practical details. On the basis of this congruent structure, effective decision-making—in the view of the G20—became possible: At the Pittsburgh G20 summit the leaders welcomed an agreement reached among the BCBS's Governors and Heads of Supervision on 7 September 2009 on future principles of banking supervision. This agreement allowed all G20 members to commit to the application of the Basel II framework by the end of 2011 (G20 Leaders Statement: The Pittsburgh Summit, Pittsburgh: 8). This came as a surprise, marking a major success for the regulation of global financial markets because the U.S. had previously been reluctant to implement Basel II;

in fact the U.S. government had proposed its own separate set of banking regulation<sup>13</sup> as late as June 2009. These very proposals led to seven core principles the U.S. Treasury issued on 3 September 2009.<sup>14</sup> By doing so, it was still unclear whether the U.S. would implement these principles within an internationally agreed framework or create a new set of norms unilaterally.

It is proposed that the compliance of the U.S. with the Basel II framework is directly related to the formal structure of the BCBS: All nation-states involved (i.e. G20) are able to articulate their demands in advance (the same way the U.S. did with its core principles), i.e. before member states negotiate a solution cooperatively. If a solution is commonly agreed on, all participating parties should have fewer difficulties in implementing the resulting standards. As this process starts with the formulation of those demands or principles by the nation-states involved and had led to a commonly agreed position in the end, this could be called a “bottom-up” process. Given a structure like this, the adaptation of the resulting standards is relatively unproblematic, and global regulation can be gained in a timely manner. The auspices for the future global regulation on banks equity capital are therefore promising: On 17 December 2009, the BCBS issued two proposals that could lead to “Basel III” later on.<sup>15</sup> These proposals were open to public comment until April 2010. Subsequent impact assessment studies were carried out in order to evaluate the consequences these new rules might have on banks and their lending capacities. The new accord was finally agreed on by the G20 leaders on 12 November 2010 and will come into effect in 2013.

Summing up the above developments regarding the BCBS, we see direct changes in the polity of the standard-setting process: Structural adaptation (enlargement) is carried out to achieve congruence of parties involved and represented in the decision-making process. By this the application of strategy option I—adjusting the policy of the standard-setter—became easier to obtain. It appears that the demands by the G20 regard only the substance of the standards but not their origin. The standards’ substance can be adjusted through guiding principles the standard-setters are to comply with. In consequence, this allows all G20 members to commit themselves to adopt Basel II/III once it is elaborated in detail by experts.

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<sup>13</sup> “A New Foundation: Rebuilding Financial Supervision and Regulation”, [http://www.financialstability.gov/latest/tg\\_06172009.html](http://www.financialstability.gov/latest/tg_06172009.html), last accessed on 3 March 2010.

<sup>14</sup> “Principles for Reforming the U.S. and International Regulatory Capital Framework for Banking Firms”, [http://www.ustreas.gov/press/releases/docs/capital-statement\\_090309.pdf](http://www.ustreas.gov/press/releases/docs/capital-statement_090309.pdf), last accessed on 3 March 2010.

<sup>15</sup> <http://www.bis.org/press/p091217.htm>, last accessed on 2 March 2010.

### **3.2 Demands on the IASB by G20**

A very different picture appears at the IASB: At the Washington G20 meeting the leaders demanded the following:

“With a view toward promoting financial stability, the governance of the international accounting standard setting body should be further enhanced, including by undertaking a review of its membership, in particular in order to ensure transparency, accountability, and an appropriate relationship between this independent body and the relevant authorities” (G20: Action Plan to Implement Principles for Reform, Washington D.C.: 1).

Strategy option II—polity adaption by modifying the standard-setting body—was obviously chosen here. The leaders do not only demand adjustments of existing standards or give more detailed directions for the future development. They also set out explicit demands on the functioning of the standard-setting organization: Its membership should be reconsidered, its transparency and accountability should be improved and its relationship with relevant (i.e. politically accountable) authorities should be strengthened.

These demands on the governance structure of the IASB were sustained in the subsequent G20 statements and became more complex through the political intention to achieve convergence between two major standards: At their meeting in London, the G20 leaders agreed to urgently call on the two most important accounting standard-setters (i.e. FASB and IASB) to work together towards a single set of global accounting standards. This way, the G20 leaders also strengthened the influence of public authorities on such future global standards. Besides FASB, which represents a single nation-state's distinct influence, G20 leaders included also supervisors and regulators, both referring to nation-states, in the standard-setting process (G20 Leaders Statement: The Global Plan for Recovery and Reform, London: 4). Under these circumstances, the institutional independence of the IASB is difficult to retain. At the time of the Pittsburgh summit the issue of the IASB's structure remained unresolved. G20 leaders demanded standard-setters to redouble their efforts to achieve a common set of global accounting standards by June 2011. While formally acknowledging the independence of the standard setting process, leaders once again requested that IASB involve various stakeholders in its institutional framework (G20 Leaders Statement: The Pittsburgh Summit, Pittsburgh: 9).

According to the above division of strategies, G20 clearly followed strategy option II (polity adjustment). The G20 tried to change IASB's governance structure in order to improve the representation of various stakeholders as well as to improve connections with public authorities. In the Washington communiqué, G20 leaders complained about shortcomings in the organization's current transparency and accountability. By doing so they urged IASB to cooperate with state-centred institutions such as FASB or regulatory institutions.

However, G20 leaders also took another path to influence IFRS: They insisted that standard-setters (i.e. IASB and FASB) work together with supervisory authorities in order to improve the standard which is regulating the banks' financial statements:

“[T]he FSB, BCBS, and CGFS, working with accounting standard setters, should take forward, with a deadline of end 2009, implementation of the recommendations published today to mitigate procyclicality, including a requirement for banks to build buffers of resources in good times that they can draw down when conditions deteriorate;...” (G20 Declaration on strengthening the financial system, London, 2 April 2009, p. 2).

This quotation indicates the use of strategy option III: Strategic inconsistency. As nation-states no longer want to accept the pro-cyclical effect IFRS seems to have, and as they are not able to implement this claim directly, IASB was embedded in a group of other regulators over which they have more control in order to force them to a common position. In terms of regime complexes, nation-states make use of the described slate by using more disposed regimes as forums to develop alternative solutions. These new rules are consciously designed to differ from the targeted regime so that nation-states threaten to appoint rival regimes.

Joachim Sanio, President of German Federal Financial Supervisory Authority (BaFin) and thereby member of the BCBS, leaves no doubt about the ultimate goal: “We need a harmonized accounting regime, on which the global Basel II standard can be built.” He continued that in view of the importance of this issue, “we cannot afford endless discussions of accounting standard-setters, who permanently stress their independence” (Börsen-Zeitung, 15 January 2010: p. 1). As this case shows a regime complex of different overlapping regulatory structures, is clearly an advantage for nation-states. In case of consentaneity among the important actors it allows credible commitment to make them independent from private expertise and thereby allows an effective influence on the addressed private sector-regime.

This strategic move by G20 leaders has proved quite effective: On 27 August 2009 BCBS issued “Guiding Principles for the Revision of Accounting Standards for Financial Instruments (IAS 39)”.<sup>16</sup> The following day, FASB in turn issued its proposal to improve its standard on fair-value measurements.<sup>17</sup>

As a result of this pressure, some of the major provisions were incorporated into the final version of the standard released by the IASB 12 November 2009. This is true especially of restrictions to apply the fair-value principle. Since then the amortized-cost approach can be used when markets are disturbed. A reclassification of financial in-

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<sup>16</sup> <http://www.bis.org/press/p090827.htm>, last accessed 26 April 2010.

<sup>17</sup> [http://www.fasb.org/cs/ContentServer?c=FASBContent\\_C&pagename=FASB/FASBContent\\_C/NewsPage&cid=1176156434356](http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB/FASBContent_C/NewsPage&cid=1176156434356), last accessed 26 April 2010.

struments leading to change of the applicable accounting principle is possible if the business model of a company changes. European states claimed this possibility during the crisis<sup>18</sup> and wanted to keep it after the revision of the IAS 39 standard.

#### **4. CONCLUSION**

Flower's question about the lead in a common global accounting system (Flower 1997: 290) has only found a partial answer. With regard to the regional dimension, it remains to be seen whether the centre of gravity will be in the U.S. or in Europe. However, with regard to the form of governance that will determine the future standards, nation-states have recovered a leading role during the financial crisis. Therefore the financial crisis—besides all the drawbacks it brought—also initiated a comeback of the state. Although trans-governmental or transnational institutions are in charge of setting these regulatory norms, nation-states have three options to shape resulting norms corresponding to their interests: They make use of them according to the institutional structures of the regime they address. If some public accountability exists—as in the case of the BCBS—nation-states content themselves with prescribing the desirable policy-outcome. If nation-states face a formally independent institution, as for example the private-sector IASB, they try to adapt the institution's polity (the decisive body and its composition) in order to realize the desired outcome. This, however, might be hard as such institution might oppose changing their role and losing their competences. In such a situation nation-states try to plot a strategic inconsistency in an interweaved regime complex with a view to pushing a private regulatory agency further.

The further development of the financial crisis will show how well the IASB can defend its independence and how strongly nation-states have to fight for their decisive authority.

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<sup>18</sup> See the European Commission press release from 15<sup>th</sup> October 2008 (IP/08/1513).

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