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Global Private Governance: Lessons from a National Model of Setting Standards in Accounting

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Abstract

We seek to advance the timely debate about global governance and specifically about the potential for a global system of administrative law to ensure transparency as well as access and accountability for those affected by the new inter- and transnational rule- and decision-makers. To do so, we present a positive political analysis of regulatory governance by *private* actors—largely neglected by social scientists but increasingly important in the international political economy. We develop a modified principal agent model to understand why governance is delegated to private rather than public agents in the first place and how such agents may be expected to differ from public ones in how they operate. Here, we emphasizes the macro-political climate in which the delegation of regulatory authority to private agents takes place, which, we suggest, is a key reason for the adoption of administrative law procedures by private agents. We focus empirically on global governance in accounting, which as of 2001 is the task of the International Accounting Standards Board, IASB. This private agent is modelled after the national accounting standards setter of the United States, the Financial Accounting Standards Board (FASB). Because FASB is the blueprint for IASB and plays a prominent role in global governance in accounting, we provide an empirical analysis of this domestic institution before pondering the trends and likely challenges at the global level.

1. Introduction

Numerous recent studies have documented the increase of global governance by international organizations, as well as formal and informal transgovernmental networks, hybrid public-private institutional arrangements, and entirely private transnational institutions. [1] These bodies establish general rules and make specific decisions with which other actors comply, based on the recognition by the latter of the authority of the former.[2] In the domestic context, such rule- and decision-making authority is embedded in a system of administrative law. This system of institutionalized procedural and substantive norms assures those who are affected by the regulator's decisions that they will enjoy "procedural participation" (i.e., that their views will be heard and considered, for instance through notice-and-comment procedures); that decisions will be taken in a transparent manner on the basis of disclosed reasons and in compliance with norms of proportionality, means-end rationality, etc.; and that the decisions are subject to review by a judicial or another independent body upon request.[3] Administrative law mechanisms that ensure accountability have a long history and tradition at the domestic level without apparent counterpart at the international or global level.[4] Yet, globalization of rule-making need not necessarily entail losing such safeguards: Based on an extensive and detailed mapping of current administrative practice of global governance organizations and networks, Kingsbury, Krisch & Stewart suggest that a *global* administrative law is not only possible but in the process of being

[1] See e.g., Tim Büthe, "Governance through Private Authority? Non-State Actors in World Politics." *Journal of International Affairs* (New York) vol.58 no.1 (Fall 2004): 281-290; Miles Kahler and David A. Lake, eds., *Governance in a Global Economy: Political Authority in Transition*. Princeton: Princeton University Press, 2003; Mark A. Pollack, and Gregory C. Shaffer, eds., *Transatlantic Governance in the Global Economy*. Lanham, MD: Rowman & Littlefield, 2001; Anne-Marie Slaughter, *A New World Order*. xviii + 341 xviii + 341. Princeton: Princeton University Press, 2004. While most of these studies focus on the increased demand for global governance, the supply of institutions must also be explained, see Walter Mattli, *The Logic of Regional Integration: Europe and Beyond*. New York: Cambridge University Press, 1999; Douglass C. North, *Structure and Change in Economic History*. New York: W. W. Norton, 1981; Mancur Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups*. Cambridge, MA: Harvard University Press, 1965. For a discussion of inter-/transnationalization versus "globalization," see David Held *et al*, *Global Transformations: Politics, Economics and Culture*. Stanford: Stanford University Press, 1999. For notational simplicity we will use "global" in this article even when social exchange or institutions may, strictly speaking, "only" be international or transnational.

[2] Miles Kahler and David A. Lake, "Globalization and Governance." In *Governance in a Global Economy* (supra at 1): 1-30. Here: pp.7f. We concur with Kahler and Lake that recognition of authority may be based on coercive power, but that "governance" connotes compliance as such being voluntary. For a discussion of alternative notions of "governance," see Rosenau, James N. and Ernst-Otto Czempiel, eds. *Governance Without Government: Order and Change in World Politics*. Cambridge: Cambridge University Press, 1992.

[3] Benedict Kingsbury, Nico Krisch, and Richard B. Stewart, "The Emergence of Global Administrative Law." *Law and Contemporary Problems* vol.68 no.3 (Summer 2005): III.D. [NOTE TO ARTICLES EDITOR: III.D specifies the section of the manuscript to which this reference refers; in the manuscript the pages are 19-21; please replace with the correct page numbers in the final version.] "Disclosed reasons" may of course be merely rationalizations.

[4] Many of these core principles of administrative law seem to be grounded in democratic theory (see Robert A. Dahl, *A Preface to Economic Democracy*. Berkeley: University of California Press, 1985). They might hence be found in full only in democracies.

created, and they open a normative-prescriptive debate over the forms that global administrative law might take.

We seek to contribute to this timely debate by presenting a positive political analysis of global governance, both theoretically and in a particular empirical context. Such a positive analysis, we submit, should precede deliberation about which administrative norms and mechanisms can and should be instituted, because a discussion of effective remedies presupposes a clear understanding of actual deficiencies and their causes. To gain such an understanding, we ask a series of analytical questions: Why is rule-making authority implicitly granted or explicitly delegated to an inter-/transnational body? What are the consequences of such a delegation of authority for the domestic and international distribution of power and resources (including information and expertise)? Why do some actors rather than others supply such governance? Do all those who are affected by the governance in a given realm have a voice in the governance institution (and if not, why not)? What are therefore the prospects for the comprehensive adoption and the likely effectiveness of administrative law procedures?

Scholars of administrative law have tended to shy away from such questions, preferring detailed accounts of administrative procedures and normative discourse over positive political analysis. Positive analysis, however, is very much needed: Lack of participation and accountability may be caused not just by exclusion or non-transparent procedures but also by ignorance, information deficits, erroneous beliefs, or collective action dilemmas. The creation of notice-and-comment procedures, for example, will achieve little when the problem is ignorance or lack of technical expertise by the subjects of a particular governance arrangement. Greater procedural transparency and formal rules guaranteeing procedural inclusion of all affected parties may be in vain if those parties' participation is in fact prevented by a collective action problem. Positive analysis and explanation of new or changing administrative law mechanisms and procedures at both the national and global levels therefore also offers tools for assessing the effectiveness and desirability of competing institutional designs for administrative law.

Such an analysis and specifically the above questions seem especially important when global governance is carried out by private regulatory bodies, because the "relatively effective means of intervention" through which democratically legitimated "public bodies, both administrative and legislative, ... [can] control or correct private governance" domestically is lacking at the global level.[5] Therefore, we focus in this paper exclusively on the potential for administrative law in the realm of private transnational regulatory arrangements. Deductively, we draw on a modified principal-agent theory, which we have developed in greater detail elsewhere,[6] to offer an analytical account of private global governance that emphasizes principals, agents, as well as the macro-political context in which any particular principal-agent relationship is embedded. To examine global private governance empirically, we focus on the little known but highly influential non-governmental organization responsible for setting global accounting or "financial reporting" standards, the International Accounting Standards Board, IASB.[7]

Accounting standards regulate how research and development expenses, performance incentives for managers such as stock options, assets in an employee pension fund, and other particular types of transaction and events may be reflected in corporate financial statements. The standards are supposed to result in statements of a firm's value and financial position, which are accurate and easily comparable across firms. Seemingly technical, these standards create incentives for firms to engage in some activities and avoid others, as well as to choose particular means in pursuit of a given goal; they thus shape the behavior of firms and consequently important aspects of a country's political economy. For various reasons discussed below, firms follow these rules in calculating and disclosing information like profits, costs, assets, liabilities, and revenues to their shareholders and the general public.

The growth of stock ownership, transnational stock market listings, and more generally the increasing integration of financial markets over the last decade or two, have intensified demands from firms and investors for international harmonization of divergent national accounting standards. The growing demand for global accounting rules has led to a delegation of rule-making authority in accounting to a non-governmental body of technical experts, the IASB, funded by the business firms that "prepare" and "issue" financial statements and by the

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5 Benedict Kingsbury, Nico Krisch, and Richard B. Stewart (supra at3) 2005: V.A., p.34.

6 See Walter Mattli and Tim Büthe, "Accountability in Accounting? The Politics of Private Rule-Making in the Public Interest," *Governance* vol.18 no.3 (July 2005) and Tim Büthe and Walter Mattli, "The Dynamics of Public Principal and Private Agent: Institutional Persistence and Change in Setting U.S. Accounting Standards." Mimeo.

7 For an analysis of other major private-sector regulatory institutional bodies, namely the International Organization of Standardization (ISO) and the International Electrotechnical Commission (IEC), see Walter Mattli and Tim Büthe, "Setting International Standards: Technological Rationality or Primacy of Power?" *World Politics* vol.56 no.1 (October 2003): 1-42.

accountancy profession. IASB began operating in April 2001.[8] It was modeled on a homologous national private institution, the American Financial Accounting Standards Board (FASB), which has been in charge of producing "generally accepted accounting principles" (GAAP) for the US market for over thirty years.[9]

Regulatory institutions like IASB and FASB, however, are not fixed structures. They undergo and have undergone changes over time. We focus here on an important dimension of change: change in the extent to which these bodies have embraced, resisted, instituted, or rejected mechanisms of administrative law, such as transparency, participation, and the proclamation of reasons for their decisions. We seek to explain such changes as well as the general operation of private-sector accounting governance as a function of political and structural factors, such as power, control, dependency, and knowledge asymmetries.

Section 2 elaborates the analytical framework and makes the case for its applicability to the realm of accounting standards setting. Sections 3 and 4 apply the framework of private-sector governance to the American and global cases respectively. In section 3 we draw on the relatively long history of private rule-making in accounting in the U.S. to test a set of hypotheses about private-sector governance. The IASB experience is too recent for comparable in-depth analysis. However, given the strong institutional affinity between FASB and IASB, we will ponder in section 4 the implications of the preceding analysis for global private governance in accounting. Section 5 considers some of the implications of our analysis for attempts to improve transnational regulatory governance through administrative law procedures at the global level.

2. Principal-Agent Theory and Private Regulatory Governance[10]

Principal-Agent Theory (P-A) is a fruitful starting point for an analysis of private governance, because it was developed for the very purpose of capturing essential characteristics of situations where rule- or decision-making authority in a specified domain is conditionally granted to one actor (the "agent") by another actor (the "principal").[11] P-A adopts the core

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[8] The IASB replaced an institutionally weaker predecessor hailing back to the early 1970s, the International Accounting Standards Committee (IASC).

[9] Domestically, FASB accounting standards are binding based on the regulatory authority delegated to the SEC by Congress.

[10] Sections 2 and 3 draw in large part on Mattli and Büthe 2005 (supra at 6).

[11] For a recent review of the literature, see Jonathan Bendor, Amihai Glazer, and Thomas H. Hammond, "Theories of Delegation." *Annual Review of Political Science* vol.4 (2001): 235-269.

assumptions of rational choice (RC) theory,[12] but differs from most RC approaches in that its *starting* assumption is that *information is neither complete nor perfect*, because transactions are costly—including the writing of detailed contracts and the monitoring of agents.[13] Delegation thus inevitably creates some discretion for the agent, which gives rise to the "agency problem" of "shirking" when the principal's and the agent's interests do not coincide, and the agent therefore acts contrary to the principal's interests after authority has been delegated to the agent. Accountability is therefore a central issue for P-A.

P-A also is promising because delegation of regulatory authority has been the focus of much of the P-A literature. While the initial delegation of authority from citizens to legislators and governments surely warrants critical analysis,[14] most of this literature has focused on delegation from legislatures to specialized bureaucracies, mostly in the United States,[15] but recently also comparatively[16] and from domestic elected officials to international governmental organizations.[17] While this literature has yielded numerous insightful analyses of delegation of governance authority to public bureaucracies and regulatory agencies, the delegation of governance functions to *private* agents has so far largely been overlooked by P-A. However, in recent years states have increasingly delegated domestic and international governance functions to private (non-governmental) actors, as novel forms of economic activities arose (e.g., internet commerce), increasing technical complexity required technical expertise that states found too costly to acquire and maintain (e.g., new financial instruments, bond ratings), and neoliberal

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[12] See Barry R. Weingast, "Political Institutions: Rational Choice Perspectives." In *A New Handbook of Political Science*, edited by Robert E. Goodin and Hans-Dieter Klingemann. New York: Oxford University Press, 1996: 167-190.

[13] See, e. g., Oliver E. Williamson, *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting*. New York: The Free Press, 1985.

[14] E.g., Torbjörn Bergman, Wolfgang C. Müller, and Kaare Strøm, "Parliamentary Democracy and the Chain of Delegation." *European Journal of Political Research* vol.37 no.3 (May 2000): 255-429. There is also, of course, an extensive literature on delegation within legislatures Kenneth A. Shepsle, and Barry Weingast, "The Institutional Foundations of Committee Power." *American Political Science Review* vol.81 no.1 (March 1988): 86-108 and "Positive Theories of Congressional Institutions." *Legislative Studies Quarterly* vol.19 no.2 (May 1994): 145-179.

[15] E.g., Thomas H. Hammond and Jack H. Knott. "Who Controls the Bureaucracy? Presidential Power, Congressional Dominance, Legal Constraints, and Bureaucratic Autonomy in a Model of Multi-Institutional Policy-Making." *Journal of Law, Economics and Organization* vol.12 no.1 (April 1996): 119-166; Mathew D. McCubbins, Rober G. Noll, and Barry R. Weingast, "Administrative Procedures as Instruments of Political Control." *Journal of Law, Economics and Organization* vol.3 no.2 (Fall 1987): 243-277. See also Terry M. Moe, "Control and Feedback in Economic Regulation: The Case of the NLRB." *American Political Science Review* vol.79 no.4 (December 1985): 1094-1116.

[16] E.g., John D. Huber and Charles R. Shipan, *Deliberate Discretion? The Institutional Foundations of Bureaucratic Autonomy*. New York: Cambridge University Press, 2002; Mark Pollack, *Engines of European Integration: Delegation, Agency and Agenda-Setting in the European Union*. New York: Oxford University Press, 2003; Mark Thatcher and Alec Stone Sweet, "Theory and Practice of Delegation to Non-Majoritarian Institutions." *West European Politics* vol.25 no.1 (January 2002, special issue "The Politics of Delegation"): 1-22.

[17] E.g., Gould, Erica R. "Money Talks: Supplementary Financiers and International Monetary Fund Conditionality." *International Organization* vol.57 no.3 (Summer 2003): 551-586. Daniel L. Nielson and Michael J. Tierney. "Delegation to International Organizations: Agency Theory and World Bank Environmental Reform." *International Organization* vol.57 no.2 (Spring 2003): 241-276.

ideas undercut the presumption of, and normative justification for, public provision of governance.[18] We therefore focus our analysis on the delegation of governance authority to private agents.

2.1. Why Delegate Authority to a <u>Private</u> Agent?

The P-A literature has identified several reasons for political principals to delegate rule- and decision-making authority to agents. The probably most general and common reason for delegation is to reduce the principal's workload and enable greater efficiency through specialization.[19] This logic is at the heart of almost any employer-employee relationship. It plays some role in most delegation of regulatory authority, domestically and globally, but at this general level is relatively uninteresting for the present analysis. Three more specific reasons for delegation, however, warrant closer examination, because each of them may make delegation of governance functions to a *private* agent particularly attractive, and because they have important implications for (the feasibility of) administrative law mechanisms.

One specific reason for delegating authority is wanting to benefit from existing specialization and expertise. Such delegation to an agent with prior specialized expertise is particularly common in highly technical and complex issues areas, for instance in the fields of science policy and space technology.[20] In such technical fields, regulatory authority may be established more cost-effectively by delegating authority to an expert because such delegation "can be an effective substitute for the acquisition of expertise" by the principal.[21]

Expertise-based delegation to a private agent may be warranted at the outset insofar as it is private actors who have the requisite expertise ex ante, but it is especially the *maintenance* of specialized expertise that may make delegation to a private agent more efficient and therefore more desirable than delegation to a public agent. Governments and public agencies, which could use the specialized expertise solely for the purpose of regulation, will find maintaining such expertise more costly than private actors who can derive positive externalities from this expertise

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[18] See, e.g., A. Claire Cutler, Virginia Haufler, and Tony Porter, eds., *Private Authority and International Affairs.* Albany, NY: State University of New York Press, 1999. Also Büthe 2004 (supra at 1).
[19] David Epstein and Sharyn O'Halloran, *Delegating Powers: A Transaction Cost Politics Approach to Policy Making under Separate Powers.* New York: Cambridge University Press, 1999: 48.
[20] Epstein and O'Halloran (supra at 19): 5f, 196ff.
[21] James E. Alt and Alberto Alesina, "Political Economy: An Overview." In *A New Handbook of Political Science*, edited by Robert E. Goodin and Hans-Dieter Klingemann. New York: Oxford University Press, 1996: 645-674. Here: p.658.

by also using it to improve products, processes, etc. This economic rationale underpins many of the arguments for industry self-regulation.[22]

Expertise-based motivations for delegation also have implications for the effectiveness of administrative law mechanisms to ensure participation and accountability. In particular, when delegation of public authority to a private agent is motivated by the public principal's lack of the technical expertise that would be required to provide governance without delegating it, we might expect the public principal to be poorly positioned to exercise oversight and to correct private regulatory decisions if they are not in the public interest.[23] And we should expect the establishment of provisions for broad participation in the governance process, such as notice-and-comment procedures, to have limited effectiveness if the technical expertise is unevenly distributed across those with a stake in (i.e., those affected by) the regulatory agent's rule- and decision-making.

The third reason for delegation that creates particular incentives for delegating governance functions to *private* agents, is "blame avoidance" or "shifting responsibility." The lower the probability of getting credit for the positive effects of regulatory governance relative to the likelihood of being held accountable for negative effects, the more attractive must delegation be to the principal.[24] The logic of "shifting responsibility" also motivates delegation in politically charged contexts, where regulatory activity may be more palatable for the regulated when carried out by an agent who is clearly separate from the principal, rather than being carried out directly by the principal. Private agents that inherently at least appear more clearly separate from the government than public ones are particularly attractive for delegation that is motivated by shifting responsibility. The implication for administrative law is that, where shifting responsibility is an important motivation for delegation, procedures that would ensure a high degree of agent accountability to the principal or easy review and revision of the agent's decisions would diminish the desired benefit of delegation and will therefore likely be resisted by the principal.

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[22] See e.g., Virginia Haufler, *A Public Role for the Private Sector: Industry Self-Regulation in a Global Economy*. Washington: Carnegie Endowment for International Peace, 2001.

[23] We will discuss this issue in more detail below.

[24] Morris P. Fiorina, "Legislative Choice of Regulatory Forms: Legal Process or Administrative Process?" *Public Choice* vol.39 no.2 (September 1982): 33-66, esp. 46ff. More precisely, delegation is attractive if the likely net costs of authority (that is, the cost of being blamed by dissatisfied stakeholders minus the benefit of gratitude from the satisfied stakeholders) are higher the closer one is to the actual exercise of authority.

2.2. Governance and Accountability After the Initial Delegation

We have focused so far on some of the key reasons for delegating governance functions to a private actor in the first place. But how do such private regulators differ from public ones in how they operate and evolve institutionally after authority has been delegated to them?

We argue that the key difference between delegation to public agents and delegation to private agents is that delegation to private agents creates a multiple principals problem. Potential private agents are almost always collective actors—firms, private associations, maybe the science and technology advisory committees of unions or environmental groups—which have an immediate and prior principal in their owners, members, or funders. When public regulatory authority is delegated to such a private actor, then this agent has at least two principals, one public and one private.

The P-A literature traditionally treats the multiple principals problem as a problem of collective action or free riding: Since monitoring is costly and any principal would have to share at least part of the benefits of her efforts with others, close monitoring is less likely than when the agent has only a single principal. The agent thus attains a higher level of discretion and will work less hard (what Wolfgang Müller calls "leisure shirking").[25] However, when the private principal pursues the interests of only one segment of the general public and only one group of stakeholders, then we should expect "dissent shirking" of the agent vis-à-vis the public principal because the private principal induces a systematic divergence of the agent's substantive preferences from the public principal's.

This qualitatively different type of multiple principals problem, which arises from the delegation to a private agent may be brought out most clearly in a very simple spatial model. Assume that the public principal (P) seeks to balance the interests of two groups of stakeholders (SH1 and SH2), so P's ideal point is somewhere between the ideal points of the stakeholders on any particular regulatory or institutional issue (see Figure 1). Unless we assume uneven distribution of political lobbying resources between the two stakeholders, we have no reason to expect a public agent to take a position on either side of the public principal. But with a private agent that has one of the stakeholders—but not the other—as an additional principal (e.g., SH1),

[25] Wolfgang C. Müller, "Political Parties in Parliamentary Democracies: Making Delegation and Accountability Work." *European Journal of Political Research* vol.37 no.3 (May 2000, special issue on "Delegation in Parliamentary Democracies," edited by Torbjörn Bergman, Wolfgang C. Müller and Kaare Strøm): 309-333, here: 320f.

we would expect regulatory policy or governance decisions by the agent systematically to favor this stakeholder and thus tend to fall between P and SH1. This model of delegation to a private agent therefore implies that one group of stakeholders will benefit from private governance at another group's expense.[26]

[FIGURE 1 ABOUT HERE]

But where should we expect the outcome to fall between P and SH1 when the two principals' preferences diverge? The assumption of instrumental rationality on the part of the agent leads us to expect that this will be a function of the relative tightness of the P-A relationships between each of the principals and the agent, which in turn is a function of the relative importance of the principals for the agent's financial and operational viability as well as effectiveness in rule-making. We will discuss each of these three components in turn.

Financial viability refers to the availability of the financial resources required for the agent to fund its operations. Unless the agent is funded entirely out of an endowment controlled by the agent itself, it will have strong incentives to take the interests of its funder into account. The more the agent depends upon its private principal for its financial viability, *ceteris paribus*, the tighter should be the P-A relationship between the agent and the private principal. In terms of Figure 1, we would expect the outcome to be closer to SH1. Conversely, the more the agent depends upon a periodic discretionary allocation of resources from the public principal for its financial viability, the tighter should be the P-A relationship between the agent and the public principal.

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[26] We do not mean to make too much of this difference: In the real world, public regulatory agencies can get captured by those whom they are supposed to regulate as George Stigler pointed out long ago ("The Theory of Economic Regulation." *Bell Journal of Economics and Management Science* vol.2 no.1 (Spring 1971): 3-21), and, as Epstein and O'Halloran point out, legislators (as the public principals of the regulatory agencies) themselves may also be very receptive to special interest lobbying when making regulatory decisions (Epstein and O'Halloran (supra at 19) 1999:10; see also Terry M. Moe, "Political Institutions: The Neglected Side of the Story." *Journal of Law, Economic and Organization* vol.6 no.3 (Special Issue 1990): 213-253. When any one group has privileged access, we would expect the regulatory activity to favor the interests of that group, regardless of whether this was the intention of the institutional arrangement (McCubbins, Mathew D., Rober G. Noll, and Barry R. Weingast (supra at 15), 1987:261; and "Structure and Process, Politics and Policy: Administrative Arrangements and the Political Control of Agencies." *Virginia Law Review* vol.75 (March 1989): 431-482) or an unintentional by-product (Glen O. Robinson, "Commentary on 'Administrative Arrangements and the Political Control of Agencies': Political Uses of Structure and Process." *Virginia Law Review* vol.75 (March 1989): 483-498). Note also that we do not argue that the involvement of non-governmental principals inherently diminishes the effectiveness or efficiency of regulation. Not all public policy decisions significantly affect everyone. If the private principals reflect without bias the balance of interests among those who have a stake in the regulatory matter, public and private benefits should coincide (though there might be less if any need for regulation under these circumstances). We also should note that, with the right socio-political incentives, a high degree of independence seems to be quite possible: Highly institutionalized professional norms appear to provide effective incentives, for instance, for former senior partners in corporate law firms to become quite independent judges after appointment, or for national policy experts to largely disregard their own countries' policy preference after joining the European Commission bureaucracy.

Operational viability refers to the availability of the technical expertise required for the agent to carry out the governance tasks delegated to it. The World Anti-Doping Agency, for instance, requires medical and bio-chemical scientific expertise and instruments (as well as expertise for making ethical judgment and improve education about prohibited substances) to carry out the governance of the "fair play" provisions of the World Anti-Doping Code, including monitoring of compliance by all athletes in the Olympics and other sports that have adopted the code.[27] How do regulatory agents acquire the needed expertise and technical support? As we suggested above, the prior existence of the requisite expertise among private actors is likely to be a key reason for having delegated to a *private* agent in the first place. If private provision of such expertise is crucial to the agent's operational viability, we would expect outcomes to favor those providing this crucial resource. Specifically, the more the agent depends upon the private principal for the provision of such expertise, the closer should the outcome be to SH1.

While ensuring its own financial and operational viability may be the agent's first concern, effectiveness as a regulator also needs to be a centrally important concern for the agent. Effectiveness here refers first and foremost to gaining acceptance for and compliance with the rules and decisions it issues. To gain an analytical handle on the issue of effectiveness, we depart from traditional P-A by recognizing explicitly that any particular principal-agent relationship is "embedded" in a broader context of norms and ideas,[28] which we may call the "macro-political" climate or "mood."[29]

The macro-political climate defines *inter alia* the "proper" relationship between public authority and private actors, which appears to have undergone several changes over the course of the 20th century in the advanced capitalist democracies.[30] In the United States, for instance, periods of an exuberantly pro-business macro-political climate that rendered any increase and even the then-current levels of government regulation of the private sector virtually illegitimate (in the 1920s, '50s, and '80s/'90s), were repeatedly followed by periods during which the mood

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27 see http://www.wada-ama.org (accessed 31 January 2005) and Kingsbury, Krisch & Stewart 2005 (supra at3):II.A.p.7.

28 Mark Blyth, *Great Transformations: Economic Ideas and Institutional Change in the Twentieth Century*. New York: Cambridge University Press, 2002; Kathleen R. McNamara, "Rational Fictions: Central Bank Independence and the Social Logic of Delegation." *West European Politics* vol.25 no.1 (January 2002, special issue "The Politics of Delegation"): 47-76; Karl Polanyi, *The Great Transformation: The Political and Economic Origins of Our Time*. (First published in London, 1944). Boston: Beacon Press, 1957; John Gerard Ruggie, "International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order." In *International Regimes*, edited by Stephen D. Krasner. Ithaca, NY: Cornell University Press, 1983: 195-231.

29 Robert S. Erikson, Michael B. MacKuen, and James A. Stimson, *The Macro Polity*. New York: Cambridge University Press, 2002: esp. 325ff.

30 See, e.g., David Vogel, "The Hare and the Tortoise Revisited: The New Politics of Consumer and Environmental Regulation in Europe." *British Journal of Political Science* vol.33 no.4 (October 2003): 557-580.

was almost hostile to business, and it was seen as nearly unacceptable for business to regulate itself.[31] Such swings in the public mood make a private principal who appears to have notably diverged from the public preference, vulnerable to challenges, and it opens opportunities for institutional change,[32] maybe even a revision of the principal-agent relationship, forced upon the agent by the public principal. More likely, though, a private agent who values his discretion will react to such a change in the macro-political climate by changing its procedures before a public principal would force a change. Change in the macro-political climate thus creates an opening for the introduction or strengthening of administrative law procedures, such as greater transparency, the establishment of public comment-and notice periods, etc.[33]

2.3. Applicability of P-A to Governance in Accounting

Before turning to the question whether the hypotheses developed above are empirically supported in the realm of accounting governance, it is worth examining whether this issue area is suitable for an application of the analytical framework developed above. Indeed, the specific reasons for delegating governance to a private actor apply in the realm of accounting. Accounting standards are complex, technical, and have been fast-changing in recent decades, as new financial instruments were invented and their accounting treatment needed to be clarified. While there are public demands for the regulation of financial reporting, very few if any government employees have the requisite technical expertise, and while experts might be trained or hired, it would be very costly for career public servants (who would be needed if government bureaucracies were to carry out the standards setting functions) to maintain such expertise, because they would not be participants of the private financial markets where the innovation in financial instruments is taking place. Expertise-based incentives for delegation to a private regulatory agent thus clearly exist. Moreover, disagreements over accounting standards appear

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[31] See David Vogel, *Fluctuating Fortunes: The Political Power of Business in America*. New York: Basic Books, 1989.

[32] See Kingsbury, Krisch and Stewart 2005 (supra at3): III.C.2., p.16 and Paul Pierson, *Politics in Time: History, Institutions, and Social Analysis*. Princeton: Princeton University Press, 2004.

[33] Substantial rather than merely cosmetic institutional or behavioral change in response to changes in the macro-climate, however, should not be expected to be automatic. As Wood and Waterman note, when signals from principals or the political environment conflict with the interests of a bureaucracy, "it is natural for bureaucracies to react slowly" (Wood, B. Dan and Richard W. Waterman, "The Dynamics of Political-Bureaucratic Adaptation." *American Journal of Political Science* vol.37 no.2 (May 1993): 497-528,:here p.504). This expectation should apply to private as well as public bureaucracies. Regulatory agents may react to such changes in the political macro-climate in recognition that it changes their constraints, but we should expect to see far-reaching changes in the formal institutions or regularized behavior of regulatory agents only when public principals translate the change in the macro climate into specific incentives for agent adaptation.

to be often grounded in conflicts of interests with little room for mutually beneficial solutions,[34] such that the regulator is bound to leave some groups and individuals with a stake in the regulatory matter dissatisfied with the outcome (see below). It appears to be an issue area where blame from dissatisfied stakeholders is likely to exceed the gratitude from satisfied ones, at least for those directly exercising regulatory authority. As the *Financial Times* recently observed: "Setting accounting standards is no way to make friends."[35]

These characteristics of accounting governance create strong incentives to delegate governance to private agents, both at the domestic and the global level. And indeed, accounting standards setting is one of the governance functions that has been delegated to private agents within several countries as well as internationally. Our analytical framework also seems suitable in that public agencies that are charged with regulating stock markets and financial reporting (be they central banks, securities commissions, or other agencies) may be seen as constituting an explicit or implicit public principal to the private agent at the domestic level, though at the international or global level the question who constitutes the public principal warrants separate analysis (see section 4). We have also suggested above that expertise-based private agents should be expected to have, by design, a prior private principal; we will examine this prediction below.

Finally, mapping preferences in a space populated by several stakeholders also seems appropriate for the analysis of accounting standards setting. The content of these standards matters to the firms that issue financial securities and therefore prepare financial statements (the "preparers"), but several other groups also have a stake in what these standards prescribe: Investors seeking information about alternative investment opportunities are probably the most important type of "users" of the financial statements; and accounting professionals must keep up with the latest developments both for keeping and for auditing firms' books.

We have suggested that the tightness of a P-A relationship is a function of the relative importance of the principal for the agent's financial viability and operational viability, as well as (indirectly) a function of what we have called the macro-political climate. Financial viability is straightforward and should be applicable in the analysis of any regulatory agent. Operational

[34] See Roger Fisher, William Uri, and Bruce Patton, *Getting to Yes: Negotiating Agreement without Giving In*. 2nd revised edition. New York: Penguin, 1991: esp. 56ff.
[35] Barney Jopson, "Key Performance Ratio Finds that Its Numbers May Be Up." *Financial Times* 1 Feb 2005:16.

viability, in the realm of setting accounting standards refers to having (or lacking) general accounting expertise, familiarity with existing financial instruments, and knowledge of current practices. The regulatory agents need this expertise to write accounting standards that are feasible in implementation as well as effective in achieving the goals of completeness and comparability of financial reporting. Finally, changes in the macro-political climate should be expected to bear upon attitudes toward the regulation of financial reporting not just because it is an instance of the more general phenomenon of government regulation of private actors, but also because accounting fraud and—maybe more importantly—technically legal but fundamentally misleading accounting practices have been seen as essential components of the spectacular corporate wrong-doing at Enron, WorldCom, Parmalat, etc.—contributing to the perception of a failure of the self-governing market. In sum, the analytical framework developed above seems suitable for a positive political analysis of accounting standards setting.

3. Principals and Agents in U.S. Accounting Governance

We now turn to an empirical examination of the plausibility of our hypotheses about the effects of delegating to a *private* agent. The setting of accounting standards in the United States provides us with a first opportunity to analyze empirically the delegation of governance functions to private actors in one of the few cases where such delegation has a long history. To hold the institutional context broadly constant,[36] we focus on the period after the 1972 reforms of U.S. accounting standards setting and on episodes in which divergent interests of the stakeholders and the agents can be well established based on existing sources and a series of interviews that we have conducted with individuals involved with accounting standards issues in American corporations, at the FASB, and at the SEC.

3.1. The Structure of Private-Sector Accounting Standardization

While some individual states had regulated the issuance and trading of financial securities already in the late 1700s, Congress asserted the authority of the federal government to regulate financial securities only in the 1930s—in response to the stock market crash that saw the Dow Jones Industrial Average lose 90% of its October 1929 valuation (attributed in part to "deceptive

[36] Cf. Tim Büthe, "Taking Temporality Seriously: Modeling History and the Use of Narratives as Evidence." *American Political Science Review* vol.96 no.3 (September 2002): 481-494.

and misleading financial reporting practices"[37]) and in response to the Depression-induced swing in the macro-political climate, reflected in the election of 1932. The Securities Act of 1933 and the Securities Exchange Act of 1934 mandated "full and fair disclosure" in the flotation of financial securities, required the filing of periodic financial statements by the issuers of publicly traded securities, and created the Securities and Exchange Commission (SEC), to which it delegated the task of specifying and enforcing all obligations arising from these two acts. Starting in 1938, the SEC—itself a public agency—in turn delegated the authority "to prescribe the methods to be followed in the preparation of accounts and the form and content of financial statements to be filed"[38] to a *private* body. This delegation of authority was controversial at the time, but it persisted, with the SEC itself retaining an oversight function and final authority, which makes it the direct public principal for the private agent. The initial and second such private accounting standards setting bodies—the Committee on Accounting Procedure (1934-1959) and the Accounting Principles Board (1959-1972)[39]—were replaced in 1972 by a novel institutional structure that is largely in place to this day and provided the model for the global private regulator. This structure consists of three bodies: the Financial Accounting Foundation (FAF), the Financial Accounting Standards Board (FASB), and the Financial Accounting Standards Advisory Council (FASAC).[40]

The FAF is composed of trustees whose task it is to appoint the members of FASB and exercise general oversight. They are also responsible for raising funds—until recently primarily from business—to pay for FASB salaries and expenditures. Trustees are elected for three-year terms and eligible for re-election to one additional term.[41]

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37 William Z. Ripley, *Main Street and Wall Street*. Boston: Little & Brown, 1927.

38 SEC, Securities and Exchange Commission. "Accounting Series Release No.150." (Issued 20 December 1973).

39 The institutional evolution of U.S. accounting standards setting, which we examine in greater details elsewhere, is beyond the scope of this article; see also Paul B. W. Miller, Rodney J. Redding, and Paul R. Bahnson, *The FASB: The People, the Process, and the Politics*. 4th edition. Boston: Irwin, McGraw-Hill, 1998: 55-58.

40 A fourth institutional body, the Governmental Accounting Standards Board (GASB), was added in 1984. GASB sets standards of financial accounting and reporting for state and local governmental units.

41 Each of the five original sponsoring organizations of the new standard-setting structure nominated one or more of the 9 trustees of the Foundation. Besides the AICPA, these organizations included the American Accounting Association (AAA), the professional organization of accounting educators; the Financial Executives Institute (FEI); the Financial Analysts Federation (FAF, now the Association for Investment Management and Research, or AIMR), and the National Association of Accountants (NAA, now the Institute of Management Accountants, IMA). In 1976, the Securities Industry Association (SIP) joined this group of sponsoring organizations. Latest additions are the National Association of State Auditors, Comptrollers and Treasurers as well as the Government Finance Officers Associations. The Foundation's original trustees were the heads of three large national public accounting firms, two regional accounting firms, an investment banker, an accounting professor, and two executives from large US corporations. By the mid-1990, the number of trustees had risen to sixteen. Trustees tended to represent and promote the interests of their sponsors.

The central operating body of the new standard-setting system is the FASB. Its seven members are all salaried and serve full-time for five year terms with possible reappointment for a second term.[42] FASB's members usually are certified public accountants (CPAs) or experts from other relevant disciplines "who in the judgment of the trustees are well versed in problems of financial reporting."[43] They work with task forces of FASB employees and outside experts to draft standards.

FASB's mission, structure, operations, and relations with external groups are reviewed by the FAF every three to five years, typically generating recommendations for institutional and procedural changes. In response to such recommendations and earlier complaints about a lack of transparency and accountability, FASB has developed rules of procedure that are supposed to guarantee to all stakeholder an opportunity for participation and ensure due process for any proposals or objections they submit.[44] So-called "sunshine" reforms in 1977 increased public access to deliberations and to the records of FASB and its task forces and set up the regular publication of plans for technical projects.[45] Later changes in FASB's procedures have further enshrined many of the norms and practices of administrative law within this body of private governance, albeit sometimes against resistance (see below). Among these procedures are provisions for the publication of "discussion memoranda" and "exposure drafts" for comment before FASB's vote on the "final draft" proposals.

The third institutional pillar of the new standard-setting scheme is the FASAC, designed to be broadly representative of groups interested in or affected by accounting standards.[46] Meeting on a quarterly basis, its members—also selected by the FAF—liaise with FASB on

[42] Each member has to sever all connections with prior employers and to divest him/herself of all investments or other financial arrangements that might create conflicts of interest.
[43] Bylaws of the Financial Accounting Foundation, chapter A, Article II-A, section 2, 1973. The members of the first Board included the president of AICPA and three senior accountants from Haskins&Sells (now part of Deloitte&Touche), Price Waterhouse, and Peat, Marwick, Mitchell&Co. The other three members were a former chief of the office of Accounting and Finance or the Federal Power Commission, a comptroller of Exxon Corporation, and an accounting professor. The current board consists of five accountants (including on with past positions in investment banking and as a business school professor of accounting), one former comptroller of a major oil corporation, and one accounting professor (see http://www.fasb.org/facts/bd_members_staff.shtml, accessed 26 August 2004).
[44] Stephen Mezias and Seungwha Chung, *The Process and Participation at FASB: A Study of the Comment Period.* Florham Park, NJ: Financial Executives Research Foundation, 1989; and Miller, Redding, and Bahnson1998 (supra at 39).
[45] Other changes included changing the voting rule for adoption of FASB standards from supermajority of 5-2 to a simple majority of 4-3 (requirements for passing proposals changed several times over the last three decades; see below), placing a limit on annual contributions from any given firm, doubling the technical staff and consolidating the staff in a single Research and Technical Activities Division.
[46] FASAC was originally comprised, in 1973, of some 20 experts from the fields of finance, accounting, industry, education, banking, and the legal profession. By the 1990s, FASAC counted about 30 members (see http://www.fasb.org/fasac/fasacmem.shtml), with representatives of "preparers," i.e., publicly listed companies, accounting for about half of the FASAC members (Miller, Redding, and Bahnson (supra at 39) 1998:43.

technical issues. The FASAC has to be heard, but its requests and recommendations need not be taken into account, and—in contrast to the procedural standards of contemporary administrative law—FASB need *not* explain any decision not to take them into account.

The post-1972 structure of U.S. accounting standards setting was, in effect, a bold experiment in self-regulation, which—like any form of administrative governance—has both legislative and judicial qualities.[47] It also closely resembles the principal-agent model developed above: The key body of the new scheme, FASB, may be understood as an agent with two principals: on the one hand the FAF which funds FASB and selects its members, and on the other hand the SEC, a public regulator whose grant of authority confers upon FASB standards the weight of federal law. FASB (and its public principal, the SEC) operates in an issue space populated by three main groups of stakeholders: business, accountants, and investors.[48] Each group is bound to be divided over some issues, but on many other aspects of accounting standards the members of each group have a coherent ordering of preferences, which allows us to treat each group analytically as a single actor. The hypotheses derived in our theoretical section should be most apparent when the three major groups have diametrically opposed preferences over a particular issue in accounting standards and standardization, leading to tensions and sometimes open conflicts over the control of private-sector rulemaking. To the extent that they are able to overcome their collective action problems, we should see any group use their available means to put pressure on FASB as well as the principals to push their agendas. Yet, we should see the business constituency, i.e. corporations preparing and issuing financial statements, being more influential than the other groups because it is business that provides financial and operational viability to the agent, FASB, via its private principal, FAF. Business thus resembles SH1 in our model above.

How do FASB's dual loyalties affect its operation and institutional structure? The following subsections will address this question by explaining the competing pressures on FASB and the principals, including changes in the specific preferences of the FASB and its principals, and the relationship between agent and principals.

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[47] See Kingsbury, Krisch, and Stewart (supra at 3) 2005: I, p.4. The accounting standards setting process is legislative in that it establishes authoritative rules, consistent with a legislative mandate, and it is judicial because it interprets its own rules (see Robert van Riper, *Setting Standards for Financial Reporting: FASB and the Struggle for Control of a Critical Process*. Westport, CT: Quorum Books, 1994:178).

[48] Kirk, Donald. "Private Standard Setting and Public Accountability: Address to the Business Council, Hot Springs, VA, October 1979." *FASB Viewpoint* (November 9, 1979) and Miller, Redding and Bahnson 1998 (supra at 39).

3.2. FASB and Business Groups

The viability of FASB depends foremost on continuing support from business groups, and especially large companies with the requisite resources and expertise available within the firm. These groups willingly support FASB as long as it is effective in keeping government regulation at bay, and as long as they feel that their preferences are understood by the agent and acted upon.[49]

When business feels that FASB is out of step with its preferences, it criticizes FASB for allegedly being overly committed to theory at the expense of practicality and ease of implementation, working too slowly and on the wrong projects, producing rules that are too complex, and being insufficiently sensitive to the cost to business of new standards[50]

Business can resort to a variety of strategies to push its demands. For thirty years, the funding of FASB was raised by the FAF from voluntary donations. The bulk of this funding has until recently come from business groups. When dissatisfied with FASB decisions, business has often reminded the agent that FASB's continuing financial viability depended upon business' continuing contributions. However, this financing arrangement has now changed. In the wake of recent accounting scandals, questions were raised in Congress and beyond about the impact of the funding structure on the independence of FASB as a regulatory agent. In August 2003, a new funding structure, initiated under the Sarbanes-Oxley Act, was implemented.[51] Under the new scheme, FASB's budget is paid by mandatory contributions of some 7,500 publicly listed companies. This change from voluntary to mandated funding has removed one important means of pressure from business.[52]

The business constituency also relies, for example, on the services of the Business Roundtable, an influential and by-invitation-only lobby group whose members are about 150 (current and some former) chief executives of the largest U.S. companies across industries and geographic regions. The Roundtable, founded in 1972, established in the late 1970s an Accounting Principles Task Force (APTF, today part of the Roundtable's Corporate Governance Task Force), made up of heads of major companies with a special interest in accounting matters.

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[49] Miller, Redding and Bahnson 1998 (supra at 39); Minard, Laurence, "Lower the Red Flag?" *Forbes* vol.121 no.12 (June 12, 1978): 95.
[50] Miller, Redding and Bahnson 1998 (supra at __); Van Riper 1994.
[51] See Sarbanes-Oxley Act of 2002, Public Law Number 107-204 (July 30, 2002).
[52] Several private-sector players interviewed have expressed concern that the new funding structure may move FASB closer to government and make is more susceptible to political interference.

APTF has sought to influence the work of the FASB through the business representatives among the trustees of the FAF—FASB's private principal. In theory, the bylaws of FAF prohibit trustee interference in technical and agenda decisions of the standards setters; in practice, however, such influence attempts do happen and tend to be successful.[53] APTF may also air its views in meetings with the SEC or push its agenda on Capitol Hill in the hope that concerted political action may sway reluctant FASB members.[54]

Finally, besides lobbying and threat strategies, business can seek to influence the making of standards via the normal due process, in particular through input in the public hearings/consultations that are part of the standardization process.[55] In fact, the FASB relies on expert input for its operational viability at that stage. Large corporations have the necessary resources, including technical expertise and organizational structure to be actively involved, and industry groups contribute an average of 60 to 65 percent of responses to FASB discussion memoranda and exposure drafts. On certain projects more than 80 percent of the submissions at the consultation phase come from large firms and industry associations. Their representation at public hearings is also in the 60 to 70 percent range.[56]

Considering the extensive resources and expertise as well as the privileged access of business to FASB, it is not surprising that it has been quite successful over the years in influencing the procedures and substantive output of the standards setter. Industry groups have succeeded, for example, in having standards cancelled or restated. A case in point is a FASB accounting rule for the translation of foreign currency transactions and foreign currency financial statements, which came into effect in 1976. Siding with the clearly stated preferences of investors and financial analysts, the new FASB standard required that exchange gains and losses resulting from translation be taken into income in the current period and not be deferred. Monetary assets and liabilities such as cash, receivables, and payables would be translated at the foreign exchange rate in effect when balance sheets were prepared, and other assets and liabilities would be translated at the rate in effect when the assets were acquired or the liabilities incurred.[57] Firms with high levels of foreign market exposure strongly opposed this standard

53 Van Riper 1994:169f
54 Miller, Redding and Bahnson 1998 (supra at __)
55 Miller, Redding and Bahnson 1998: esp. 67ff (supra at __)
56 Sampson, Clarence. "The 'Process' in Due Process: A Behind-the-Scenes Look at Standards Setting." FASB Viewpoint (Oct. 14, 1991): 4-6.
57 Van Riper 1994:32.

because it introduced what they considered excessive earnings volatility. Large firms were united in their position on this issue, and smaller listed firms with no foreign exchange exposure were indifferent, allowing business opponents of the new standards to forge a unified 'business' position on this issue. Working through FAF and through lobbying groups, they put pressure on FASB to withdraw or change the standard until FASB announced in 1979 that it was working on a new standard that later replaced the 1976 rule.

Business groups have been successful not only in shaping the content of accounting rules; they also have left their imprint on the institutional structure and mode of operation of standard-setting in accounting. Several examples are noteworthy: 1) In response to business' complaints that it was working on the wrong projects, FASB established in 1984, at the urging of FAF, the Emerging Issues Task Force (EITF) to help it identify new trends and address new problems, providing firms greater influence on FASB's agenda. 2) Under pressure from business for more "pragmatism" and "practicality" on the part of FASB, the FAF trustees agreed in the 1990s to increase from one to two the number of FASB members who are direct representatives from the corporate world . Business also secured an additional place among the Foundation trustees.[58] 3) Similarly, when a FASB member was up for re-election in 1990, business lobbied successfully to prevent his reappointment.[59] 4) The bylaws of the FAF explicitly prohibited interference with FASB technical or agenda decisions. A 1991 revision, however, opened the possibility that the trustees may "provide advice and counsel" to FASB on specific items. The trustees exercised this provision, for example, in a 1992 meeting, in response to fierce opposition by the Business Roundtable and other business organizations to FASB's proposal for the expensing of stock options. In view of a unified position of the business community, the trustees urged members of FASB to drop their proposal—successfully: The FASB abandoned its proposal for expensing stock options.[60] 5) Finally, in the mid-1980s, a period of general deregulation, corporate

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[58] The new chairman was Dennis Beresford. Art Wyatt resigned one year later from the Standards Board charging that the trustees were giving undue prominence to the views of preparers of financial information at the expense of users.

[59] The name of the Board member was Arthur Northrop. Miller, Redding, and Bahnson (1998:183) sum up the episode as follows: "Northrop's reappointment was not supported by the Financial Executives Institute because he had gravely disappointed leaders of the preparer constituency by not always taking positions on the issues that they expected, despite the fact that he had spent more than 40 years with IBM. This decision is significant because it shows that the trustees were again willing to use their appointment powers to try to shape the outcome of the Board's process to meet their own needs."

[60] Ten years later, after the Enron debacle, FASB felt time was right for resuscitating its stock option project, resulting in the December 16, 2004 revision of the U.S. accounting standard for "Share-Based Payments" ("Statement 123(R)"; see http://www.fasb.org/news/nr121604_ebc.shtml), which requires the expensing of stock options. This time business was less unanimous in opposing the project. Nevertheless, IT firms, in particular, have mounted a strong lobbying campaign against the project. As a result, the House of Representatives passed in July 2004 the Stock Options Accounting Reform Act (H.R.3574) that would override the standard setter by limiting options expensing to the five most highly paid executives. The Senate referred the bill

America felt that it was high time to curb what it viewed as rampant standard setting,[61] by changing the voting rule in FASB from simple majority back to supermajority to make it more difficult to adopt new standards. The trustees complied and voted by 11-5 to change the voting requirement.[62]

Notwithstanding all of these episodes where business succeeded in getting its way at FASB, it would be wrong to jump to the conclusion that accounting standards setting simply boils down to business capture of a private-sector regulator. As we argued in section 2.2, the delegation relationship is embedded in a broader political and economic context that affects and shapes this relationship. Changes in this macro-political context may change perceptions of the proper balance of interest representation and thus the urgency of weighing competing interests differentially in the process of rulemaking and improving the effectiveness of mechanisms of administrative law in private governance. This logic is illustrated in the following section.

3.3. FASB and SEC

As noted above, the SEC is the public-sector principal of the FASB. It is charged with overseeing private-sector standards-setting activity, and legally has the power to revoke the FASB's mandate or override its standards and replace them with its own rules. The SEC also monitors compliance with FASB standards and is responsible for their enforcement. There is a close working relationship between the SEC (primarily the Office of its Chief Accountant) and the FASB. This relationship has been described by a long-time FASB staff member as follows:

> [A] close liaison was maintained between the two organizations…[T]heir staffs were in almost daily contact by telephone on a wide range of matters…[T]he

to the Committee on Banking Housing, and Urban Affairs, where it "died" when the committee did not take any action before the 108th Congress ended (http://thomas.loc.gov/cgi-bin/bdquery/z?d108:HR03574: (accessed 1/5/2005)). However, upon heavy lobbying of the S.E.C. by opponents of expensing, with support from a bipartisan group of members of Congress, FASB agreed to a 6 to 12 months delay before issuers of financial statements have to comply with the new standard. The political battle over stock option expensing in the U.S. may therefore be expected to continue for most of 2005 (See Floyd Norris, "Audit Board Delays Rule on Options As Expenses." *New York Times*, October 14, 2004: C1 (late edition); Gary Rivlin, "Senators Lobby S.E.C. Chief to Delay New Options Rule." *New York Times*, October 8, 2004: C3 (late edition); and Gary Rivlin, "Regulators Adopt Tighter Rules on Accounting for Stock Options." *New York Times*, December 17, 2004: C5).

[61] Interview with former FASB official.

[62] As noted above, the rule had been changed in the late 1970s from supermajority to simple majority. The supermajority requirement had been recommended by the Wheat Committee, which was at the origin of the new scheme of standard-setting in accounting, on grounds that it would reduce the likelihood of controversial rulings which may not enjoy wide support. The change to simple majority in 1977 was justified in terms of speeding up the process of establishing standards and creating less scope for compromising on the substance of a standard (see Financial Accounting Foundation. 1989. "The Structure of Establishing Financial Accounting Standards: Report, 26 January 1989." Norwalk, CT: FAF: 8). Revealingly, in the wake of the Enron scandal of 2001 the FAF decided to move back to simple majority. The FASB had come under heavy criticism for being slow to act and failing to adopt rules that would have tightened the criteria for keeping so-called special purpose entities off corporate financial statements.

> [SEC] chief accountant participated in meetings of the Advisory Council…and [FASB] and the Commission held periodic joint meetings…to discuss matters of mutual concern. In addition, the respective chairmen met informally as circumstances required.[63]

Operationally, however, FASB depends little on the SEC. The FASB staff has grown from a mere eight in 1973 to about 85 by the mid-1990s; over the same period—a period of greatly increased complexity of accounting matters—the staff in the Office of the SEC's Chief Accountant remained more or less steady, fluctuating around 25. The staff of FASB is thus more than three times as large as that of the SEC Chief Accountant's Office, making any suggestion by the SEC that it might re-appropriate standards setting (beyond the details of a particular measure) an empty threat. At current levels of Congressional funding for the SEC, it has neither the expertise nor the capacity to take on standards setting, as it is hardly able to fulfil its monitoring and enforcement mission (interviews with current and former SEC staff).

Further, FASB pays (private-sector) salaries that are much higher than those offered to SEC staff.[64] The considerably better pay has tended to attract more accounting talent to the FASB than the SEC. As Miller, Redding, and Bahnson put it:

> Although working at the SEC may provide an intangible benefit from performing a public service, it seems unlikely that the [SEC] would be able to consistently locate, hire, train, and retain people whose talents and backgrounds are equal to those of the people at the FASB and who are also willing to make a long-term commitment.[65]

The higher level of expertise at FASB should objectively improve the technical quality of the standards and the efficiency of standards setting, as we argued in section 2. Yet, it also has the effect that SEC employees at the highest level on occasion encounter their superiors from former private-sector jobs as the FASB members or FASB senior staff whose work they are now supposed to oversee (interviews at SEC and FASB).

Arguably the most important role performed by the SEC staff is to feed back to FASB systematic data on enforcement problems with existing accounting standards or report

[63] Van Riper 1994:144. Van Riper worked for the FASB from 1973 to 1991.
[64] For example, in 1997, the SEC chief accountant earned $123,000 while Board members or FASB's director of research and technical activities earned $345,000. The salaries of the SEC Chief Accountant's professional staff ranged from $47,180 to $99,250, whereas FASB project managers earned between $80,000 and $125,000 (Miller, Redding, and Bahnson 1998:158).
[65] Miller, Redding, and Bahnson 1998:158.

difficulties that SEC registrants may experience in implementing specific FASB rules.[66] Such information assists the agent in revising and improving its standards. The SEC, however, rarely tells FASB what items to work on. For the most part, the flow of information is from FASB to the SEC. FASB keeps the SEC informed of new projects, but it depends on the SEC neither for guidance nor expertise. Whereas the early and untested FASB still had to fight turf battles with the SEC, it has over time established itself quite unambiguously as the focal U.S. institution for rule-making in accounting.[67]

3.4. FASB, SEC, and the Accounting Standards Stakeholders in the Macro-Political Context

Our account of the relationship between FASB and the SEC would be incomplete, however, without considering the role of exogenous analytical factors, chiefly the macro-political context. Three main groups have a stake in accounting standards: the business firms that issue financial statements (analyzed in more detail above), the users of such statements (mostly investors), and the accountant or "preparers." All three of these groups operate within a broader macro-political context, which affects their relative power. The weight given to the concerns of the first group of stakeholders (i.e., business) vis-à-vis the concerns of the second group (i.e., investors), for instance, is partly a function of more general politically salient attitudes toward regulation.

The SEC as a politicized regulatory agent is bound to be attentive to this broader political context. The President appoints the five Commissioners (subject to Senate confirmation and the restriction that no more than three of them may be of the same political party). At least a majority of the Commissioners therefore tend to share the policy views of the current administration (though they may differ on specifics), and Congress oversees the SEC, holding it accountable as it sees fit.[68] The SEC's approach to regulatory matters, including accounting standards setting, is therefore very much a function of the mood of a period reflected in specific political and economic realities. As a result, SEC demands and expectations of FASB are likely

[66] Note, however, that FASB staff may learn of enforcement and implementation problems also directly from interactions with its constituents.
[67] Schuetze, Walter. 1978. Reflections of a Former Member of the FASB (with comments, The Rise of 'Economic Consequences' by Stephen A. Zeff). Stanford: Graduate School of Business.
[68] See, for example, Khademian, Anne M. The SEC and Capital Market Regulation. Pittsburgh: University of Pittsburgh Press, 1992:35f; Schwartz, Bernard, ed. 1973. The Economic Regulation of Business and Industry: A Legislative History of U.S. Regulatory Agencies. 5 vols. New York: Chelsea House Publishers, 1973:2679ff.

to vary over time. The election of President Ronald Reagan, for instance, institutionalized a change in the macro-political climate in favor of deregulation and economic laissez-faire. Among Reagan's first appointments was a new SEC chairman, John Shad, who had a far less activist attitude than his predecessor Harold Williams. Shad, in turn, filled the chief accountant's position with Clarence Sampson, who largely left FASB to its own devices.[69] Unsurprisingly, it was especially during the Reagan and Bush (Sr.) presidencies that business solidified its control over FASB. Such influence is not undisputed: Dennis Beresford, FASB chairman from 1987 until 1997, steadfastly denied that the corporate community had gained influence over the FASB's deliberations on technical issues. A FASB insider, however, commented in 1994: "In a literal sense, in terms of FASB's painstaking consideration of the details of any given issue, [Beresford] is right. But in terms of the *overall balance of power* in the standard-setting structure, the atmosphere in which the standard setters work, and the trend lines and fault lines that are developing, he is overlooking some stark realities."[70]

Occasionally, individual members of Congress have criticized what they perceived as excessive business influence in private rule-making. Representative John Dingel (D-MI), for example, former chairman of both the House Committee on Energy and Commerce and its Subcommittee on Oversight and Investigations, wrote in the mid-1980s to the SEC chairman advising him of the subcommittee's expectation that the SEC use its power to shield FASB from what he called "improper influence" by the business community. A few years later, during the (first) battle over how to account for stock options, the chairman of the House Subcommittee on Telecommunications and Finance, Representative Edward Markey (D-MA), deplored business' "ferocious hardball tactics and not-so-subtle threats" to FASB and went on to note:

> The federal government allows the accounting profession to establish its own rules and standards, with limited federal oversight, because it has been promised that the profession can do so objectively and responsibly…The…reported threats raise serious doubts about the wisdom of delegating such broad and important responsibilities to the accounting profession in the first place.[71]

More generally, Dingel, Markey, and a few others felt that the interests of users of financial information (investors, creditors, and others) were being overlooked. Such users

[69] Miller, Redding, and Bahnson 1998:102f.
[70] Van Riper 1994:170; see also Gerboth, Dale. 1973. "Research, Intuition, and Politics in Accounting Inquiry." *Accounting Review* vol.48 no.3 (July 1973): 475-482.
[71] News release issued by Representative Edward Markey's office, April 7, 1993; quoted in Van Riper (1994): 155.

typically want a maximum of disaggregate, detailed, reliable, and relevant information. From their perspective, standards should achieve maximum disclosure of firms' assets and liabilities and present them in a consistent, easily accessible format. Users also favour a transparent and broadly-inclusive process of standardization. Investors and other users, however, are disadvantaged vis-à-vis reporting business firms not only because they have fewer resources and tend to be less well organized as a group, but also because the delegation to a private agent puts them in a less favourable position to influence the process of standardization.

Accountants responsible for auditing the books of firms are the third main group with a stake in standardization. Generally, they are inclined to want more standards, and more specific ones, which will defuse differences of opinion with clients. At the same time, however, accountants depend on firms for audit engagements, and until recently increasingly also for various forms of consulting work.[72] Though they pride themselves on their analytical abilities and professional objectivity, they may be tempted to take on a less stringent and more compromising approach, especially in a highly competitive environment. And there is little doubt that the environment for consulting became markedly more competitive in the second half of the 1980s and throughout the 1990s, thus making auditors much more pliant to the wishes and demands of business firms.[73]

For all these reasons, politicians such as Dingel and Markey demanded that standardization be taken over by the SEC or by a congressionally mandated "self-regulatory organization" under the control of the SEC, for example, along the lines of the municipal Securities Rulemaking Board, whose rules covering municipal bond trading are subject to formal approval by the SEC and official review by the three federal bank regulatory agencies prior to becoming effective.

These demands, however, fell on deaf ears in a macro-political climate of deregulation and unbridled faith in market forces—until a series of major corporate accounting scandals, coupled with a marked cooling of the economy, dramatically changed the mood of the time,

[72] The Sarbanes-Oxley Act restricted the kinds and amounts of non-audit work that can be done by the same accountants who work as auditors for a given firm. See Sarbanes-Oxley Act of 2002, §201 and Regulation S-X (17 CFR 210) Art.2 Rule 2-01, as updated by SEC Release No. 33-8183, effective 6 May 2003 (current version at http://www.sec.gov/divisions/corpfin/forms/regsx.htm; accessed 25 Jan 2005).

[73] Stevens, Mark. 1981. *The Big Eight*. New York: Macmillan; idem, 1985. *The Accounting Wars*. New York: Macmillan; Stevens, Mark and with Carol Bloom Stevens. 1991. *The Big Six: The Selling Out of America's Top Accounting Firms*. New York: Simon & Schuster.

invigorating the SEC to take on a more activist role.[74] In a speech notable for its directness and forceful tone, SEC Chief Accountant Robert Herdman noted in 2002:

> [E]ven before Enron's collapse, we called upon the FASB to work with us to address concerns about timeliness, transparency, and complexity…Going forward, we plan to make some *changes to the historical way in which we have delegated our authority to oversee the standard-setting process*…We plan to 1) broaden funding sources and make the funding involuntary, 2) meaningfully participate in selecting of the members of FASB and setting the FASB agenda, 3) exercise our authority to review standards actually adopted, and 4) ensure that the FASB promulgates principle-based standards, which adapt faster to changing business environment and emphasize overall accuracy and completeness.[75]

The SEC's first new objective has been attained. As mentioned above, under the Sarbanes Oxley Act, FASB now receives mandated funding from public companies.[76] Commenting on the funding change, Robert Herz, new FASB chairman since 2002, spoke words that in the pre-Enron era would have struck many within the private-sector standards community as pure heresy: "[W]e need the support, understanding, and partnership of politicians and government officials in helping [to] ensure that accounting standard setting is not subject to inappropriate constituent influence. And indeed, I believe that a clear aim of Sarbanes-Oxley in trying to bolster the financial security of the FASB through the mandated funding was to help ensure that our standard setting is carried out in an independent, objective, and neutral way. That's a tough one for some people to understand and even tougher for some to accept."[77]

Progress on Herdman's other objectives is less certain. In particular, it is unlikely that much will change in the scope and intensity of SEC oversight given the continuing asymmetry of resources and staff between FASB and the Office of the SEC Chief Accountant. While the staff of the latter has increased since the passage of the Sarbanes-Oxley Act, so have the tasks that the Office is asked to tackle. They include not only keeping an eye on private-sector standards

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[74] Stiglitz, Joseph. 2003. *The Roaring Nineties: A New History of the World's Most Prosperous Decade.* New York: W. W. Norton & Company, esp. 115ff, 241ff.

[75] Herdman, Robert. "Moving Toward the Globalization of Accounting Standards." Speech delivered at the Schmalenbach Institute for Business Administration, Cologne (Germany), 18 April 2002. Available at: www.sec.gov/news/speech/spch554.htm (accessed 16 July 2004), emphasis added. Herdman reiterated the main points in Congressional testimony, see (U.S. House of Representatives 2002a; also online at www.sec.gov/news/testimony/021402tsrkh.htm (accessed 16 July 2004)).

[76] Note that a similar arrangement exists in Britain where the Financial Reporting Council, which is responsible for setting and enforcing accounting rules, draws its corporate funding from a levy applied by the Financial Services Authority, the main financial regulator.

[77] Herz, Robert. "The Financial Reporting Partnership." Speech to the American Institute of Certified Public Accountants, 12 December 2003. At www.fasb.org/herz_aicpa_12-12-03.pdf (accessed 26 Aug. 2004).

setting, but also working to improve the implementation, auditing, and enforcement of accounting standards.

Nonetheless, the change in the macro-political climate post-Enron has triggered a series of notable additional institutional changes of FASB, aimed at improving its due process. In the summer 2002, for example, the FASB sent letters to chief executive officers of mutual funds, investment and commercial banks, rating agencies and other user groups, inviting them to join the newly-created User Advisory Council (UAC). The UAC, whose purpose is to offer user-groups a direct channel of communication with the Board, has now about forty members. It meets twice a year with the Board. Another outreach initiative is the creation in 2004 of the Small Business Advisory Committee (SBAC). Participation of small business firms has traditionally been rare, either because it was simply too costly or because of weak organizational support structures and collective action problems plaguing small firms. SBAC, which meets twice yearly with FASB, is meant to overcome some of these difficulties and give small business a voice in the process of rule-making in accounting. Finally, it also is notable that the FASB has agreed to return to majority decision rule to improve the speed with which accounting standards are adopted.

4. Implications for Global Private Governance in Accounting

The IASB has been in existence for four years now—too short a period for systematic study. Nevertheless, drawing on the preceding analysis, we will seek to elaborate here the implications for the international experiment in private rule-making in accounting. We thus will first clarify the identity of both agent and principals at the global level, and, second, determine how and to what extent differences in P-A relationships between the US and the international cases are likely to affect the conclusions reached in the preceding section.

4.1. An International Private-Sector Scheme for Setting Standards in Accounting

As previously mentioned, the international institutional scheme for setting accounting standards closely follows the structure of the American model. It comprises four major bodies:

the trustees, the IASB, the Standards Advisory Council (SAC), and the International Financial Reporting Interpretations Committee (IFRIC).[78]

Ensuring the viability and providing general oversight of the international private accounting standards setter is the responsibility of the nineteen trustees of the International Accounting Standards Committee Foundation (IASC).[79] They appoint the members of the IASB, the Standards Advisory Council, and the IFRIC. They also monitor the IASB's effectiveness, raise funds for the IASB, approve its budget and are responsible for constitutional changes. The International Federation of Accountants nominates candidates to fill five of the nineteen trustee seats; international organizations of preparers, users and academics may each select one representative.[80] The remaining eleven trustees are 'at-large', that is, they are not selected through a constituency nominating process but chosen based on recommendations of individual trustees.

The IASB has fourteen members (twelve full-time and two part-time members), appointed by the IASC Foundation trustees. The Board has sole responsibility for setting accounting standards. At least five Board members must have a background as practicing auditors, three as preparers of financial statements, and another three as users of financial statements. One Board member hails from academia. Seven of the full-time members have formal liaison responsibilities with national standard-setters in order to promote the convergence between national and international accounting standards (but they cannot be voting members of the national standard-setting bodies).[81] Each Board member has one vote, and a simple majority of eight votes is required for the adoption of a standard.

The Standards Advisory Council is formally charged with commenting on IASB projects and giving advice to both trustees and Board members. SAC is geographically diverse and has

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[78] See www.iasb.org; see also Kristina Hallstrom, *Organizing International Standardization* (Cheltenham, UK: Edward Elgar Publishing, 2004. On international accounting standards, see Hennie Van Greuning and Marius Koen, *International Financial Reporting Standards* (Washington: World Bank Publications, 2004); Barry Epstein and Abbas Ali Mirza, *Wiley IFRS 2005: Interpretation and Application of International Accounting and Financial Reporting Standards* (New York: Wiley, 2005); and Clare Roberts, *International Financial Reporting: A Comparative Approach* (London: Prentice Hall, 2005).

[79] The foundation is a not-for-profit corporation registered in Delaware.

[80] These organizations include the International Association of Financial Executives Institutes, the International Council of Investment Association, and the International Association for Accounting Education and Research.

[81] The national standard-setters are the FASB, the British Accounting Standards Board (ASB), the Canadian Accounting Standards Board (AcSB), the Australian Accounting Standards Board (AASB), the French Conseil Nationale de la Comptabilité (CNC), the German Accounting Standards Committee (DRSC), and the Accounting Standards Board of Japan (ASBJ).

about fifty members, predominantly from industry and the accountancy profession. Its members are appointed by the trustees for a renewable term of three years. SAC meets three times a year.

The IFRIC, finally, is responsible for reviewing accounting issues that are likely to receive divergent treatment in the absence of authoritative guidance. It has twelve voting members and a non-voting chairman. IFRIC interpretations are valid only if approved by the IASB.

The process of developing standards typically follows four steps: 1) During the early stage of a standard project, the IASB may establish an advisory committee headed by a Board member to provide advice on the issue arising in the project. SAC may also be invited to offer comments. 2) On major projects, IASB publishes an initial discussion paper for public comment. 3) Upon reviewing the comments, IASB issues an 'exposure draft' for public comment. 4) After considering the comments, IASB publishes the final standard.

In sum, the key institution of the new international accounting standards-setting system is the IASB; it is the agent in charge of setting standards. Its private-sector principal is the board of trustees of the IASC Foundation whose membership comprises mostly representatives from the accounting profession and industry.

4.2. Endorsement by Public-Sector Principals

Who are the public-sector principals of the IASB? Unlike in the US case where the sole public-sector principal is the SEC (which has conferred regulatory authority upon the FASB), no single international governmental organization (IGO) possesses exclusive jurisdiction in accounting. Instead, several major IGOs claim interest and responsibility in the area of financial reporting; and over the past ten years, many of these IGOs have come to endorse the IASB (and its predecessor, the IASC), thereby committing themselves to accept international accounting standards as binding rules.

For example, the WTO stated at the conclusion of the Singapore Ministerial Meeting of 1996 that "[w]e encourage the successful completion of international accounting standards…by the International Federation of Accountancy (IFAC)… [and] the International Accounting

Standards Committee."[82] Joel Trachtman has argued that this statement signals the WTO's deference and in effect delegation (at least in part and in political terms, as opposed to legal terms) to these organizations.

> The WTO thus has…'delegated' to specific functional organizations the task of establishing standards to facilitate the free movement of accountancy services. This particular delegation is not inconsistent with prior practice in other areas, such as food safety standards (Codex Alimentarius Commission) and general product standards (ISO). We begin to see some evidence of a common institutional solution to [trade problems] utilizing informational 'delegation' to specialized functional organizations. The further question, however, is how will the WTO [and its member states] ensure that these organizations reflect appropriately the trade perspectives that concern the WTO? This is an agency problem… [H]ow can the WTO ensure that [these functional organizations] are faithful and diligent agents?[83]

Another critical endorsement for the IASC came in 1995 when an agreement was reached with the International Organization of Securities Commissions (IOSCO) committing stock market regulators to endorse a set of 'core standards' when completed in 1999.[84] In 1998 the G-7 Finance Ministers and Central Bank Governors issued a declaration similarly endorsing the work of the IASC and calling on the committee to "finalize by early 1999 a proposal for a full range of internationally agreed accounting standards."[85] This and other statements by institutions such as the World Bank, IMF, and the Basle Committee on Banking Supervision (BCBS),[86] as well as endorsing legislation by powerful groups such as the European Union,[87] have provided the IASB/IASC with an implicit but nevertheless firm mandate to produce global financial reporting rules. As a result, not only has the pace of standards production increased rapidly, but the

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[82] World Trade Organization, Singapore Ministerial Declaration Adopted on 13 December 1996, WT/MIN (96)/DEC, para. 17. The IFAC writes auditing standards only.

[83] Joel Trachtman, *A Sectoral Analysis of Disciplines on Domestic Regulation and International Standard-Setting in Financial Services* (June 7, 2002), mimeo. See also "World Trade Organization supports IASC standards," *Management Accounting: Magazine for Chartered Management Accountants* 75, 2, February 1997, p. 3.

[84] Under the agreement, IOSCO was allowed to monitor the IASC standard-setting process both as a non-voting observer at steering committee and Board meetings. The IOSCO lived up to its commitment and agreed in 2000 to back international accounting standards (IASs) for cross-border offerings and listings.

[85] G-7, "Declaration of G-7 Finance Ministers and Central Bank Governors," 30 October 1998; see also G-7, "Final Report to the G-7 Heads of State and Government on Promoting Financial Stability," 21 June 1997; and G-7, "Strengthening the Architecture of the Global Financial System: Report of the G-7 Finance Ministers to G-7 Heads of State or Government for their meeting in Birmingham, May 1998," 15 May 1998.

[86] See IMF, "Report of the Management Director to the Interim Committee on Progress in Strengthening the Architecture of the International Financial System," 26 April 1999; The World Bank, *Financial Accounting, Reporting and Auditing Handbook*, Washington, DC, January 1995; James Wolfensohn, "Accounting and Society: Serving the Public Interest," remarks to the World Congress of Accountants, Paris, 26 October 1997; Basle Committee on Banking Supervision, "Report to G-7 Finance Ministers and Central Bank Governors on International Accounting Standards," April 2000; and Financial Stability Forum, "Issues Paper of the Task Force on Implementation of Standards," presented at the FSF meeting on 25-26 March 2000. The World Bank now includes IASs as a condition of its loan agreements.

[87] The EU has adopted regulation requiring listed companies to prepare consolidated accounts in accordance with IASs by 2005.

number of countries with stock listing requirements or national securities legislation permitting foreign companies to prepare their consolidated financial statements using international accounting rules has also grown steadily.

4.3. Principal-Agent Relationships in the International Context

Faced on the one hand with multiple public-sector principals (the IGOs) and on the other with a private-sector principal (the trustees of the IASC Foundation), to whom will the IASB listen most closely?

We have argued above that the agent's behaviour will diverge from principals' preferences as a function of the tightness of the P-A relationship between each of the principals and the agent. In addition, we hypothesized that the relative influence of principals will depend on the relative importance of the principals for the agent's financial and operational viability as well as effectiveness in rule-making, given the macro-political context. Let us consider each of these factors in turn.

Funding for the IASB comes largely from voluntary business contributions, which is similar to the situation in the US prior to the Sarbanes-Oxley Act of 2002. The IASB reported receiving in 2001 about $11 million from 125 companies, $5 million from the 'Big Five' accounting firms, and between $1million and $2 million from central banks and bodies such as development banks. In theory, the IASB's independence is ensured by the separation of the IASB from the fundraising. The FASB case suggests, however, that such separation fails to shield standard-setters in practice from considerable business pressure. Indeed, the chairman of the IASB, David Tweedie, complained only one year after the IASB was launched that certain powerful donors were threatening to withdraw their financial support and "perhaps [even] destroy the organization" if IASB failed to show greater sensitivity to their policy preferences.[88] It thus appears that powerful firms will seek to trade big cash for favors as long as IASB funding is voluntary. This may come at the expense of the interests of investors and other stake-holders who favor detailed and transparent financial reporting. The US case suggests that alternative sources of funding are required to guarantee effective independence. One possible arrangement would be for securities regulators in countries subscribing to IASB rules to add a levy to their

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[88] Andrew Hill and Andrew Parker, "Standard-Setters Are Targeting Stock Options Again," *Financial Times*, November 11, 2002, p. 21.

listing fees; another is for the IASB to be funded via contributions from central banks, financial services regulators, and governments. The risk with the latter option, however, is that it may expose the IASB to political pressure.

The viability of IASB, like the viability of FASB, is not simply a function of financial resources; it also involves *operational* viability for which the agent needs to rely on specialized expertise. Like in the American case, technical expertise at the international level resides primarily in the private sector. However, such expertise is unevenly distributed geographically, introducing a major regional bias. At the global level, it is the Americans and British who arguably have the most extensive experience writing rules for national capital markets – the world's largest such markets. Indeed, the US capital market alone accounts for half of the world's capitalization. Unsurprisingly, accounting expertise for writing standards for corporate financial statements is heavily concentrated in the Anglo-Saxon world.[89]

This striking regional asymmetry in expertise and resources is, in part, the consequence of fundamental differences between the Anglo-Saxon model of accounting and the continental European tradition. They reflect differences in the legal system, the relative importance of capital markets, and the role of government in capital and other markets. In the US and UK, where stock markets have long been the main source of capital for firms, the needs of investors have been a main consideration in the development of accounting standards. The elaboration of standards has been delegated by public regulators to the private-sector, specifically, the accountancy profession. In most continental European countries, the main purpose of statements of accounts has been tax collection and the protection of creditors. The basis of accounting thus tends to be highly legalistic. Private shareholding has long been much less widespread than in the Anglo-Saxon world; individual investors traditionally have preferred bonds to equity. The key providers of capital have traditionally been banks. These financial institutions are often represented on the boards of companies in which they are significant investors. As such they are assumed to be

89 The accountancy profession in the UK dates back to 1854 (when the Society of Accountants was founded) and in the US to 1887 (when the American Institute of Accountants was established). The German profession dates only from 1932, and the French from 1942. According to Stewart Hamilton, for example, the US counted in the early 1990s over 260,000 certified public accountants and the UK some 100,000 chartered members of accountancy bodies; in France and Germany the figures were 11,000 and 5,000 respectively. Though the distribution of accounting expertise is undoubtedly skewed, these numbers may exaggerate the difference by not considering that the various functions of accountants in the US are fulfilled by several different professions in some other countries (such as Wirtschaftsprüfer, Steuerberater, and tax lawyers in the German context); see Stewart Hamilton, *Financial Times*, March 20, 1998, 12.

privy to insider information; legal disclosure requirements are therefore of less importance to them than to American or British holders of financial securities.

In short, in the continental European tradition the dominant concern is taxation and the protection of credit institutions, not the provision of information for investors. Accounting principles are enshrined in tax laws which are the products of democratic political processes; by contrast, in the Anglo-Saxon model, accounting rules result from private-sector processes funded by industry.[90]

The contest between these two models (which incidentally also is a contest for international relevance and salience of the technical expertise that support the competing models) seems to have been decided in favour of market-oriented reporting. This is in no small part due to major European corporations, who – to tap into the vast US capital market - have accepted listing requirements of the New York Stock Exchange (NYSE), most notably compliance with the US Generally Accepted Accounting Practices (GAAP) produced by the FASB. The motivation for cross-border listings is straightforward: such listings broaden a firm's financial options, often allowing it to raise more capital and on better terms than in the home market; they also broaden the shareholder base, spreading financial risk for firms; last but not least, they add an element of prestige and recognition to a firm's name.[91] The first major European corporation to embrace US accounting rules and list on the NYSE was Daimler-Benz in 1993. When it broke ranks, many Europeans regarded the move as treachery.[92] The lure of the US capital market, however, seemed irresistible and soon other major European firms jumped on the US GAAP

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[90] Inevitably, differences in philosophies and general principles underlying accounting standards lead to fundamental substantive differences in the treatment of many economic activities (such as mergers, pensions, leases and changes in the value of financial instruments). Consider the following example: income taxes in Germany are based primarily on externally reported accounting profit, so there are strong legal and economic pressures to report income and asset values conservatively. Consequently, German accounting standards require that allowance be made for all possible losses. Management has considerable flexibility in determining the appropriate allowance. Specifically, transfers to and from reserves need not be disclosed. Thus if a firm wants to report an increase in income it can charge some expenses against reserves instead of against income without having to disclose such charge in the financial statements. Such practices are expressly prohibited in the US and UK where reserves can be set aside for identifiable probable losses and where transfers to and from reserves must be disclosed in the financial statements.

[91] Leonardo Martinez, "Private Expertise and Global Economic Governance: The Case of International Accounting Standards," M.Phil thesis, Department of Politics and International Relations, Oxford University, April 2001, pp. 54-56.

[92] Not only were they incensed by Daimler-Benz's willingness to adopt US GAAP, they were also troubled by its acceptance of the requirement to publish quarterly results. Few Germans understood the American fixation on earnings per share as a performance measure.

bandwagon, including Nestlé, Unilever, VEBA, Hoechst, Rhone-Poulenc, Olivetti, Peugeot, Citröen, and Volkswagen.[93]

Like FASB, IASB relies for its operational viability largely on the technical expertise of private-sector groups. Given the dominance and attraction for global business of the American and British capital markets, it is little surprise that Anglo-Saxon views weigh heavily in the process of shaping international accounting rules. One measure of Anglo-Saxon influence can be gleaned from the composition of the IASB in 2001. Five of the fourteen Board members were Americans. The US, UK, Canada, South Africa, and Australia together accounted for no fewer than ten members.[94] Considering that under IASB's rules the adoption of a standard requires approval by eight of the Board's fourteen members, Anglo-Saxon influence is dominant.

Finally, we argued above that while ensuring operational viability may be the agent's first concern, effectiveness as a regulator also needs to be a centrally important concern for the agent, that is, the regulator's ability to gain acceptance for and compliance with its standards. Attaining this objective does not seem to have been overly difficult for the IASB – despite its strong regional bias. In part, this is attributable to the multitude of public principals (IGOs) that endorsed the IASB. Lack of a single or primary public principal who could threaten IASB with re-negotiating the grant of authority, in a way in which this can be done domestically by the SEC, leaves the agent with greater freedom of action. The reason is two-fold: a setting of many public principals allows the agent to play one principal against another; and, second, such setting may give rise to the kinds of collective action problems that are familiar from the literature on multiple principals. Whose responsibility is it to monitor, reprimand, or punish the agent? These activities are costly in the sense of taxing already scare resources of IGOs, and they require

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[93] Foreign companies raised in 1990 $8 billion in the US; by 1998 the number had shot up to $170. See SEC Division of Corporation Finance, Statistical Report 1997 and SEC Annual Report 1998; see also Franck Bancel and Usha Mittoo, "European Managerial Perceptions of the Net Benefits of Foreign Stock Listings," *European Financial Management*, 7, no. 2 (June 2001): 213-236.

[94] The chairman is David Tweedie, former head of the British Accounting Standards Board; the vice chairman of the new Board is Thomas Jones, a British national who formerly was chief financial officer of Citicorp. The Board includes two accountants with long FASB experience: Anthony Cope and James Leisenring (a former FASB vice chairman) who is the official liaison Board member to FASB. The other liaison members to their respective national boards are Tricia O'Malley, former chairwoman of the Canadian Accounting Standards Board and KPMG partner; Hans-Georg Bruns of Germany, an official of Daimler Chrysler; Gilbert Gélard, a French partner of KPMG and former IASC Board member; Warren McGregor, a former chief executive of the Australian Standards Board of Canada; Geoffrey Whittington, an accounting professor at Cambridge University; and Tatsumi Yamada, a partner at the Japanese affiliate of PriceWaterhouseCoopers. The remaining full-time Board members are Robert Garnett, a South African and an executive of the minerals giant Anglo American, and Harry Schmid, a Swiss executive of Nestle. The two part-time members are Mary Barth, a Stanford University professor and former partner of Arthur Andersen, and Robert Herz, a partner at PriceWaterhouseCooper in New York.

technical expertise that IGOs may simply not possess. In other words, the presence of multiple principles translates into soft constraints on the IASB.

IASB regulatory effectiveness has also been boosted by an overriding preference of global firms for a single set of accounting rules. The European case is particularly instructive: After unveiling regulation requiring European firms to prepare consolidated accounts in accordance with international accounting standards, the EU insisted that it would retain the authority to exercise necessary regulatory oversight and correct any perceived material deficiencies or concerns regarding IASs.[95] This was prompted largely by the perceived Anglo-Saxon bias of the IASB. However, it is questionable whether such conditionality can be effective. In theory, it does seem to be a reasonable way of ensuring that any new standard passes a minimum legitimacy threshold. In practice, however, it may well turn out to be an ineffective policy, because European multinationals have a strong preferences for common global standards and are therefore likely to oppose any review decision that 'Europeanizes' IASs, resulting in two sets of rules.

An exception to this rule should be expected only when large segments of corporate Europe are opposed to particular international standards or if it is fundamentally at odds with the macro-political climate. This seems to have been the case recently in the row over rules regarding the financial reporting of derivatives and other financial instruments. The IASB proposals (known as IAS 32 and IAS 39) requires companies to report on derivatives and certain other instruments at market values rather than historic costs, and place restrictions on the use of these instruments in hedge accounting. Many European banks and insurance companies oppose such proposals arguing that the new rules would inject heavy volatility into profits and balance sheets. The final outcome is uncertain.

Some critics oppose IASB standards not only on substantive but also on procedural grounds. They argue that the IASB due process is faulty and insist that the IASB improve the process by making deliberations more transparent and getting more input from companies and investors. These demands have become much more salient and pressing since ENRON and a series of other corporate scandals which have ushered in a new macro-political climate affecting private-rule making in accounting.

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[95] For this purpose the Commission promoted the creation of a review body named the European Financial Reporting Advisory Group, incorporating expert users, accountancy professionals, and regulators.

Similarly to the FASB post-ENRON, the IASB has been bowing to this mounting pressure for institutional chance and has agreed to strengthen some of its procedures to comply more fully with basic principles of administrative law. For example, the IASB has recently agreed to publish near final versions of accounting standards so that companies and investors can get early warning about their format. The IASB previously released draft standards for consultation, and then simply put out the final version several months later. The new arrangements will ensure that standards are released in several draft versions, so that companies and investor can watch the rules as they develop. The IASB will also look at issuing discussion papers on controversial accounting issues, and do more field testing of its proposed standards.[96] Further, the IASC Foundations trustees have pledged to play a greater role in ensuring that the IASB follows due process and improves its deliberative procedures. Such improvements will include measures to reduce the cost of involvement in IASB proceedings (e.g., by broadcasting IASB meetings over the internet and posting observer notes on the IASB website in advance of Board meetings) and more extensively draw on a wide range of advisory and user groups in the discussions of near-final drafts of exposure drafts and standards. Finally, the trustees have also agreed to expand their number by offering two more seats to Asian countries.[97]

More far-reaching changes are unlikely, however, mainly because the control by public-sector principals of the IASB remains weak and poorly coordinated as a result of structural difficulties but also conflicting political agendas among the principals. Tellingly, the trustees have recently rejected a demand by the European Commission for greater representation on IASB of countries using international accounting standards—which, since 2005, are predominantly European countries.[98]

5. Conclusion

We have sought to advance the timely debate about global governance and specifically about the potential for a global system of administrative law to ensure transparency as well as access and accountability for those affected by the new inter- and transnational rule- and decision-makers. To do so, we have conducted a positive political analysis of the delegation of

[96] Andrew Parker, "IASB to Improve Consultation Procedures," *Financial Times*, 24 March 2004, p. 29.

[97] See International Accounting Standards Committee Foundation, *Review of the Constitution – Proposals for Change*, Consultation Paper (London: IASCF Publications Department, November 2004).

[98] Ibid, pp. 26-30.

regulatory authority to private agents—largely neglected by social scientists but increasingly important in the international political economy. We have focused empirically on global governance in accounting, which as of 2001 is the task of the International Accounting Standards Board, IASB. This private agent is modelled after the national accounting standards setter of the United States, the Financial Accounting Standards Board (FASB). A firm analytical grasp of the FASB process is therefore helpful when pondering the trends and challenges that we may soon observe at the inter-/transnational level. Moreover, as we have seen, Anglo-Saxon accounting standards experts are particularly influential at the transnational level, apparently due to the domestic institutional structure and high concentration of accounting standards expertise in Anglo-Saxon countries. A central player in this world is FASB. An understanding of the IASB must therefore begin with an understanding of the politics and economics of FASB.

Self-regulation of socio-economic actors, which is at the heart of delegation of regulatory authority to private agents, has a number of advantages. It ensures that the regulated themselves have a voice in drawing up the regulation (which, *ceteris paribus*, should raise compliance), and it allows them to establish the economically most efficient means to achieve the regulatory objective. These reasons also motivate the private sector to voluntarily supply (resources for) regulatory governance.[99] Moreover, private regulatory governance makes such governance less costly for the general public, in part because the regulated economic actors will themselves provide the expertise that would otherwise have to be acquired and maintained by government employees. Yet, it also creates challenges for equal access for, and accountability to, all others who have a stake in the regulation—and it may make administrative law procedures less effective than usually presumed.

We have asked at the outset why rule-making authority is granted or delegated to a particular and private body. Building on principal-agent theory, we found that—among the general reasons for delegating governance—shifting responsibility, benefiting from prior expertise, and the need to maintain expertise in a complex and fast-changing issue area provide special incentives for delegating to a private rather than public agent. At the same time, shifting responsibility as a reasons for delegation, for instance, makes it less likely that administrative

[99] In addition, suppliers of governance may here as always be motivated by a quest for power, and private sector providers of governance also seem motivated by the opportunity to keep government regulation at bay, which appears to be particularly important to the business community in the liberal market economy of the United States.

law procedures are instituted to increase the accountability of the agent to the delegating principal since such procedures would diminish the benefit of blame avoidance for the principal.

We also have emphasized the importance of asking who the main actors are in the governance institutions, and have suggested that, when technical expertise is required for effective participation but unevenly distributed across those with a stake in the resulting rules and decisions, we will see those stakeholders having similarly uneven power in governance, unless specific steps are take to institutionally safeguard the interests of those with a relative lack of technical expertise. We have empirically found that those with the least technical expertise, namely the users of financial statements (mostly investors, who additionally face collective action problems), hardly play any role in the domestic and global governance on accounting standards—which is particularly striking since, at least in the United States, public regulatory authority over financial reporting was established in the 1930s precisely to safeguard the interests of investors. In such situations, some of the procedures of administrative law—such as openness of the standards setting process to input from all interested parties during notice-and-comment periods—by themselves will do little to improve the governance output for the previously disadvantaged group, even if such procedures may be instituted with great fanfare in response to pressure from a shift in what we have called the macro-political climate.

Turning to the practice of governance after authority is delegated to a private agent, we have argued that when delegation of governance functions is motivated by wanting to benefit from the agent's prior expertise, delegation to private agents creates a particular kind of multiple principals problem, where the agent ends up with at least two principals: one public and one private. We have stipulated that this arrangement will advantage the stakeholder group that constitutes the private principal over other groups with a stake in the regulatory matter whenever those who constitute the private principal are cohesive amongst themselves yet differ in their preferences from the other groups. The agent’s actions under these conditions should be a function of what we call the relative tightness of the competing P-A relationships. This tightness of a P-A relationship depends, in turn, on the extent to which the agent's financial and operational viability is dependent upon each of the principals, as well as the extent to which the macro-political climate demands or permits private regulatory authority to be relatively independent of public oversight.[100] Changes in this broader context, in which any particular P-A governance relationship is embedded, can deeply affect the nature of the relationship, not least by creating strong incentives for the adoption of administrative law procedures to address concerns about, for instance, unequal participation or bias.

In sum, global governance can surely be improved through administrative law. Our findings suggest, however, that an assessment of the likely effectiveness of specific administrative law measures—i.e., their effectiveness in solving perceived problems rather than offering symbolic satisfaction to momentary critics—requires careful empirical analysis of the causes of those problems in the particular realm of governance that is at stake. The influence of the stakeholders in transnational regulation, for instance, may well be institutionally balanced by ensuring effective input for other stakeholders; we only caution that the nominal establishment of some of the standard procedures to achieve such greater balance by itself may not be suitable in the global governance of complex, technical issue areas. At the same time, a number of institutional changes and incentives might be quite effective, such as creating an independent source of information along with greater opportunities for stakeholder input, or changing the agent's funding structure.

[100] It also is a function of the principals' monitoring capabilities, which, however, again turns on the distribution of technical expertise.

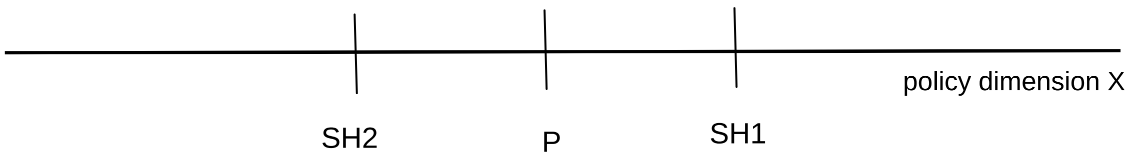

Figure 1
Ideal Points for Simple Regulatory Delegation Scenario