MAKING ACCOUNTING MORE INTERNATIONAL: WHY, HOW, AND HOW FAR WILL IT GO?

by Ray Ball, University of Rochester

What are the driving forces behind the current initiatives to globalize accounting standards? Does it make sense to have a single international accounting standard, or is it more realistic—and perhaps more desirable—for national and international standards to coexist?

There is a strong and growing movement to make accounting practices more uniform across national borders—to "internationalize" or "harmonize" the rules of accounting. It could transform the practice of accounting in many countries. It could require managers in U.S. corporations to quickly become familiar with a new set of rules. And because of the complex interaction between accounting rules and the ways in which business is conducted, it could have substantial effects on U.S. corporate affairs.

Commonly-asked questions include:
- Why does it make sense to make accounting rules more global?
- Why is it happening now?
- How is the globalization of accounting being accomplished?
- Why were there national differences in the first place?
- Will individual countries still put their own national stamp on their accounting rules, or will there be essentially uniform international rules?
- Is it desirable to eliminate national accounting differences?
- How far should the U.S. go in supporting international accounting standards, and what should be my corporation's position?

Before attempting to provide answers to these questions, it may be worth a short digression on why we have accounting rules in the first place and why accounting is important.

Stated as briefly as possible, we have accounting rules so there can be general agreement about how important commercial transactions are to be implemented. For example, in order to write and enforce loan agreements that restrict a borrower’s ratio of debt to total assets, one requires rules—acceptable to both borrowers and lenders—for counting debts and counting assets. As another example, public corporations raise large amounts of capital in public markets, and, to allow their shareholders and creditors to monitor their performance, such companies must have rules—acceptable to both managers and shareholders—that govern the amount and type of information to be publicly disclosed to investors. To compensate managers on the basis of profits, companies require rules—acceptable to both managers and shareholders (and compensation committees)—for counting profits. The common thread in these examples is that accounting information is used in a variety of corporate transactions, and acceptable rules of accounting must be arrived at to allow them to proceed.

In sum, generally-accepted accounting rules are an integral part of how corporations transact. Change the accounting rules and you change how corporations behave.
THE ECONOMIC AND POLITICAL PRESSURE TO INTERNATIONALIZE

Accounting rules are set and administered by standard-setting bodies that tend to develop in one of two basic ways. One is to grow out of the accounting profession and remain part of the private sector, as have the U.S. Financial Accounting Standards Board (FASB) and the U.K.'s Accounting Standards Board. The alternative is for such accounting bodies to originate in and remain part of government, of which the French Conseil National de la Comptabilité is the classic example. But, regardless of whether the standard-setting body is part of the private or the public sector, accounting rules everywhere are shaped ultimately by two forces: market economics and politics.1

The main determinant of accounting rules is market demand. In many market settings, financial statements are used in transacting with corporations, so corporations incur the cost of preparing them. The other determinant of accounting rules is politics—and politicians, by virtue of their control over regulators, find ways to interfere with almost everything. The relative importance of market and political influences varies across countries, across time, and with the accounting issue involved.

Not surprisingly, the pressure for more uniform international accounting rules therefore comes from two directions: increased globalization of the markets in which accounting reports are used, and increased internationalization of the political processes that regulate those markets. I discuss each in turn.

Market Demand for Accounting

Accounting information is used in a wide variety of market transactions. Stock market investors use accounting information in their buying and selling decisions, and thus in setting stock prices. In short-term debt markets, lenders use accounting information in loan decisions. For example, banks analyze accounting reports when assessing the creditworthiness of potential clients, or when evaluating loans they have already made to clients. In long-term corporate debt markets, accounting information is also used both for credit assessment and subsequent evaluation decisions, though typically in more complex ways than in the case of short-term lenders. For instance, contracts for unsecured long-term borrowing by public companies usually include covenants under which the company agrees to limit the proportion of its assets financed with debt, or maintain a minimum level of working capital (current assets minus current liabilities), or not to pay out the contributed capital as dividends.

Accounting reports also are used in evaluating and compensating managers based on their company's reported performance. It is difficult to conceive of investors contributing enormous amounts of risk capital to corporations run by professional managers without an independent score-keeper. And, besides outside investors and creditors, there are other potential "consumers" of corporate accounting information. A company's suppliers, its employees, its managers, and even its customers have an interest in receiving information about its financial position. This is true whether they are individuals or companies. Indeed, the demand for accounting information arises from all parties who could potentially transact with the corporation, including those who might buy its shares, write analysts' reports about it, lend to it, work for it, or even buy its products (especially when the products come with long-lived commitments or warranties).

And because the range of actual and potential parties transacting in markets with publicly traded corporations is so large, virtually all democracies—particularly common-law countries—have a tradition of "public disclosure," of providing free accounting (and other) information to all. The enormous variety of market uses creates the primary demand for accounting information, and the market is thus the primary influence on the rules accountants use to report that information.

Political Regulation of Accounting

The second effect on accounting is politics. In most countries, the political process has a large say when it comes to writing the accounting rules, though the mechanisms for doing so differ substantially. Under the U.S. Securities Acts, an agency of the U.S. Government (the Securities and Exchange Com-

---

1. For the pioneering research on the economics and politics of accounting, see Boedbl, Watson and Brodell, "Economics, Politics and Accounting Theory," (Lexipwood) CIB, NJ, September, 1985.
mission) has legal oversight over U.S. accounting rules. And even though it delegates this function to a private-sector body (the Financial Accounting Standards Board), it flexes its regulatory muscle whenever it disapproves of what is being done. For example, the SEC put a lot of pressure on the FASB to "mark to market" (that is, record on balance sheets at market value rather than historical cost) a wider range of corporate investments in financial securi-
tics, including derivative products.

Recently, the FASB bowed to political pressure and abandoned its proposed new rule on accounting for stock options granted to executives by their corporations. The proposed rule would have booked the value of the granted options as a component of executive compensation expense, which would in turn have reduced granting corporations' reported earnings. Concerned lobbying by prominent execu-
tives caused Congress to pressure the FASB and the SEC to abandon the proposal. Although the execu-
tives allegedly feared adverse investor reaction to lower reported earnings, cynics thought they feared disclosing their total compensation. Ironically, one of the leading lobbyists of Congress was Bill Gates, founder of Microsoft and erstwhile defender of unregulated markets. Executives of Silicon Valley firms, including Microsoft, have unusually large stock option schemes.

The politics of accounting differ across coun-
tries. The SEC normally attempts to maintain at least the appearance of protecting small investors from losses, whereas Japanese rule-making, for example, has been dominated by the interests of companies and institutional lenders and investors. In Japan, the Ministry of Finance codifies accounting rules under the guidance of the Business Accounting Delibera-
tion Council, with the Japanese Institute of Certified Public Accountants fulfilling an essentially interpretive role. In spite of the differences in political machinery, accounting rules everywhere are influ-
enced in some way by politics.

Politics also influences how managers exercise any choice among accounting methods they are allowed by the rules (for example, in choosing among various depreciation methods). This is espe-
cially important in politically-sensitive areas such as defense contracting, utilities (with large numbers of geographically-concentrated voters), and corpora-
tions with large organized-labor payrolls. These corporations are more likely to choose conservative accounting methods that make them look less prof-
table and so avoid attracting political attention.2

Another way that the political process affects accounting is through tax accounting rules. In some countries (including France, Germany, Japan, and most of South America), tax laws have a large direct effect on accounting rules because the same or similar rules are used to calculate both a company's taxable income and the income it reports in its public financial statements. For example, German corpora-
tions routinely take charges against taxable income that are essentially extra depreciation charges, and because the German tax rules and the Commercial Code require this practice to be mirrored in the published accounts, German companies routinely report highly conservative income statements and balance sheets.

Tax rules have less effect in the U.S., where there are substantial differences between tax and reported ("book") income. But even in countries that do not equate reported accounting income and taxable income, there are subtle interactions be-
tween tax rules and accounting rules because the firm's transactions-recording system is used to pre-
pare both. So, while accounting rules are shaped primarily by the various needs of users, they also are affected by politics.

**WHY NOW?**

Because accounting rules are shaped ultimately by economics and politics, it should come as no surprise that the push for international accounting rules is being driven by two related developments. First and foremost is the progressive globalization of the markets in which accounting reports are used. A secondary, but nevertheless important, factor is increased internationalization of the political influ-
ences on accounting—particularly, the growth of efforts among nations to coordinate their regulation of capital markets.

The recent acceleration in the globalization of markets and political processes is no doubt due to many things. Without question, however, the largest single driving force is the drastic reduction in recent times of the costs of producing, communicating,

---

accessing, processing, and interpreting information. With the threat of the Cold War receding, it is becoming clear that the most important invention since the wheel is not atomic power, but the electronic computer. \(^1\) Enormous (and related) breakthroughs have been made in satellite and fiber-optic information transmission, communications software, software for database management and processing, organizational decentralization, management education, and all aspects of information handling. Invention after invention has cut almost every component of information costs to an astonishing pace. When accumulated over decades, the effect has been truly revolutionary.

Cross-border transacting has mushroomed as a consequence. International communications and transactions that today are routine for low-level operational employees were, until very recently, the province of a managerial elite. Low-cost access to an abundance of international information has reshaped many markets. To an unprecedented degree, managers, employees, suppliers, investors, and customers now live and work in a "global village." When such people use accounting information in international transactions—say, in lending to a foreign corporation, investing in its shares, deciding to work for it, or buying its products—they create a demand for the internationalization of accounting. That is, they create a demand for accounting standards that transcend national boundaries. Cross-border trading requires cross-border trading institutions.

Politics is becoming more international as well. Voters and politicians are better informed about the actions of foreign policymakers and their consequences. For example, the U.S. press now closely follows the politics of German monetary policies, French interest rate policies, European Union farm subsidies, and Japanese auto and rice imports. In this fashion, public opinion in one country becomes a political issue in another.

Information costs continue to fall space, so the trend to internationalize commerce and politics, and thus accounting, continues almost unabated. Below I outline the way in which accounting rules are becoming more global, including the operation of the International Accounting Standards Committee (IASG). But first it is necessary to describe the base from which this process is working—that is, the way in which accounting rules differ across countries, and why.

**NATURE AND CAUSES OF NATIONAL DIFFERENCES IN ACCOUNTING RULES**

Why are there national accounting differences in the first place? Here again, the reason is that accounting is an integral part of each country's own economic and political institutions. As one might expect, there are enormous differences among countries in how markets and politics are conducted. Nevertheless, it is useful to think of countries as falling into three distinct accounting groups: Anglo-American, Continental European, and South American. \(^2\)

**Anglo-American**

This is the largest group, comprising over 30 countries. Its accounting traditions were developed in England and Scotland. They were exported to most former British colonies (including the U.S.) and to countries that were early in building multinational corporations (notably, the Netherlands). The group includes Canada, Hong Kong, India, Indonesia, Israel, Kenya, Mexico, Nigeria, Philippines, Singapore, South Africa, and Zimbabwe.

Because these tend to be "common-law" countries, case law and precedent have a greater impact on accounting than does codified law. "Common law" is so called because it arises organically from the commonly-accepted practices of the marketplace. When a practice becomes commonplace, the courts "read it in" to subsequent commercial agreements, and this process becomes a rule.

Common law allows parties to a transaction who share no close ties to reach an agreement with the assurance that an independent body (the courts) will interpret it against a rich background of common practices. If a contract does not unambiguously provide for a particular eventuality, men common

---

1. The New York Times (11 January 1989), an expected that is one of the remarkable achievements of economic in a great number of countries by the second half of 1987—evidence that a 9% growth rate is going to continue.

Regardless of whether the standard-setting body is part of the private or the public sector, accounting rules everywhere are shaped ultimately by two forces: market economics and politics.

practice fills in such "gaps." Close ties between parties are thus not needed when entering complex, long-term transactions, which can be described as "arm's-length." In part because this style of legal system supports transactions by parties without close ties, companies tend to have active public capital markets that attract widespread individual investment from the public at large.

Not surprisingly, accounting rules in the Anglo-American group have been determined largely in the private sector and have been oriented toward disclosure across an arm's-length market to interested parties. These parties are presumed by the courts (and by agencies such as the SEC) to rely entirely on publicly-disclosed information because they have no close ties to the corporation. Chief among them are investors—shareholders, creditors, bankers, and long-term lenders of debt capital—many of whose only communication with the corporation is through public disclosure.

Continental European

This group comprises a variety of countries in which the legal system and the accounting rules are codified by government ministries. Close interplay between government and major players is necessary because codified law, lacking the organic origin and evolutionary mechanisms of common law, relies upon the government ministries possessing an acute knowledge of contemporary commercial affairs. For the system to work, the major players must be few in number, so corporate capital is largely supplied by banks and other institutional investors. And because the players must be in close contact with one another, the governing boards of public corporations have representation from banks (Deutsche Bank alone sits on over 100 German boards), labor unions, and perhaps major suppliers or customers. Transactions in such countries tend to be based more on private information and less on public information than in common-law countries.

Most of continental Europe falls into this group (including Belgium, Denmark, France, Germany, Italy, Norway, Spain, and Sweden), as do several small former colonies. Japan also belongs to this group owing to its incorporation of the German commercial code and the French accounting code during the Meiji Era (1868-1910). In this group of countries, the comparatively close interplay between markets and governments in most aspects of business also tends to the setting of accounting rules. The accounting and tax rules in these countries are remarkably similar and in many cases, even identical, countries like Brazil and Argentina have been forced to implement accounting rules to provide constant-dollar financial statements, with inflationary gains and losses clearly and separately identified.

Institutional Diversity is the Norm

The institutional differences among these groups—especially, between the Anglo-European and the other two groups—are significant and fundamental. While such differences are being eroded by modern communication costs, they seem resilient. And within the three individual categories cited above, there are further differences. To European accountants, it would seem strange to place Germany, France, and Italy in the same box. Stereotypes notwithstanding, the German accounting code is written in general terms and allows considerable discretion, whereas the French code is more rigid.

Further, some countries do not fit within any category very well. For example, accounting in Finland evolved to meet the needs of its once-
dominant forest-products industry. In this industry, companies create value largely by planting, managing, and growing forests. But because the Anglo-American accounting model does not record profits until decades later when the forest is cut and then sold, Finland developed its own accounting model to meet its special requirements. Nevertheless, as it has opened its economy to foreign investment, Finland has embraced the IASC's international rules (described below).

Switzerland, which has almost made a business out of secrecy, has minimum financial disclosure rules. To be sure, all large multinational Swiss corporations disclose well in excess of these requirements because they transact with international lenders, investors, customers, suppliers, labor unions and managers; but other Swiss firms are under no requirement to do so. As in continental European accounting systems, Swiss accounting allows companies to have particularly large "hidden reserves" arising from undisclosed or undervalued assets.

What we learn from international comparisons of accounting systems, then, is that there is no one "true" way of doing accounting. Rather, accounting rules evolve as an integral part of the markets and politics of each country, and these forces differ substantially among countries.

**HOW INTERNATIONALIZATION IS BEING ACCOMPLISHED**

The differences, however, are narrowing. In response to the breathtaking collapse in the cost of transacting internationally, institutional structures are changing rapidly. As part of this, accounting is internationalizing at a rapid pace. I now summarize the principal ways in which this is happening.

**Corporate Solutions**

Some companies have adopted their own solutions. One simple solution is preparing "convenience statements," which merely translate a firm's financial statements into a foreign language while still using home-country accounting rules. Some companies prepare "parallel" financial statements, under the rules of one or more foreign countries in which they do business. Perhaps the most highly publicized example of such parallel reporting occurred when Daimler-Benz in 1993 became the first German corporation to list on the NYSE. To comply with SEC regulations, Daimler-Benz was required to issue statements prepared according to U.S. GAAP. German corporate executives in general viewed the corporation's compliance with U.S. rules, which meant disclosure of large U.S.-GAAP losses, as a breaking of ranks. German accounting rules, like those of many other European countries, allow profits to be under-reported during good years by burying "hidden reserves" in the accounts that can later be drawn down to cover losses in bad times. And, just as it was for many of its corporate compatriots, 1993 was a bad year for Daimler-Benz. Although the company had reported DM168 million profit under German rules, that profit became a DM549 million (then $500 million) under U.S. GAAP.

Few other European firms have yet followed the lead of Daimler-Benz, nor are they likely to do so soon. Nevertheless, some are moving toward more globally acceptable accounting methods. For example, more than 20 large French, German, and Swiss corporations now prepare their consolidated group financial statements under international Accounting Standards Committee (IASC) rules—rules that, as explained below, are likely to accommodate many aspects of Anglo-American accounting practice. Companies have incentives to adopt these solutions because they make it easier for foreign investors, suppliers, customers and governments to transact with them.

**Accounting Firms Become Multinational**

As accounting firms' clients engage in more international transactions (for example, opening an overseas plant, entering joint ventures with foreign corporations, buying or selling internationally, borrowing from a consortium of foreign banks, or listing one's shares for trading on the London, Tokyo or New York stock exchanges), the accounting firms that audit the transactions have incentives to become more international. Thus, there has been a spate of worldwide mergers of accounting firms, with each of the majors (the "Big Six") seeking a permanent office in most large cities of the world.

---


24

VOLUME 7 NUMBER 2 • FALL 1995
Competition Among Financial Markets

Financial markets increasingly are competing on a worldwide basis to attract listing by foreign corporations. This puts pressure on markets and regulators to accept financial statements prepared under foreign or IASC rules. The London and Hong Kong stock exchanges now accept financial statements prepared under IASC standards as satisfying their listing requirements. The World Federation of Stock Exchanges encourages its members to accept IASC statements. The International Organization of Securities Commissions (IOSCO), a worldwide coalition of regulatory bodies, is working with IASC in developing its standards and has representatives on the IASC Consultative Group. IOSCO has announced that it will defer considering recognition of IASC standards until they are essentially completed, but it is expected to increase the pressure on countries' regulatory bodies to accept IASC standards.

There are costs and benefits for corporations in listing their stock on foreign exchanges. Benefits include widening the base for raising new debt and equity capital, increased liquidity, and better matching of the country profile of the firm's investors with that of its profit (that is, better hedging of its profits against the currency risk faced by investors). The costs include listing fees and costs of complying with foreign regulations, including (if required) the considerable costs of preparing foreign-rule accounts. As one example of the trend toward global listing, Philip Morris, the tobacco and consumer products company, is listed on 13 exchanges outside the U.S.

The SEC has been adamantly that foreign firms listing in the U.S. must comply with U.S. rules, including filing U.S.-GAAP statements. Its view is reported to be that statements prepared under non-U.S. GAAP are misleading. The SEC does allow foreign corporations to trade American Depository Receipts (ADRs), which mimic (but are not foreign shares under U.S. law, without filing U.S.-GAAP financial statements. However, trading in ADRs is restricted to the over-the-counter market, which has little depth and liquidity. One effect of the SEC's position is that U.S. financial markets are getting less international business than otherwise. If New York decides to challenge London as the largest international financial market in the world, it may pressure the SEC to relax its hardline stance.

International Accounting Standards Committee (IASC)

The IASC is a London-based coalition of professional accounting bodies from over 80 countries. In 1973, it has adopted the delicate task of promulgating international accounting rules. Until recently, the influence of the IASC has been limited by its nor yet having assembled a complete set of accounting rules, but it has accelerated its standard-setting program and plans to complete a comprehensive set of rules by 1999. By the end of 1994, IASC had published 20 accounting standards that address accounting for inventories, R & D, construction contracts, joint ventures, hyperinflation, and other issues. It is estimated that 50% of 1994 budget was financed by professional accounting bodies and 25% by corporate contributions (including 20% by U.S. corporations).

The influence of the IASC is growing quickly. Most national accounting professions have actively supported the IASC, though U.S. support has been lukewarm. Several countries (including Singapore, Malaysia and Hong Kong) have adopted IASC rules as their own after a small amount of requisite rewriting. The Chinese Ministry of Finance is creating that country's first set of accounting rules, starting with IASC standards and revising them to better suit Chinese institutions and politics. Moreover, most national bodies, when drafting their rules in relation to an emerging problem such as accounting for derivatives, now seek information on the consensus solution worldwide. In such cases, the IASC plays a coordinating role.

IOSCO

IOSCO—the international club of market regulators—has requested its members to recommend one IASC standard (on cash flow disclosures) for acceptance in their own countries. In the U.S., the SEC has agreed to that request, with the effect that U.S.-registered corporations can choose between the FASB and IASC rules. IOSCO has announced that

---

2. At the end of 1994, there were 85 members. Details are in the IASC Annual Review 1993. 107 Fenchurch St. London EC3 2DR.
3. An excellent summary of IASC work is provided by Peter Weidner, An Introduction to International Accounting Standards, 1994.
it will defer endorsement of IASC standards until they are complete. Since work on the remaining 16 standards—on topics such as financial instruments and interim reporting—is scheduled for completion in mid-1999, we can expect a millennium-induced bout of international accounting `ever."

**European Union (EU)**

The EU requires companies operating in its member countries to comply with various EU directives. Among other things, these specify EU-wide accounting rules, disclosure practices, and requirements for practicing as an auditor. Like many aspects of European unification, implementation of the important Fourth Directive remains controversial in many EU countries. For example, in Article 2 states: "The annual accounts shall give a true and fair view of the company’s assets, liabilities, financial position and profit or loss." The "true and fair" requirement is of British common-law origin and underlies the Anglo-American accounting model, and thus differs sharply from the Continental-European model of codifying exact accounting rules. It specifies criteria for rules to satisfy, and requires judgment in deciding whether the accounts are "true and fair," but it does not codify those rules. Since EU and national laws operate jointly, one effect of Article 2 has thus been to insert a common-law concept of "true and fair" into the codified legal systems of some EU countries.

**Other International Accounting Institutions**

As might be expected, a wide variety of groups are involved. To cite one example, the International Federation of Accountants (IFAC) is a worldwide coalition of accounting bodies that operate in parallel to IASC by issuing non-binding standards for independent auditing of accounts. In addition to the IFAC, other participating groups include the International Chamber of Commerce, the International Association of Financial Executives Institutes, the International Banking Association, the International Bar Association (O.E.C.D.), and the United Nations Division on Transnational Corporations and Investment.

Finally, it is important not to overlook Eastern Europe and China. As these countries convert from planned to market economies, accounting firms are discovering an enormous opportunity to contribute to and profit from their development of accounting principles. "From the ground up," Accounting for the former Soviet Union has been described as a conspiracy between accountant and plant manager to prove that the plant met its output quotas. Against this background, the creation of a truly independent accounting profession in Eastern Europe is no easy task. Whatever the outcome, much of it will be imported from other countries.

From this short survey, we can see that internationalization of accounting is proceeding apace, but along complex and somewhat uncertain paths.

**THE ECONOMIC AND POLITICAL LIMITS TO INTERNATIONALIZATION**

There are limits to how far internationalization can go. While the concept of a "global Village" is a partial reality, most of us transport most of the time in a "local village." We will use our own locally-adapted business practices and political processes for the foreseeable future. One reason is that economic and political institutions change slowly; history, as they say, is destiny. The other reason is that the clear majority of commercial and political activity remains international, so the primary driving force behind the majority of actual accounting practices remains domestic in nature. It does not make sense to adopt a single set of accounting rules when the contexts in which accounting information is used vary substantially across countries. Equally, it would be folly to have to fully integrated markets and politics. It would take a truly remarkable transformation of the capital-market institutions for most European countries to embrace Anglo-American accounting rules. Perhaps the greatest barrier to worldwide adoption of IASC rules is that they are perceived as being "too American." A German group of accountants recently complained that the international accounting standards being developed by the IASC are largely based on Anglo-Saxon principles of accounting, which give priority to the matching of revenues and expenses, as compared to the continental European principle of conservatism. 9 By contrast, the
French accounting profession is currently pressing hard for IASC standards to be adopted in place of the present system of centrally computed rules (which originated in the Napoleonic Code). But even this proposal is being resisted by the French bureaucracy, due to its legendary conservatism and also to French managers' objections to detailed disclosures under IASC rules.

Domestic commercial and political factors are highly unlikely to go away. Until capital markets become fully integrated, with similar methods of raising capital and controlling managers, it will probably be rational to maintain different accounting practices across countries. Perhaps this is what the Europeans have in mind when they describe their move toward accounting rules that are more uniform as a process of "harmonization" as opposed to "integration."

GLOBAL ACCOUNTING RULES WOULD BE TOO RIGID AND TOO POLITICAL

Nor is complete internationalization of accounting rules a good idea. A single, centrally planned, worldwide set of accounting rules would be Marx's dream. Its governing body would be a United Nations of the participating countries' professional accounting associations, regulatory bodies, stock exchanges, corporate lobby groups, labor unions, banks, stock exchanges and financial analysts' associations, among others. Such a body would also likely invite participation by organizations such as the World Bank, the IMF, OECD, worldwide and regional political and trade groups, and the U.N. itself. Politics would become the driving force behind accounting rules. There would be excessive gridlock. The bureaucracy administering the rules would have neither the incentive nor the institutional capacity to respond to—much less encourage—productive innovations in business practice.

Two factors are worth keeping in mind. First, the fundamental source of the United States' great wealth and its role in the world—and also the driving power behind its great corporations—is its open, innovative institutional structure. By both historic, and current world standards, the inventive energy of its free markets is comparatively unrestrained by political interference. In general, wealthy societies exhibit a long history of experimentation with institutional practices, a process whereby less efficient practices are discarded if they cannot compete with more efficient innovations. Wealth is not guaranteed by possessing natural resources or by access to advanced technologies, as even a casual glance at nations like Russia and Argentina will show. Switzerland, Japan, Hong Kong, and Singapore are poorly endowed with natural resources, but are wealthy in comparison with their better-endowed neighbors. In poorer societies, institutional evolution is comparatively more suppressed by the political sphere, and institutional practices are less efficient. The conclusion: nurture the free evolution of business institutions in general.

Second, because accounting rules are an integral part of the evolving institutional structure, they cannot simply be laid down once and for all. They require continual maintenance. A case in point is the emergence of long-term non-cancellable leases as a widespread financing method in the early 1970s. Under the old accounting rules, which naturally had not anticipated the innovation of financial leases, these transactions were not recorded on balance sheets, even if the lessor had full recourse to the lessee/borrower's assets. The protest afforded lenders by balance-sheet debt/equity constraints suddenly was rendered less effective because a prevalent form of full-recourse long-term financing was not recorded as debt.

In 1976, to restore the usefulness of their balance sheets, U.S. accountants implemented new rules to capitalize leases that, according to several objective criteria, are financing transactions. The new rules book the present value of qualifying lease payments as a leased asset, and a lease liability of the same amount, even though no such asset and no
Liability to pay such an amount exists in law. Therefore, corporations and lenders to corporations were able to write debt-ratio covenants that better reflected the economic substance of corporate financing transactions rather than their narrow legal form. As a consequence, one could lend to a corporation with greater assurance that its leverage was effectively constrained by agreement. The new accounting rules thus increased the efficiency with which future debt contracts were written.13

This adoption of the accounting rules, however, could not have been introduced a decade earlier, when discounted present value still was a largely academic concept. At that time, present values would not have been understood by most balance-sheet readers (including analysts and major stockholders, strange as it may seem in hindsight), and it would have been extremely difficult to convince a court that a strictly notional present value calculation should be counted among a corporation’s liabilities. This episode reveals how accounting rules and corporate transactions (in this case, long-term debt covenants and long-term leases) evolve together. It also illustrates that accounting rules, which can affect all firm’s financial statements and all users of financial statements, must be based on generally accepted commercial concepts (in this case, acceptance of the present value technique and the idea that certain leases are essentially financing agreements).14

More recently, accountants have sought to find rules to better reflect innovative corporate transactions in financial derivatives. Better accounting rules for derivatives would mean that investors and lenders could transact with greater assurance about the extent and nature of a corporation’s risk exposure. And this in turn would reduce the “information costs” to corporations of using derivatives in even legitimate hedging transactions—costs that today are very large.

Accounting practices have evolved over millennia (many of the surviving Babylonian clay tablets are accounting records), as an integral part of the evolution of commercial practice. If the evolution of accounting rules is impeded, then innovation in business practice generally is impeded. The conclusion nurture the free evolution of accounting rules. Eliminating the unprofitable perspective of different countries evolving different rules might appeal to some, but in my view it should not be an objective. This is not to say that the trend toward internationalizing accounting rules will not or should arrest the increasing internationalization of markets and policies suggests the trend will and should continue. Corporations engaging in significant cross-border transactions can prepare supplemental reports under IASC rules, or simply provide foreign-language “convenience statements,” at small cost, without their home countries completely abandoning their legal standards. IASC standards can be adopted piecemeal by smaller countries, emerging countries, and countries in which transactions using accounting information are largely international, without placing worldwide accounting under the control of one planning body. Diversity among nations’ accounting rules can be reduced voluntarily, as nations compete in increasingly integrated world markets for financial and other transactions, without legislating its elimination. I hasten to add that this conclusion is not based on any opinion that U.S. accounting standards (for those of any other country) are better than IASC (or any other) standards. It is based on an opinion about the best process for the evolution of accounting standards across the world.

SUMMING UP

We live in fascinating times. We have not yet experienced the full impact of the massive reduction in information costs over recent decades. One important consequence of the “information revolution” is that further integration of both markets and politics seems inevitable on a worldwide scale. Accountants are scrambling to provide financial information that is more intelligible across national boundaries because countries differ remarkably in their accounting rules, in the philosophies

13. In the U.S., the notion that accounting rules substantially must form a widely accepted basis for contracting is reflected in the term “generally accepted accounting principles” (GAAP), used to describe U.S. rules to many countries which wished to adopt them. Accounting is effective in requirements that generally are “fair.” Because fairness is a property of the relative treatment of all interested parties, it is a different test of imposing acceptance by all. Comments 400-406 discuss notions such as common practice, common procedure and the representative “prudent man” when deciding what is fair.
A single, centrally planned, worldwide set of accounting rules would be Marx's dream.

underlying their entire accounting systems and even in their attitudes to public disclosure generally. There is pressure to reduce diversity in accounting rules, and the International Accounting Standards Committee (IASC) rules are growing in volume, stature, and usage.

On the other hand, economic and political integration is far from complete, and it seems highly likely to remain so. While further internationalization will reduce some or much of the diversity in accounting rules and practices across nations, it will not eliminate it. Nor should it.

RAY BALL

is Wescan Professor of Business at the University of Rochester's William E. Simon Graduate School of Business Administration.