

What's the Problem? Competing Diagnoses and Shifting Coalitions in the Reform of International Accounting Standards

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Introduction

It does not happen very often that a technical matter such as accounting makes it into the final declaration of a G20 summit, agreed by the heads of government of the world's leading nations. Nevertheless, this happened on November 15, 2008, two months after the bankruptcy of Lehman Brothers terrified capital markets, and roughly eighteen months after the first signs of the financial crisis had become tangible and started to impact the balance sheets of most banks worldwide. After holding their initial meeting as a Group of Twenty in Washington to deliberate about the means to cure the most severe financial crisis since the interwar period, the leaders of the G20 called on their finance ministers to formulate recommendations in areas such as “Mitigating against pro-cyclicality in regulatory policy” and “Reviewing and aligning global accounting standards, particularly for complex securities in times of stress” (G20 2008). Ever since, measures to reform international accounting standards – namely, those produced by the International Accounting Standards Board (IASB) – have been on the working agenda of G20 meetings, even if they have moved from front to backstage and are increasingly repeated using similar phrases (see the Declarations of the London, Pittsburgh, Toronto, Seoul, and Paris summits: www.g20.utoronto.ca).

Accounting standards are rules for valuing different types of assets and liabilities that are entered into a firm's balance sheet for the purposes of financial reporting and supervision. At the international level, so-called International Financial Reporting Standards (IFRS) have been developed since 1973 by a private standard-setting body, the International Accounting Standards Board (IASB) and its predecessor, the International Accounting Standards Committee (IASC), predominantly staffed by accountants from large international accounting firms (Botzem/Quack 2006; Nölke/Perry 2008). The rising number of countries adopting IFRS and, in particular, the decision of the European Union to make

IFRS binding for all publicly listed companies in its member states from January 2005 onwards, gave rise to debates on the political accountability of the standard-setter and the rule-setting process itself (Botzem 2010; Nölke 2009).

Prior to the EU's decision to adopt IFRS, the US Securities and Exchange Commission (SEC) had been rather reluctant to consider IFRS for use by American companies abroad or to let foreign issuers in the United States file financial statements according to IFRS without reconciliation with US Generally Accepted Accounting Principles (US GAAP) as developed by the US Financial Accounting Standards Board (FASB). It had, however, initiated and supported a project by the International Organization of Securities Commissions (IOSCO) to produce core standards by 1998. After the EU adopted IFRS, concerns about additional costs that American companies might encounter if they had to prepare a second set of financial statements according to IFRS in Europe, fostered more openness on the side of the SEC. In 2007, the SEC voted to allow foreign issuers in the United States to file financial statements according to IFRS without reconciliation to US GAAP. Therefore, the stage seemed set for convergence of the two leading accounting standards systems worldwide prior to the financial crisis (Posner 2010).

Accounting rules themselves, however – with one exception relating to financial instruments – had not received extensive political attention but rather had been treated as a technical matter before the crisis unfolded. Therefore, the appearance of such an arcane issue on the G20 agenda provides an interesting case on the basis of which to explore why and how this issue came to be considered a problem worth being included on the global political agenda for restoring the stability and improving the robustness of the financial system. According to Kingdon (1995), the financial crisis can be seen as a window of opportunity to be exploited by different actors in their struggle to connect problems, politics, and policy streams in order to identify which issues are relevant for “the active and serious consideration of authoritative decision-makers” (Cobb/Elder 1983: 86). Interest-based as well as epistemic community explanations would typically focus on agenda-setting as a programmatic phase in the policy process, followed by less politicized decision making and implementation. Other authors, however, have argued that bringing up an issue for political consideration does not tell us much about what is going to happen next, and that instead, it might be more promising to study how problem definitions shape the subsequent policy process. They argue that problem definition consists of more than the identification and description of difficulties.

As Stone (1989: 282) points out, problem definitions always imply causal stories and potential solutions, and they provide images that attribute cause and responsibility. Weiss (1989: 118) agrees that problem definition is “concerned

with the organization of a set of facts, beliefs and perceptions – how people think about circumstances.” According to this author, problem definition can be the “overture” to jointly building an “intellectual framework” for further action (Weiss 1989: 98–99). However, problem definition can also become a “weapon of advocacy” that actors use strategically to form coalitions with other actors that have the potential to shape decision making. Furthermore, problem definition can also be an “outcome” of policymaking, in so far as the solutions pursued and the policy instruments used to achieve them may change problem definitions over time by raising awareness of new issues, changing preferences of actors, or weakening the stance of formerly dominant groups (Weiss 1989: 116–117).

While policy analysis has widely recognized that the initial definition of a problem has implications for the subsequent policy process, less consideration has been given to the ways in which problem definitions may remain contested and continue to shift throughout a reform process, and what the implications might be for reform outcomes. In the case of the global financial crisis, exploring how competing problem diagnoses and related reform proposals shaped the policy process is particularly promising for two reasons.

First, given the urgent need to act and the complexity of global financial markets, proposals to fix the problems underlying the financial turmoil were developed under conditions of high epistemic uncertainty. It is therefore likely that different sets of actors brought partial views of root causes and reform proposals to the table. One would expect them to strategize by building on their respective expertise to foster their goals in the policy response. Hence, there was a strong likelihood that competing diagnoses and proposals would emerge.

Second, theories of regime complexity (Alter/Meunier 2009) would lead us to expect that the polyarchic, fragmented, and multi-layered structure of the global financial regulatory system provided opportunity and incentives for competing diagnosis and proposals to co-exist throughout the reform process without necessarily converging towards a shared view of problems and solutions. Debates on the causes of and remedies for the unfolding financial crisis took place in many different policy forums. Although one of the goals of reform was to coordinate these bodies within the framework of a more coherent and comprehensive global financial architecture, we suggest that most of the process took place in a fairly decentralized and networked manner, providing a breeding ground for continued struggles between competing diagnoses and solutions, as well as shifting coalitions.

In this chapter we present a case study of debates and reform activities concerning the role of international accounting standards in the global financial crisis. This case study is based on process-tracing using publicly available documents and interviews with key actors, complemented by insights from recently

published studies by other authors (André et al. 2009; Posner 2010; Stellinga 2011; Thiemann 2011). While the reform of accounting and prudential capital rules is closely interlinked this chapter focuses on accounting (for the reform of Basel standards, see Goldbach/Kerwer in this volume).

We argue that the reform process concerning international accounting standards unfolded as continued struggles over two competing diagnoses – arising from a transparency and a prudential approach – and gave rise to shifting and sometimes fairly counterintuitive coalitions across typical industry–regulator or private–public divides. Continued competing problem diagnoses did not prevent reform altogether – in fact international accounting standards and the governance of the standard-setter were modified significantly between November 2007 and November 2011. However, the reform process unfolded in such way that it generated new differences between the international and US standard-setters. Paradoxically, the reform process has produced as one outcome something that it aimed to resolve at its beginning.

International accounting standards for financial instruments: The choice of valuation principles

The financial crisis has provoked a controversy about how and what banks and other financial institutions should publicly report about their economic performance. In order to analyze this controversy and its outcomes, it is helpful to look at two broad changes in the economic and regulatory environment of financial institutions which have occurred since the 1980s and have impacted on the disclosure and reporting requirements of (financial and non-financial) companies dealing with financial instruments. The first trend, often referred to as financialization, consists of the rise of capital markets, increasing securitization, and the proliferation of complex structured financial instruments, such as derivatives. Partly fostered by the business strategies of financial institutions themselves, this trend has resulted in the disproportionate growth of the trading book, containing financial instruments held for sale, as compared to the banking book, containing traditional loans and savings. It has also blurred the lines of demarcation between the two books since financial products on the banking book are now often secured with financial instruments on the trading book (Matherat 2008). Another development was that more assets of banks were held by conduits in the growing shadow banking sector, which remains outside the financial reporting of the sponsoring company (Thiemann 2011). Financial-

ization has also fostered investor demands for transparent and time-sensitive reporting on the value of the assets held by the company at a given point in time over the demands of other stakeholders, such as creditors, prudential regulators and, to a lesser extent, managers who might have taken a long-term view on the company's economic performance.

The second important change refers to a shift in the policy approaches of national and international financial and monetary regulators, characterized by Wade (2008) as the emergence of a standards/surveillance/compliance regime for global financial regulation. Regulators increasingly relied for their macro- and micro-prudential policies on instruments that assumed that market discipline and disclosure of investor-relevant information would limit harmful and excessive risk taking (Allen/Carletti 2008). Regulators also increasingly relied on financial companies' internal risk management and auditing data for prudential supervisory purposes (Laux/Leuz 2009, 2010), as is particularly evident in the Basel regime for calculating risk exposure and capital requirements (Helleiner et al. 2009). This regulatory approach – built on the theory of rational and efficient markets – assumed that market prices provided a good approximation of the worth of assets and that securitization and financial innovation would even promote financial stability because more liquid markets would enhance allocative efficiency (FSA 2009: 39; Orléan 2011). In many respects, it signified a departure from previous prudential approaches, particularly prevalent in continental European countries (Richard 2005), which had relied more strongly on the principle of prudence and on counter-cyclical buffers to shield financial institutions from market fluctuations.

From the 1980s onwards, the development of financial reporting standards by the two leading standard-setters worldwide, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB), mirrored and promoted a market-based approach to disclosure and supervision. By initiating a standard-setting project for Fair Value Accounting (FVA) in 1991, the IASB followed the FASB. In the United States, the shift towards FVA had been a response to accounting scandals during the savings and loan crisis in the 1980s and early 1990s, as well as to the rise of securities markets and increasing securitization through derivatives (Hellwig 2009), accompanied by the empowerment of financial professionals (Useem 1999).

Historically speaking, there are at least three ways to provide information about financial assets and liabilities in a company's balance sheet: Historical Cost Accounting (HCA), Fair Value Accounting (FVA) and accounting at amortized cost. In HCA, an asset or liability is reported at the original monetary value at the time it was acquired or incurred and amortized over its lifetime. In prin-

principle, this method relies on past transaction prices resulting in accounting values. HCA is considered “prudent” and “conservative”; it tends to buffer the balance sheet of an entity against market price fluctuations. It also potentially sets counter-cyclical incentives for economic entities’ behavior in so far as market prices above acquisition costs might trigger sales, while market prices below acquisition costs should lead companies to hold on to assets. One of the downsides of HCA, as shown in the US savings and loan crisis, is that it is insensitive to current price signals and can lead financial companies to ignore the depreciation of their assets under current market conditions. Underlying HCA is an understanding of the firm as an ongoing concern, as well as a certain skepticism about market prices providing the most accurate estimate of “true value.” HCA was the prevalent approach to accounting for financial instruments well into the 1970s in most industrialized countries.

In contrast, FVA reports the value of an asset or liability based on the price that it would receive if transacted in markets at the time of measurement. FVA is thus a method that shows the assets and liabilities of an entity at a value that would be achieved in arm’s length transactions on markets at the date of the balance sheet. The advantage of FVA is that, under conditions of functioning and efficient markets, it provides an accurate representation of the price at which assets could be realized in transactions. FVA is also seen as providing management with up to date information relevant for decision making. Proponents consider FVA as an early warning system against mistakes in handling risk since declining prices will be immediately reflected in the balance sheet and profit and loss statement. While elegant in theory, however, in practice FVA raises a number of questions concerning how fair value can be empirically established (Whittington 2010). This is an issue especially in inactive or illiquid markets. One problematic feature of FVA, according to a critical report by the European Central Bank (2005), is that by relying on market prices for the valuation of company assets it can have undesirable pro-cyclical effects. Rising asset values during “boom” periods can lead companies to take on high risks while declines in market prices in “bust” periods might lead to panic sales and thereby exacerbate a downward spiral. Accordingly, in good times, banks tend to lend more (which implies to some extent taking on riskier clients) whereas in times of distress they tend to limit lending, and thereby reinforce recession. Underlying FVA is a view of the firm as a bundle of assets and liabilities of which the investors should be able to establish the realizable or exit/liquidation value, i.e. the value of the firm at the time of sale. Compared to HCA, it is optimistic about the efficiency of markets in generating prices that approximate the “true value” of the firm’s assets.

A third method, accounting at amortized cost, is usually used for the subsequent measurement of financial instruments initially acquired at fair value. The

value of such a loan or receivable is reported using the effective interest rate method taking into account changes in the macroeconomic environment¹.

In the 1990s, FASB and IASB were both in favor of expanding FVA beyond financial assets held on companies' trading books. They considered that this approach provides a more comprehensive and accurate picture of the different classes of financial assets held by an entity. In their view, FVA provided more appropriate and high-quality information for investors interested in transparent and timely disclosure of economic performance data. In both cases, however, their proposals met fierce opposition from the banking industry (Laux/Leuz 2009). When the FASB proposed FVA in the United States, American banks argued that this accounting method did not suit their business model and was not relevant for their investors either. Only investment banks were more receptive to FVA because most of their business consisted of trading financial instruments on a daily basis. After negotiations with the industry and some revisions, FASB published a fair value standard in 1991. Two years later, it expanded the requirement for FVA to debt and equity securities that were held for trading or for sale. In 1998, derivatives were required to be measured at fair value.

Finally, in 2006, FASB issued FAS No. 157, Fair Value Measurements, which was aimed at providing a single and consistent definition of fair value and established a hierarchy of valuation techniques. When applied as mark-to-market accounting, prices in existing markets were used as fair value. In the absence of active markets, fair value was to be calculated on the basis of prices in reference markets or, in situations where market prices were not available or reliable, by using market valuation models (Laux/Leuz 2009: 827). Companies had to classify their assets and liabilities in one of three categories: while financial instruments Available for Sale (AFS) and Held for Trading (HfT) were to be valued according to fair value, financial instruments Held to Maturity (HtM) continued to be valued according to amortized cost. While generally moving towards FVA, US GAAP retained some categories for loans at amortized cost (see Table 1).

At the international level, IAS Exposure Draft 40 for financial instruments was published by the International Accounting Standards Committee (IASC) in 1991. It was subsequently modified and separated into IAS 32, "Financial Instruments: Presentation" (adopted in June 1995), and IAS 39, "Financial Instruments: Recognition and Measurement," which was revised several times before being adopted as the last core standard required by the International Organization of

1 For technical details see the definition provided by PriceWaterhouseCoopers (2006: 23): "The carrying amount of a financial instrument [...] is computed as the amount to be paid/repaid at maturity (usually the principal amount or [...] face value) plus or minus any unamortized original premium or discount, [...] and less principal repayments."

Table 1 Financial Instrument Categories – US GAAP

Categories of financial asset	Characteristics	Balance sheet measurement
Held to maturity assets	Usually debt instruments purchased with the intent and ability to hold until maturity	Amortized cost
Financial assets as held for trading	Possibly debt or equity instruments bought and held principally to sell in the short term	Fair value
Available for sale financial assets	Debt or equity instruments which are held neither to maturity nor for trading	Fair value

Source: Bragg (2010: 254).

Securities Commissions (IOSCO) in 1998. Among the reasons for this lengthy standard-setting process was once again resistance from the banking sector, this time mainly in continental Europe (André et al. 2009; Botzem 2010). French banks, in particular, were opposed to expanding FVA to financial instruments other than those on the trading book, and especially to financial instruments held for hedging purposes. Camfferman and Zeff (2007: 367) report that IAS 39 was approved at the December 1998 meeting of the IASC with a very tight vote of 12 members in favor, Australia voting against and France, United Kingdom, and the United States abstaining for different reasons. As a result of long and controversial negotiations, IAS 39, published in 1998, consisted of a mixed model combining different measurement methods. It established a hierarchy of valuation techniques for fair value similar to that in US GAAP. But as a result of complicated negotiations, IAS 39 distinguished between five categories of financial instruments (instead of three, as in the case of US GAAP) which are displayed in Table 2.

As a result, more financial instruments were subsequently measured at amortized costs under IAS 39 than under the FASB's FAS 157. In addition, the so-called Fair Value Option in IAS 39 allowed companies irrevocably to classify financial instruments, independently of category, to fair value to increase consistency of financial reporting. From the beginning, IAS 39 was criticized for its complexity and there was agreement among the parties involved that it would require revision in the medium term. Controversies surfaced again following the European Union decision to adopt IFRS. IAS 39 was the only IFRS standard that was not endorsed by the EU at the outset, following strong opposition from continental European banks. In 2005, the European Union endorsed the Fair Value Option in a revised version. However, the so-called hedge accounting option was still pending when the financial crisis broke in 2007 (Botzem 2010). Hedge accounting includes rules for financial instruments, often derivatives,

Table 2 IAS 39-Categories of Financial Instruments – IFRS

Categories of financial assets and liabilities	Characteristics	Initial valuation	Subsequent measurement
Held to maturity assets	<i>Includes</i> Investments in debt Instruments quoted in an active exchange <i>Excludes</i> Equity shares Loans and receivables Held for trading	Fair value	Amortized cost
Available for sale financial assets	<i>Includes</i> Ordinary share investments Convertible notes Preference share investments <i>Excludes</i> Derivatives held for trading	Fair value	Fair value
Originated loans and receivables	<i>Includes</i> Accounts receivables Loans to other entities Credit card receivables <i>Excludes</i> Instruments quoted on an active exchange Held for trading derivatives Preference shares	Fair value	Amortized cost
Financial liabilities at fair value through profit or loss	<i>Includes</i> Share portfolios held for short-term gains Forward contracts Interest rate swaps Call options	Fair value	Fair value
Other financial liabilities	Any other category not described above	Fair value	Amortized cost

Source: Compilation based on IAS 39 as issued by the IFRS Foundation (www.ifrs.org/IFRSs/IFRS.htm).

which are used as a defense (hedge) against future financial risk arising from a change in the price of the underlying asset.

As indicated by this brief – and unavoidably somewhat technical – overview of accounting for financial instruments, by the mid-2000s IASB and FASB were still some distance from convergence in their rule-setting. The US side was unhappy about the complexity of the categories in IAS 39 as compared to the

FASB standard and the EU Commission's decision not to endorse the rules on hedge accounting. On other items, FASB standards were – as the crisis would show – still more problematic. FASB standards on consolidation – in other words, which financial instruments, and particularly special purpose vehicles, were to be included in the financial report of an entity – left significant leeway to American banks, whereas IFRS standards were more stringent, although by no means perfect in this respect (Thiemann 2011). Nevertheless, the roadmap towards a convergence of standard-setting appeared to be set. In 2002, IASB and FASB had signed the Norwalk agreement in which they indicated their willingness to work towards making their “existing financial reporting standards fully compatible as soon as practicable” and to “coordinate their future work programs to ensure that, once achieved, compatibility is maintained” (IASB-FASB 2002: 1). Four years later, in February 2006, this commitment was further detailed and specified in the form of “A Roadmap for Convergence between IFRSs and US GAAP 2006–2008.” According to this roadmap, convergence on the Fair Value Option and impairment (rules for writing off assets that have a higher carrying value than what could be earned in the market) were supposed to be concluded by 2008. Other topics already on the working agenda but not yet to be concluded by 2008 were issues of consolidation and guidance on fair value measurement (IASB-FASB 2006: 3, updated by IASB-FASB 2008).

In sum, it seems fair to conclude that critical voices highlighting possible undesirable effects of the shift in valuation methods from amortized costs towards fair value were in a minority before the crisis. In the case of banks, their concerns seem to have been overridden by the gains for financial institutions and their professionals (Philippon/Reshell 2009; Godechot 2011) that could be derived from booming financial markets under FVA. Moreover, the main focus of international regulators, concerning accounting, was on the reduction of the remaining discrepancies between the sets of standards issued by IASB and FASB, and fair value seemed a promising approach to work towards more convergence, overriding concerns about possible undesirable effects on macro-financial stability (Erturk et al. 2008). Thus, judging from the mid-2000s, there appeared to be increasing agreement on the future development of accounting standards between a significant number of financial institutions, accounting standard-setters, and national and international financial regulators. This changed significantly as the first signs of a major financial crisis became visible, first in the United States and then worldwide. In the following section we will analyze how certain aspects of accounting standard-setting came to be considered problematic by some actors, and how shifting coalitions of actors shaped the way in which accounting standards became part of the reform agenda.

Putting accounting standards on the international policy agenda

Following a long period of sustained financial market growth and credit expansion, defaults on subprime loans in the US mortgage sector increased significantly throughout 2006 and the first two quarters of 2007, followed by a drying up of interbank markets. The customer credit run on Northern Rock, a UK bank, in September 2007 showed that the financial turmoil was not limited to the United States but was spilling over into Europe (FSA 2009: 27). During this period, representatives of the banking industry, first in the United States and then in Europe, increasingly expressed concerns about the implementation of recently introduced accounting rules for financial instruments (FAS 157 in the US and IAS 39 in Europe). Banks reported practical problems with establishing mark-to-market values in markets under stress, and uncertainty about the conditions under which assets could be moved from fair value to amortized cost categories. The concerns voiced by representatives of banks and banking associations thus referred to a lack of guidance on how to implement fair value for financial instruments under changing market conditions, as well as re-articulating their more general skepticism, voiced earlier, about the appropriateness of fair value accounting for banks. On both continents, the banking industry lobbied standard-setters to suspend their accounting rules for financial institutions in order to allow them to accommodate illiquid markets. In the first instance, the FASB and the IASB resisted doing so, arguing that accounting consistency should be protected independently of market conditions and that it was exactly the function of FVA to signal where risk management strategies in banks had been mistaken or had failed. Changing the rules would give rise to management manipulation and harm investor confidence instead of re-establishing it.

In the fall of 2007, US and European banks experienced further losses on their trading books valued on a mark-to-market basis because of the drying up of commercial paper markets, a problem that triggered the return, for reputational reasons, of assets from special investment vehicles from the shadow market onto banks' balance sheets (Thiemann 2011). Governments and regulators, too, started to worry about the causes of the escalating crisis. There was considerable uncertainty about underlying cause–effect relations and cross-sectoral and international interdependencies. In the case of accounting, the recent introduction of new measurement methods and classification categories made the role of FVA in the unfolding of the crisis rather opaque and difficult to assess empirically. As a consequence of this epistemic uncertainty, several international bodies set up working groups to investigate the causes of and propose remedies for the crisis, considering also the role of capital ratios and accounting rules.

Three reports, produced during this period by the Financial Stability Forum (FSF), IOSCO and International Institute of Finance (IIF), deserve attention because they demonstrate that at this stage, apart from the banks themselves, most actors still adhered to a transparency approach which emphasized that accurate and timely disclosure of business information, if implemented correctly and consistently, would not only enhance the efficiency of financial markets, but also send clear signals to banks that their risk management required corrections, thereby helping to resolve the crisis in the medium term.

The FSF report “Enhancing Market and Institutional Resilience” was published in the run-up to the G7 meeting in Washington in April 2008. The FSF, a group of major national financial authorities – such as finance ministries, central banks, and international financial bodies – founded in 1999 to promote international financial stability, had been asked to prepare this report by the group of G7 finance ministers and central bank governors in October 2007. The FSF (2008) identified severe problems with financial industry practices, including poor underwriting standards, weaknesses in valuation, failures in risk management, and a lack of disclosure, particularly in regard to special purpose vehicles and off-balance sheet financial instruments. The report also pointed to the bad performance of credit rating agencies. Weaknesses in regulatory frameworks and other policies were seen as an exacerbatory factor contributing to the financial crisis. FSF recommendations focused on strengthening prudential oversight of capital, liquidity, and risk management in the context of the existing Basel II Accord, improving the quality of disclosure and valuation, changing the role of credit agencies, strengthening authorities’ responsiveness to risks, and enhancing arrangements for dealing with stress in the financial system.

Thus, while maintaining a market-based regulation approach, recommendations were directed towards improving prudential oversight, information, and disclosure where it seemed to have failed and had sent the wrong signals. In the area of disclosure and valuation, the FSF report (FSF 2008) urged the Basel Committee on Banking Supervision (BCBS) to strengthen its risk disclosure and asked accounting standard-setters to take urgent action to improve and converge financial reporting standards for off-balance sheet assets, thereby pointing at an early stage to the role of the shadow banking sector in amplifying the crisis. Furthermore, it pressed FASB and IASB to provide more guidance on valuations when markets are no longer active and to suggest ways of reporting uncertainty about valuations. In order to achieve these goals, it urged the IASB to establish an Expert Advisory Panel (EAP) on Fair Value in Declining Markets. Interestingly, the FSF report made no reference to possible pro-cyclical effects of accounting rules at this time.

In parallel, an IOSCO task force constituted in November 2007 had studied how the subprime crisis in the United States led to instabilities in global financial markets. IOSCO's report, published in May 2008, came to similar conclusions to those of the FSF, which was not surprising since the two working groups had liaised during preparations. However, IOSCO (2008a) highlighted the spillover effects from mortgage banking, derivatives markets, and structured finance leading to a liquidity crisis of hedge funds and institutional investors in the fall of 2007 and a near failure of several investment banks in the spring of 2008. In the section on valuation and accounting, the IOSCO report engages more explicitly with the question of whether FVA is adequate for the task of financial reporting on financial instruments or whether there are better alternatives. While acknowledging that difficulties of valuing at market prices in illiquid markets can exacerbate risk aversion and can lead to pro-cyclical worsening of market conditions, the report emphasized the beneficial role of FVA in providing early warning signals. It stated that banks lacked experience and skill in dealing with valuations under conditions of stress. Consequently, the report called for better guidance related to the measurement of FVA and better training of banking staff in preparing disclosure for investors.

In response to FSF and IOSCO, the Institute of International Finance (IIF), a global industry association of 400 large banks, investment banks, insurance companies and investment firms, formed a working group in October 2007. The IIF Committee on Market Best Practices seized the opportunity provided by the upcoming G7 meeting in April 2008 to publish an Interim Report (IIF 2008a), followed by a final report in July 2008 (IIF 2008b). While the Interim Report acknowledged the responsibility of the industry and urged IIF member banks to adopt improvements in risk management and accounting practices, it also made recommendations regarding public regulation. In particular, the report pointed to pro-cyclical effects of the implementation of Basel II. Like the FSF and IOSCO, the IIF called for more guidance on the application of FVA under stress and in illiquid markets. However, the IIF also suggested a need for a broad dialogue on the long-term implications of fair value accounting. More specifically, the report (IIF 2008a: 17) stated:

A critical subset of issues revolves around whether mark-to-market exacerbates the overall degree of risk aversion in the marketplace and thereby contributes in a procyclical manner to the continuation and possible worsening of market stress. [...] broad thinking is needed on how to address such consequences, whether through means to switch to modified valuation techniques in thin markets, or ways to implement some form of "circuit breaker" in the process that could cut short damaging feedback effects while remaining consistent with the basics of fair-value accounting.

As a lobbying association, the IIF emphasized the need to reduce pressure on banks in order to prevent the collapse of individual institutions, although it also referred strategically to macro-prudential arguments about pro-cyclicality to bolster its claims. Less affected competitors, investors' and analysts' associations denounced this as a self-serving call for exceptional measures. Financial regulators and banking supervisors were also wary of moral hazard. The common view at the time was that existing accounting rules, despite their imperfections, could have a strong purgative effect, enabling a faster recovery.

This view was also reflected in the G7's communiqué of April 11, 2008, which incorporated recommendations made by the FSF. Among many other proposals, it suggested that the "International Accounting Standards Board (IASB) and other relevant standard-setters should initiate urgent action to improve the accounting and disclosure standards for off-balance sheet entities and enhance guidance on fair value accounting, particularly on valuing financial instruments in periods of stress" (G7 2008). André et al. (2009: 11) conclude that the IASB's response to the financial market crisis resulted from this period: the IASB established, as requested by the FSF, an Expert Advisory Panel (EAP) on Fair Value with the FASB as an observer. The IASB also amended disclosure rules in IFRS 7 to provide more information about model-based estimations of fair value, the maturity of derivatives, and liquidity risk (André et al. 2009: 12). Finally, the IASB asked its staff to urgently advance the consolidation project which was already on the active working agenda of the convergence program. The purpose of the EAP was not to discuss the general issue of fair value accounting, but instead to consider the specific technical problems of asset valuation in markets under stress. As the draft report of the EAP released by the IASB on September 16, 2008 observed (IASB EAP 2008: 15):

Some think that, in periods of market turmoil, adverse market sentiment can create an apparently illogical view of risk and that fair value measurement should not consider the effect of this on model inputs, such as credit and liquidity premiums charged. However, the objective of measuring fair value is to establish what the transaction price would have been on the measurement date in an arm's length exchange and market sentiment is a factor in determining any transaction price.

As a general orientation, the IASB continued to pursue fair value as a single measurement principle for all financial instruments, as documented by the release of a discussion paper "Reducing Complexity in Reporting Financial Instruments" (IASB 2008) to coincide with the April 2008 G7 meeting (see Stellinga 2011 for a highly critical response to this draft).

By late summer 2008, "Fannie Mae" and "Freddie Mac" had become increasingly reliant on government funding in the United States; the funding of UK mortgage banks became more difficult; and the interbank market was nearly

at a standstill (FSA 2009: 27). The opportunistic demands of individual banks, American and European banking associations, and the IIF to reconsider the appropriateness of FVA beyond technical questions of valuation remained largely unheard. International prudential and securities regulators recognized that there had been an inappropriate implementation of FVA under illiquid market conditions which might have had feedback effects, and that valuation methods in banks might not have been sophisticated enough. However, they also maintained that a transparent surveillance regime based on market discipline was still the most appropriate regulatory model to pursue. Accounting standard-setters responded halfheartedly to FSF pressure to provide clearer rules on consolidation and guidance on FVA but they continued to pursue their convergence agenda based on fair value accounting as the underlying paradigm. The prevailing problem definition was that, if anything, the implementation of accounting standards in practice had been weak and needed to be fixed by more explicit guidance.

How can an equal playing field be established for banks under stress?

September 2008 brought the global financial system to the brink of collapse. After Lehman Brothers filed for Chapter 11 bankruptcy protection on September 15, financial institutions operating internationally faced a double squeeze. Their exposure to illiquid assets forced them to make massive new write-downs and fire-sales of other classes of financial products in order to meet their capital requirements. This precipitated a run by investors eager to disinvest from the institutions which seemed to be the most vulnerable according to their deteriorating books (Hellwig 2009). While stock indexes plummeted because of liquidity pricing, and the cost of interbank lending rocketed because of the general mistrust among surviving banks, major banks became strongly reliant on central bank support (FSA 2009: 27). During this period accounting debates were profoundly redefined (Humphrey et al. 2009; Ojo 2009). Heads of government, finance ministers, prudential banking regulators, and central bankers gradually reformulated their views on the role that accounting rules played – in conjunction with the implementation of Basel II – in the unfolding of the financial crisis, and what steps needed to be taken to revise them in ways that would help to re-establish financial stability and bolster the robustness of the financial system. The major push to do so came from Europe. It was framed by governments and legislators as a problem of competitive disadvantage affecting some banks rather than others.

As documented in more detail by André et al. (2009: 13–15), a meeting of the finance ministries of European members of the G7 (France, Germany, Italy, and the United Kingdom), called by President Sarkozy on October 4, 2008, took place in the heat of the financial turmoil following the collapse of Lehmann Brothers. It was followed by an announcement by the EU Council of Finance Ministers (ECOFIN) some days later that urged the IASB to amend the rules of IAS 39. The revision should allow banks to move certain assets and liabilities from FVA to amortized cost categories. The European Commission threatened that if the IASB did not amend IAS39 accordingly by the end of October 2008, the European Accounting Regulatory Committee (ARC), formally in charge of endorsing IFRS, would meet in mid-October to pass a draft removing paragraphs from IAS39 which prevented reclassification from FVA to amortized cost.

According to André et al. (2009: 13–15) this initiative can be traced back to French banks taking advantage of the financial crisis to renew their earlier calls on the government to intervene to support them and to press the international accounting standard-setter to revise its FVA rules. More specifically, the authors report that President Sarkozy, responding to lobbying by large French banks, had asked for an expert report by René Ricol – a French accountant who had served as the president of the International Federation of Accountants – on whether existing US GAAP standards would allow American banks to reclassify mortgages and financial instruments in the Available for Sale (AFS) category under the current unusual circumstances in ways that would leave European banks at a competitive disadvantage. The Ricol Report concluded that this was indeed the case, and the European Commission's Internal Market and Services Directorate General (DG MARKET) took action based on the requirement of EU directives that IFRS must not disadvantage European companies as compared to those in other major markets.

The IASB, fearing major damage to its legitimacy by a further departure by the EU from the application of IFRS standards, responded by suspending their constitutional due process and passing the requested amendments of IAS 39 on October 13, 2008, against the votes of its American members who argued that the European reading of US GAAP was mistaken. However, the European Commission through DG MARKET, and the French government through a meeting of European members of the G20, stepped up its pressure for further-reaching reforms of international accounting standards. On October 27, 2008, DG MARKET sent a letter to the IASB – discussed in more detail by André et al (2009: 15) – raising questions about the reclassification of assets categorized under the Fair Value Option (which by definition excluded moving them to amortized cost), a revision of the specific impairment rules, and issues related to the valuation of embedded derivatives. The response of the IASB, transmitted

by letter on November 14, 2008, was that it would set up a series of roundtable discussions on the financial crisis by the end of the year, and that any further steps to amend standards would need to take place within the established standard-setting due process and in conjunction with the FASB to ensure global convergence (cited according to André et al. 2009: 16).

Thus, in the face of the mounting crisis, the European Commission and member state governments supported banks in their demands for greater managerial leeway to reclassify assets that were rapidly losing value and forcing fire-sales or write-offs. They did so based on concerns that individual banks would collapse and exacerbate the crisis. The problem definition, however, was re-phrased somewhat instrumentally in order to find a lever to break the resistance of the IASB. In the first instance, DG MARKT justified its demands with arguments that a level playing field needed to be established between US and European banks in dealing with the crisis. In the second instance, justification was again based on the need for a level playing field, but this time between different European banks (those that been allowed to reclassify by the amendment of IAS 39 and those that had not been allowed to do so because they had chosen the fair value option in the first place). The issue of derivatives, in turn, referred once more to equal treatment of US and European banks. There was little reference to a more long-term perspective concerning how to define accounting standards in line with steps undertaken to reform Basel capital requirements. Longer-term macro-prudential considerations were mentioned only in a side note. In other words, the European Commission and member state governments were concerned about transparency of disclosure in a competitive environment. As their realignment with the banking industry became visible and pressure on standard-setters rose, security regulators, unaffected parts of the banking industry, and standard-setters became increasingly concerned about the negative effects of piecemeal reforms on the transparency of disclosure standards.

Convergence on immediate policy steps, yet continued divergence of problem definitions

Various diagnoses and suggestions for remedies to the escalation of the crisis crystallized around the G20 meeting on November 15, 2008, in Washington. An analysis of the reports, letters and communiqués submitted in the run-up to this meeting confirms the realignment of problem definitions by European banks and governments, as well as the re-articulation of a distinctive view of both problem definitions and remedies by securities regulators and standard-setters.

On the one hand, EU heads of state and government moved beyond their earlier level-playing-field strategies, pursuing a more principled prudential approach to encompassing regulation and supervision of all kinds of financial markets and products. This regulation was required to follow principles of accounting and transparency that prevent “creating bubbles in periods of growth and make crises worse in periods of downturn.” To achieve this end, they urged accounting standard-setters to reform their governance structure to allow for “a genuine dialogue with all the parties concerned, in particular, with prudential authorities” (French Presidency of the European Union 2008). The Institute of International Finance, as a voice of the banking industry, sent a letter pointing to the need for reform of the Basel II Accord to avoid future pro-cyclical effects, a reconsideration of the reliance on ratings, and a broader dialogue about the application of FVA in financial institutions (IIF 2008c).

On the other hand, IOSCO (2008b), in its open letter to the G20, highlighted the importance of investor confidence in transparent disclosure and accounting as crucial to the success and liquidity of financial markets, and hence the stability of global financial systems. As a “community of authorities responsible for capital markets” it reiterated its commitment to the development and enforcement of global high-quality accounting standards that provided clear, accurate, and useful information to investors. While IOSCO acknowledged that accounting standard-setters needed independence to develop high-quality standards, it underlined that its “members must have a means of ensuring that accounting standard-setters are working in the best interests of investors.” The letter referred to previous coordinated work with the IASB to establish a Monitoring Board to enhance the accountability of the IASB to capital market authorities worldwide. A group of national standard-setters, as well as the Basel Committee, supported the IASB as standard-setter and called for its independence, as did investor associations (André et al. 2009; Stellinga 2011). The SEC, having just commissioned a report on the role of FVA in the crisis under pressure from Congress, also maintained a transparency view (as fully explicated in the final report, SEC 2008).

Thus, while the alignment between European governments and commercial banks on a critical view of fair value continued and was increasingly framed not only as support for banks under stress but also as a macro-prudential issue, security regulators, standard-setters, and investors continued to emphasize their transparency view. While these two camps had some common ground for policy measures, they diverged on others. There was by no means a clear line of demarcation between public regulators, as the differences between the pronouncements of governments, prudential regulators, and securities regulators show. Even among prudential regulators, there was no unanimity. For example, Daniele

Nouy, head of the French bank commission, in March 2008 declared that “mark-to-market accounting is changing the dynamics of this crisis – the pain comes very fast [...] But hopefully the recovery will come very fast too” (Hughes/Tett 2008). Also among banks, there was no unified opinion. In the United States, Goldman Sachs dismissed IIF proposals, coining them “Alice-in-Wonderland accounting” and Morgan Stanley publicly distanced itself from the Institute. In July 2008, Goldman even announced it was quitting the IIF (Dauer 2008).

The Trustees of the International Accounting Standards Committee Foundation (IASCF 2008) sent a letter to the G20 acknowledging policymakers’ and prudential supervisors’ concerns about issues of pro-cyclicality. However, it emphasized that the primary goal of accounting standard-setters was to provide investors with adequate information. Since pro-cyclical effects were arising, if at all, from interactions between accounting standards and Basel capital requirements they should be addressed by a dialogue with prudential supervisors – in the first instance, the Basel Committee. Furthermore, it was announced that the IASB and the FASB were about to establish a high-level advisory group – consisting of senior leaders with broad experience in financial markets and official observers representing key global regulators – to consult on how improvements in financial standards could contribute to re-establishing investor confidence in financial markets.

Faced with the urgent need to develop a regulatory response to the escalating crisis, the G20 summit in Washington on November 15, 2008 saw an alignment of different actors that focused on commonalities in immediate measures to be taken rather than agreement on cause–effect analysis. The G20, in its declaration and among many other recommendations, reiterated some of the calls made by the FSF in April of the same year, such as asking the accounting standard-setters to provide guidance on the application of fair value to financial instruments during times of illiquid markets and to work on disclosure standards for off-balance sheet vehicles. It increased pressure on the IASB to enhance its governance to “ensure transparency, accountability, and an appropriate relationship between this independent body and the relevant authorities” (G20 2008), leaving it thereby open to whom the IASB should be accountable in the end – to securities regulators as demanded by SEC and IOSCO, or to prudential regulators as suggested by the European Union. The G20 statement also reiterated that regulators should work towards financial statements that include “a complete, accurate, and timely picture of the firm’s activities (including off-balance sheet activities) and are reported on a consistent and regular basis” – which was closer to the suggestions of IOSCO than the concerns about potential pro-cyclicality articulated by banks and EU governments. Still, concerns that regulation might reinforce pro-cyclicality were not entirely pushed off the agenda. The IMF and

FSF were asked to review how “valuation and leverage, bank capital, executive compensation, and provisioning practices may exacerbate cyclical trends” in preparation of the next summit in April 2009 (G20 2008).

Coping with the systemic crisis

The period between October 2008 and April 2009 saw exceptional government recapitalization of banks across the United States and Europe. From November 2008 onwards, it became clear that the financial crisis was spilling over into the real economy. Banks with large impairments of assets started to ration credit and economies went into recession. Other near failures of banks required governments to infuse even more money to rescue them in order to prevent further escalation of the financial crisis (FSA 2009: 27). As these developments unfolded, politicians and regulators became increasingly wary of possible pro-cyclical effects of existing regulation, at the same time as a number of high-level expert groups and international regulatory bodies published reports with theoretical reflections on and empirical analyses of such pro-cyclical effects. In February and March 2009 alone five expert group reports and policy papers were published which, among other issues, included a review of possible pro-cyclical effects of prudential and accounting rules: the de Larosière Report, the FSA Turner Review, the FSF and IMF reports, and an European Council Key Issues Paper deserve more detailed consideration because they express a major shift in the problem definition of international financial supervisors, combined with a more systematic articulation of revisions to be considered by the two leading standard-setters.

First, a high-level group on financial supervision in the EU, chaired by Jacques de Larosière, former Managing Director of the IMF, released its report on February 25, 2009 (High-Level Group 2009). This group had been convened by EU President Barroso in October 2008, and included a number of senior experts with experience in prudential regulation and central banks. The report concluded that the existing regulatory framework had been insufficient and had partly reinforced downward spirals as the crisis unfolded. In particular, it pointed to the need for a fundamental review of the Basel II regulations and their implementation with the aim of introducing counter-cyclical measures. The report also stated that mark-to-market accounting under conditions of market stress had reinforced the downswing, and that as a consequence fair value accounting of financial instruments needed to be limited. The report argued that FVA accounting as implemented under IFRS had not been neutral but had produced

biased incentives for short-term business strategies. It advocated embedding the “public good of financial stability” (High-Level Group 2009: 21) in accounting standard-setting and pushed strongly for more accountability of the IASB by giving the “regulatory community” a permanent seat in its decision making bodies.

Second, the Turner Review published by the UK Financial Service Agency under the leadership of Lord Turner in March 2009 (FSA 2009: 39), commissioned by the Chancellor of the Exchequer in October 2008, also concluded – based on a similar diagnosis – that “major changes in our approach to capital, liquidity, accounting and institutional coverage” were necessary. However, the report went further and also questioned some of the assumptions underlying the previous market-based regulatory system. It asked whether market prices really were good indicators of value; whether securitized credit really fostered economic stability; and whether market discipline could limit excessive risk taking. The Turner Review highlighted a need for higher capitalization of banks, a serious revision of the Basel II regime to avoid pro-cyclicality, the creation of counter-cyclical buffers, and measures to offset pro-cyclicality in published accounts (FSA 2009: 61–62). The report also argued that while the fair value “accounting philosophy is appropriate from an idiosyncratic perspective – an individual bank operating in a reasonably stable financial and economic environment – from the point of view of regulators, and of systemic financial risk, it has serious disadvantages. On both the trading book and banking book sides, it can fuel systemic procyclicality” (FSA 2008: 65). The FSA believed that a dialogue with accounting standard-setters was required on how a counter-cyclical approach to bank capital could become visible in published accounting figures to raise managers’ and shareholders’ “awareness of the need to assess the performance of banks in the light of the position in the economic cycle” (FSA 2009: 67). Both the Turner Review and the de Larosière Report referred to the existing and successful practice of dynamic provisioning implemented by the Bank of Spain as a best practice model.

Furthermore, in fulfillment of their mandate, the FSF and IMF also published reports and papers on the issue of pro-cyclicality in the run-up to the G20 summit in April 2009. The FSF, based on consultation with various prudential and supervisory agencies as well as stakeholders, came to the conclusion that the current financial crisis had illustrated the “disruptive effects of pro-cyclicality.” Pro-cyclicality was defined as “dynamic interaction (positive feedback mechanisms) between the financial and the real sector of the economy” that tends to “amplify business fluctuations and cause or exacerbate financial instability” (FSF 2009: 9). The report suggested that elements of the existing prudential and accounting regimes had been a contributory factor. The FSF highlighted the importance of a macro-prudential assessment of the weaknesses of existing

regulation and suggested policy measures in four areas to dampen pro-cyclical effects in financial systems. First, the FSF (2009) recommended revising capital requirements under Basel II in such a way that they would promote prudential capital buffers over the credit cycle. Second, it argued that earlier recognition of losses – which current accounting rules excluded – would have dampened cyclical fluctuations. Hence, it suggested that accounting standard-setters should reconsider their incurred loss model and establish alternatives. Under the incurred loss model a provision for loan losses is recognized only after a credit event has been identified that is likely to result in non-payment of a loan. Third, the FSF pointed to the likelihood of pro-cyclical effects arising from parallel increases in risk taking and fair value valuation in banks. It argued that FVA also needed to be considered from a macro-prudential perspective. As a consequence, prudential regulators and accounting standard-setters were urged “to examine the use of valuation reserves or adjustments for FVA when data or modeling needed to support their valuation are weak” (FSF 2009: 25). Finally, accounting standard-setters should consider “possible changes in their standards to dampen adverse dynamics potentially associated with fair value accounting” (FSF 2009: 26). An IMF Working Paper (Novoa et al. 2009) published the same month took a more moderate line. While it found that weaknesses of FVA may introduce unintended pro-cyclicality, it still considered fair value to be the preferred framework for financial institutions. In line with the other reports, capital buffers, forward-looking provisioning, and more refined disclosure were seen as measures that could mitigate the pro-cyclicality of FVA.

Finally, a Draft Key Issues Paper prepared by the Economic and Financial Affairs Council of the European Union (Council of the European Union 2009), adopted by the European Council in the run-up to the G20 summit in London on April 2, argued pretty much along the same lines, referring to the de Larosière Report, to request financial regulation that would dampen rather than amplify economic cycles and an improvement of accounting standards on provisioning and valuation.

At the London G20 summit (2009a) heads of government took a fairly unified approach to financial regulation (while disagreeing on other issues, such as fiscal stimulus packages). Their “Declaration on Strengthening the Financial System” incorporated the problem analysis of the above mentioned reports and many of their policy recommendations. It explicitly urged the Financial Stability Board and BCBS to work with accounting standard-setters to implement its recommendations. While reaffirming the framework of fair value accounting, the G20 asked accounting standard-setters to take action by the end of 2009 to reduce the complexity of standards and improve accounting standards for loan-

loss provisions, off-balance sheet exposure, and valuation uncertainty. Standard-setters were called to work with supervisory regulators to achieve clarity and consistency in the application of valuation standards worldwide. They were to make progress with developing a single global standard and improve the involvement of stakeholders, including prudential regulators and representatives from emerging markets.

At the height of the financial crisis, the IASB saw itself surrounded by a shift of emphasis in diagnoses on the secondary causes of the financial crisis: while excessive risk taking, bad underwriting standards, and ill-directed financial innovation were still considered root causes, views on the role of prudential and accounting standards in the unfolding of the crisis had gradually changed. At the beginning of the crisis, the focus had been either on their coverage (for example, disclosure and accounting of off-balance sheet vehicles), their implementation (insufficient skill and experience of banking staff in dealing with new Basel II and FVA accounting rules), or equal playing-field issues (amendments of reclassification under IAS 39). Now the interface between prudential and accounting standards was considered a potential secondary cause that had reinforced the crisis. Demands and recommendations for reform, while formally confirming the fair value framework, argued increasingly from a prudential perspective that favored a more long-term horizon for the valuation of assets and liabilities than fair value accounting did.

At the end of March 2009, probably in light of the recommendations expected from the G20 summit, the IASB and the FASB had already decided at a joint board meeting to accelerate the process of standard revision. The Chair of the Financial Crisis Advisory Group (FCAG), which had met for the first time in January 2009, sent a letter to then Prime Minister Gordon Brown, as the host of the London G20 summit, highlighting that the group was in the process of considering various studies, including those mentioned above, and soliciting further input from other interested parties to advise the IASB and the FASB on accounting issues related to fair value, loan provisioning and off-balance sheet vehicles (FCAG 2009a). Following the April Summit, the IASB announced that it would undertake the development of a new standard for financial instruments (IFRS 9 to replace IAS 39) instead of pursuing further piecemeal revisions. In press releases, dated April 7 and April 24, 2009, the IASB (2009a, 2009b) explained that it was willing to take up the issues identified by the April summit and committed to working with the FASB towards convergence, but that it also believed that reforms should be undertaken in the context of a comprehensive project rather than in response to pressures from interested governments and business parties for piecemeal changes. The IASB project was subdivided into

three parts, dealing with (i) classification and measurement of financial instruments, (ii) impairment of financial instrument, and (iii) hedge accounting.

Pending further research, it appears that the establishment of a Financial Crisis Advisory Group (FCAG) and the Monitoring Board of the IASC Foundation, established in January 2009, together with extensive outreach work undertaken by the IASB, shaped the direction of the new standard-setting project. The resulting IFRS9 standard represented a compromise that included a revisited and simplified mixed model for the classification of financial instruments and consideration of more forward-looking alternatives for loan loss provisioning. The FCAG included senior prudential and supervisory regulators, central bankers, bankers, investors, and accountants from a range of countries, including India and South Africa. The Monitoring Board was a response to long-standing criticisms by IOSCO, the European Commission and others concerning a lack of public accountability. The members included IOSCO, Japan's Financial Services Agency, the SEC, and the European Commission (which, however, withheld signing the Memorandum of Understanding for several months), with the Basel Committee on Banking Supervision present as an observer.

In the press release announcing the publication of its final report, the FCAG (2009b) stated: "Accounting was not a root cause of the financial crisis, but it has an important role to play in its resolution." The report itself (FCAG 2009c: 3) presented a modified transparency approach: it recognized that financial reporting played an important role in the financial system and was of "great importance to investors and other financial market participants, [...] and to regulators and other users." However, the limitations of financial reporting figures also needed to be recognized because "regulators and others cannot rely exclusively on the information" (FCAG 2009c: 9). The report recommended that the IASB and the FASB "explore alternatives to the incurred loss model for loan loss provisioning that use forward-looking information," including expected loss and fair value models (FCAG 2009c: 7). For remaining differences between prudential and accounting standards, the Boards were asked to "develop a method of transparently depicting any additional provisions or reserves that may be required by regulators" (FCAG 2009c: 8). Furthermore, improvements in the standards for consolidation and off-balance sheet assets were requested.

The FCAG and the Monitoring Board underlined and supported the need for independence on the part of the accounting standard-setter. While the range of actors who should have a voice was defined more broadly – including regulators and not just investors – it was argued that independence was required to maintain a coherent and reliable standard-setting process shielded from the strategizing of interested parties. In its Statement of Principles made public on September 22, 2009, the Monitoring Board declared: "We view the primary

objective of financial reporting as being to provide information on an entity's financial performance in a way that is useful for decision-making for present and potential investors" (IASCF Monitoring Board 2009: 2). Therefore, the institutionalization of public oversight on the IASB did not fundamentally alter the priority given to investors as addressees of the accounting standards it produced. Nevertheless, it redefined the independence of the standard-setter by giving public authorities a lever in the nomination of trustees and in raising issues concerning the standards themselves.

The re-emergence of convergence as a key problem

When the G20 met six months later for their summit in Pittsburgh on September 24, 2009, the emphasis had changed once more. There was a strong call on "national authorities [to] implement global standards consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism, and regulatory arbitrage" (G20 2009b: 7). International accounting bodies were urged to "redouble their efforts to achieve a single set of high-quality, global accounting standards" and complete their convergence by June 2011 (G20 2009b: 9–10). Overall, there were increasing concerns that governments would implement regulatory changes in different ways, leading potentially to divergence and regulatory arbitrage. The background of this shift of emphasis from pro-cyclicality to divergence was manifold: while in April 2009 governments had been meeting under the threat of a severe economic downturn, September 2009 saw a gradual relaxation of the crisis as individual banks started to recover thanks to massive public support, and to the reclassification of financial instruments in their books. Furthermore, the work on problems of pro-cyclicality had been taken up by the Basel Committee, and to a lesser extent had also been considered by the IASB in dialogue with the former. However, some of the reform responses of governments and regulators under the threat of failing financial institutions were endangering a coordinated global response because they had created new sources of disparity between prudential and accounting standards rather than reducing them. Furthermore, the crisis had shown how such discrepancies could lead governments and business to engage in regulatory arbitrage and piecemeal rule changes which endangered overall coordination of responses.

This had become particularly apparent in the field of international accounting where, in contrast to other issue fields, such as capital requirements, two leading standard-setters were operating in parallel and liaising with each other. As time went by, it became increasingly clear that the way the revision of ac-

counting standards had unfolded between the two standard-setters had generated a number of side-effects which were increasingly complicating the policy goal of convergence.

One underlying problem was that both standard-setters worked with different timelines in their responses to the crisis. While the IASB chose to subdivide its project into three phases, the FASB decided to develop a single proposal. As a result, they presented their drafts at different times for public comment to distinct audiences and received quite different responses. A second, and related, source of disparities consisted of distinctive dynamics in their socio-economic and political contexts. For example, the SEC (2008) report on fair value, published in December 2008, which dismissed any role for accounting standards in amplifying the crisis, shielded the FASB from industry lobbying and pressure from Congress to review its standards, while several reports by European and international bodies increased such pressure on the IASB. Finally, a kind of intellectual vacuum emerged after the IASB-FASB joint Discussion Paper on “Reducing Complexity in Reporting Financial Instruments” received broad and virulent criticism. Stellinga (2011: 54) shows that this included disagreement between the standard-setters and the broader accounting community. With the FVA approach as the basis for convergence questioned, it was unclear what the broader intellectual framework for convergence would be.

Three different standard-setting projects illustrate these new sources of divergence: the project on the measurement of financial instruments, the work on impairment, and the standard on consolidation. We will treat them in sequence.

In July 2009, when the IASB and the FASB published their respective proposals for new standards for the classification and measurement of financial instruments within the course of a day, it became apparent that the two standard-setters were diverging in their broader orientations. The IASB Exposure Draft for IFRS 9, “Financial Instruments: Classification and Measurement,” published on July 14, distinguished between assets accounted for at amortized cost and at fair value. Broadly speaking, financial instruments with loan characteristics would be held at amortized cost, provided banks could show they would hold them for the long term. Everything else, including equities, derivatives, and more complicated securities, should be accounted at fair value. Responding to multiple criticisms from banks, regulators, and accounting communities (Stellinga 2011: 58–61) the IASB revised the standard in such a way that the final document published in November 2009 took into account the loan characteristics as well as the business model to allow for classification in an amortized cost category, and allowed for reclassification if the business model changed in a way that could be demonstrated to external parties. In contrast, the FASB proposal for addressing the classification and measurement of financial instruments, im-

pairment and hedge accounting published on July 15 (finalized as an exposure draft in May) proposed much greater use of fair value measurement than IFRS 9, with almost all financial instruments at fair value and only a few financial liabilities under the amortized cost option. While the latter received considerable criticism for FVA of loans, the FASB nevertheless continued a full fair value approach up to 2010.

Similarly, the approach taken by the IASB on impairment issues, published as an exposure draft in November 2009, was receptive to suggestions made by the FCAG that loss impairment and provision should be more forward-looking. The recognition of a credit event was removed. In contrast, the FASB proposal developed a different solution that would write off losses at a given time and maintain the logic of a credit event. As stated by the IASB itself (2011: 5), "In redeliberating their original impairment proposals each board began to develop a model for impairment accounting that was a variant of its original proposal." Given the strong urgency that the FSB and the G20 attributed to convergence on the issue of impairment for reasons of prudential and supervisory oversight, the Boards then decided to address the discrepancies by developing and publishing a supplementary document which suggested a kind of meta-frame consisting of two open portfolios, established by the risk management of the banks. Work on this project, as on the one on hedge accounting, is still ongoing at the time of writing, with no easy solution for convergence in sight.

In the area of consolidation of special purpose vehicles and other financial entities which was brought onto the political agenda at an early stage in April 2008, and subsequently followed by the IASB with an exposure draft in December 2008, the approaches taken by the FASB and the IASB again diverged in the course of the crisis instead of converging. After closely monitoring the comprehensive consolidation approach taken by the IASB, the FASB decided not to join this project at the time, and instead is in the process of developing narrower improvements to existing guidance. The IASB, in turn, finalized its standards for Consolidation and Disclosure in May 2011, according to which control (defined in a broad sense) is the defining criterion for consolidated entities. While the IASB argues that developments are broadly in alignment in this area, this remains to be seen, since the FASB's exposure draft of amendments is still under debate at the time of writing (IFRS 2011a, 2011b).

From this short review it is apparent that both Boards are still struggling with substantial differences in their approaches towards accounting for financial instruments, some of which have become even more pronounced in the course of the financial crisis. It remains to be seen whether the FASB will step back from its plans to expand fair value accounting, and what direction it will take towards incorporating IFRS. An SEC (2011) Staff Paper on the latter issue was

published in May 2011 and comments received by July are still under consideration by the SEC. In addition, it needs to be mentioned that the EU has so far refused to endorse any part of the new IFRS 9 standards as long as the whole package has not been finished. The EU's opting out of endorsing the standards raises questions about the degree to which revisions in IFRS have been implemented by European banks and financial companies in their accounting practices to date.

Conclusions

The results of our analysis indicate that at no stage in the process have actors converged, either on a single joint problem definition or on a single global reform project. Instead, problem definitions have evolved and changed over time: some actors have aligned their views and strategies, others have continued to articulate a different view of cause–effect relations, and reforms have developed step by step, at times merely responding to uncoordinated short-term pressures. This all points to the need to study problem definition and political action in interaction over time, rather than as two successive phases of the policy process.

As problem definitions have gone hand in hand with specific recommendations on standard-setting and governance reform, they have given rise to shifting actor coalitions. As the crisis unfolded, national governments, the European Commission, and prudential regulators saw accounting rules no longer merely as a means to achieve transparency, but also as a macro-prudential tool. Under the stress of the crisis, this brought them in line with the goals of large parts of the commercial banking sector. However, investment banks, securities regulators, analysts and investor associations, as well as the standard-setters, with some modifications in the case of the IASB, maintained that the principal goal of accounting standards was to provide a timely and accurate picture of the economic performance of an entity to its investors. Thus, coalitions around problem definitions arising from a transparency and a prudential approach cross the traditional divides between industry and regulators, or private and public actors.

The results furthermore suggest that changes in problem definition, as well as their prioritization or deprioritization in the public debate, can be attributed to two main factors: exogenous changes in the economic context – particularly the worsening of the crisis – and the endogenous dynamics of the reform process itself. Two events mark critical moments in the evolution of struggles over problem definition: the collapse of Lehmann Brothers on September 15, 2008, escalated the systemic risk involved in the financial crisis; and the announce-

ments by the IASB and the FASB of their respective proposals on measurement on July 14 and 15, 2009, made visible the potential for divergence between the responses of the United States and international standard-setters to the G20 agenda. While the first event triggered an alignment of views in response to systemic risk, the second event and its aftermath are outcomes of the accounting reform process.

Continued struggles over competing diagnoses arising from the transparency and prudential approaches did not prevent reform altogether. The IASB has revised its standards on consolidation in such a way that it should include all financial instruments held under the (broadly defined) control of a given entity. IFRS 9 provides clearer guidance on fair value measurement and simplifies the classification categories. Proposals on impairment, at least at the time of writing, seem to follow an expected rather than an incurred loss model. The establishment of a Monitoring Board has made the governance structure of the IASB more publicly accountable, although mainly towards securities regulators and less towards prudential regulators, with the underrepresentation of emerging market economies and developing countries persisting.

Nevertheless, the absence of a global governance architecture that would have provided incentives for both standard-setters to pursue a common revision of standards rather than as separate albeit linked projects, seems to be a crucial difference compared to reforms in other areas such as capital ratios. As a result of this specific governance arrangement, the reform process itself has generated new disparities between IFRS and US GAAP in the area of financial standards, while the declared aim of most of the actors involved is to foster convergence between systems. Paradoxically, the reform process itself has produced new problems. It has re-emphasized the problem of how standards can respond to different business models and processes while providing a comparable, relevant, and comprehensible picture of a company's economic situation. Here, as so often, the devil lies in the details.

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