The Risk of Deflation in Germany and the Monetary Policy of the ECB

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Since the spring of the current year a discussion has begun among economists on the world-wide danger of deflation. A study recently published by an IMF task force has put concerns in this regard, particularly with respect to Germany, back on the economic policy agenda. What would need to be done in Germany in order to better deal with this danger?

Danger of deflation in Germany?

Germany is on the borderline of deflationary. This is the conclusion reached in a study recently published by the IMF with the express approval of the IMF's chief economist, Kenneth Rogoff. For the federal government, the Chancellor, and the Minister of Finance, Mr Eichel, have publicly disputed this, as have the President of the Bundesbank, Mr Welteke as well as the Chairman of the Council of Economic Experts, Prof. Wiegard. This suggests that those responsible in Germany see no need for the ECB to take measures to counter a deflationary development.

Deflation refers to a general decline in the level of consumer prices, as measured in the EU by the harmonised index of consumer prices (HICP). In analogy to the definition of a recession, a decline of the price index over at least two consecutive quarters is the official benchmark for the occurrence of deflation.

There are different sources of deflation. On the one hand deflation my result from a general improvement in efficiency on the supply side, with increases in productivity leading to price reductions. On the other hand, it can be the result of a weakness of demand. This may lead to wide-spread price wars associated with a large margin of underutilised production capacity, and may even include ruinous competition. In such a case, one speaks of a demand-side deflationary process (IMF 2003, p. 9ff.).

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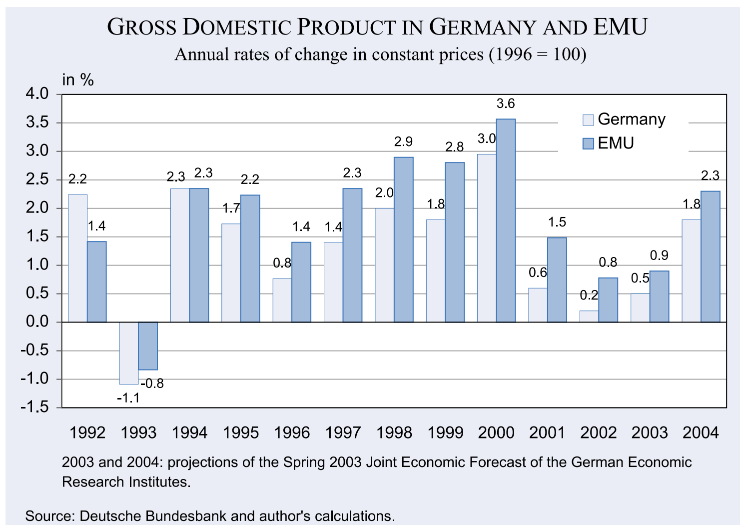
Whilst supply-side deflation was a longer lasting phenomenon in the 19th century during the era of industrialisation, in the world economic crisis of 1929 to 1933, deflation represented the effects of a weakness in demand which spread rapidly throughout the world. The concerns of the IMF economists focus at present on the danger of a demand-side deflation. Germany is only one of numerous countries that are at risk. However, deflation in a country like Japan or Germany, which are the second and third largest economies after the United States, represents a much greater threat than deflation in a smaller country; in addition, in assessing the danger one must take into account Germany's position as the largest economy within the EU.

The ECB possesses the instruments of monetary policy needed to combat deflation. The ECB has just recently redefined its monetary policy guidelines in order to better take into account the deflationary danger in EMU (ECB 2003). Instead of setting a policy goal of an inflation rate under two percent, the goal is now defined as an inflation rate of about two percent. In addition, with a view towards avoiding deflation, the ECB has set a lower limit of one percent inflation as a further monetary policy benchmark. These corrections in the ECB's monetary policy goals are, however, not sufficient to put a timely end to the present deflationary danger in Germany. Owing to inaccuracies in measuring inflation, as a rule a rate of inflation of one half percent is already considered to be the critical value at which deflation may appear.

Leading economists have characterised the new monetary policy orientation proposed by the Executive Board of the ECB as misleading (De Grauwe 2003). In particular, there is no clear commitment by the ECB to combat quickly a potential deflationary risk in individual member countries of EMU, like, for instance, Germany. The reason for this, it is argued, is that the ECB's decisions must be geared to the average of all member countries. Gearing decisions to specific countries would contradict the spirit of EMU. Thus the present attitude of the ECB means that only in the case of a deflationary risk facing the entire EMU could the ECB take monetary policy measures to counter the danger.

Adam S. Posen (2003) of the Institute for Institutional Economics in Washington arrives at conclusions that are very similar to those of the IMF.

Figure 1



He sees Germany threatened by the Japanese illness: prolonged economic stagnation threatening to give rise to a demand-side deflation. The causes are twofold: first, in Germany, as in Japan, there is a crisis in the financial markets; and second there has been weak growth during the last three years (cf. Fig. 1). In Germany this growth weakness resulted in an unmistakeable and unexpected contraction in retail sales of 4 percent in the first quarter of 2003, and in an unforeseeable decline in gross domestic product of 0.2 percent. Whether these developments mainly reflect short-term effects of the Iraq war is a subject of controversy. For some time now, Germany has been the laggard with respect to economic growth in the EU, and the latest figures indicate a poor growth outlook for the entire EU.

Britain's National Institute of Economic and Social Research, which also does research for the ECB and for the Ecofin Council, has carried out simulations which point to a current deflationary danger for Germany, which will be accentuated if the sharp revaluation of the euro continues.

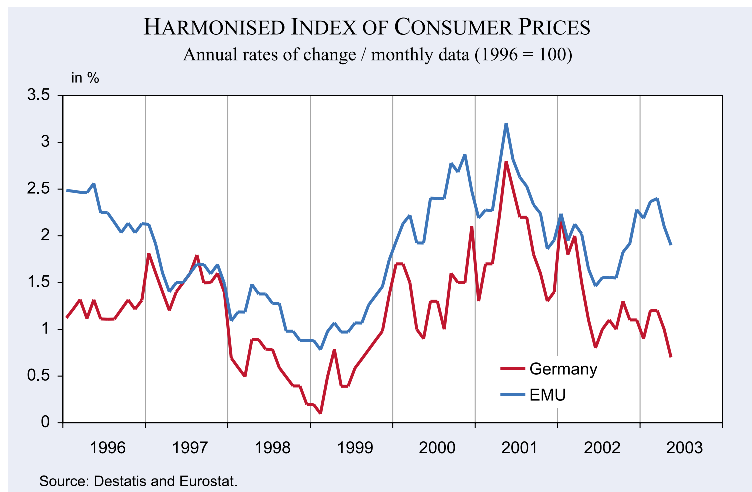
In this context it is not only the sharp revaluation of the euro vis-à-vis the US dollar that deserves attention, but also vis-à-vis other world currencies such as the Japanese yen. The value of the euro has risen against the Chinese renminbi and against the currencies of other Asian threshold countries owing to the past export orientation of these countries towards the U.S. and Japan and in conformance with a new exchange rate policy. This means that the international price competitiveness of the euro area and especially of Germany is weakened. This is all the more threatening as in the past the euro zone's economic growth was essentially determined by exports. Two-thirds of the euro area's 0.8 percent economic growth rate in 2002 was accounted for by the surplus of exports to non-EU countries. The looming record deficit of $500 billion in this year's US trade balance may limit the willingness of the U.S. to assume the role of engine of growth for the world economy. A devaluation of the dollar helps to reduce the deficit, but at the same time it exerts a deflationary effect on those countries experiencing a revaluation of their currencies. In the U.S., too, anxiety concerning the possibility of deflation has made itself felt, especially since the "new economy" bubble has burst; the deflationary risk on the other side of the Atlantic is, however, less acute than in Germany. In the U.S., the interest rates are at an historic low, with the federal funds rate at 1 percent; in Japan, the Japanese Central Bank, with its policy of interest rates at virtually zero, has lost almost room for manoeuvre for monetary policy. Under these circumstances, devaluation of one's own currency in order to stimulate the domestic economy turns out to be a beggar-my-neighbour policy.

In Germany, the boundary conditions imposed by the world economy together with the domestic structural and fiscal crises add up to a growing demand-side deflationary danger. Although wages and salaries are increasing in nominal terms, private households are presently raising their savings ratio so that a perceptible downturn in private consumption is being observed. Available supply is not matched by adequate domestic demand, since both private investment and public expenditures are in decline or virtually stagnant. Furthermore, the German financial markets are in an unstable condition unlike anything experienced in the history of the Federal Republic. There is no scope for a rigorous expansionary fiscal policy, like that currently being followed in the U.S.; in contrast, Germany is currently trying to reduce the high budget deficit which, though otherwise appropriate, is not the answer to the challenges faced by fiscal policy.

Imperfections of the European Monetary Union

When the Maastricht Treaty on forming a European Monetary Union was being negotiated, there was considerable controversy about the necessary preconditions for a country's membership in EMU. According to the theory of optimal currency areas, a currency area can only function efficiently, when there is a sufficient degree of convergence between the geographically defined economic units that use the common currency. The fathers of EMU had the same kind of hopes that prevailed when the German currency union was formed at the beginning of the 1990s: that a sufficiently rapid convergence between the member countries would emerge. However, in the run-up to 1998, and even thereafter, this has not been attained. One important reason for this is the still great disparity in per capita incomes in the EMU countries leading to a more rapid alignment of per capita income, not only through the common EMU financial market, but also through the price level in the individual countries. Experience indicates that this results in differences between the rates of inflation in countries with a high per capita income such as Germany, and in those with a low level of per capita income, such as Ireland, Greece or Portugal. In the complex processes involved in a reduction of the disparity of living standards in a situation in which the price levels are also disparate, it is entirely possible that there will be differences in the rate of inflation between the different EMU countries.

Figure 2



Source: Destatis and Eurostat.

Another influence working against a rapid convergence of the inflation rate in individual countries is the Balassa-Samuelson effect (Rogoff 1996; Erber 2002). As a consequence of the political nature of the selection process for EMU members, the union will continue to be an imperfect currency union for some time.

Because the convergence of inflation rates of EMU member countries can be expected to continue to be inadequate, Germany will tend to remain at the lower end of the range of inflation rates within EMU, owing to the Balassa-Samuelson effect. Two years ago, Hans-Werner Sinn (2003, Sinn and Reutter 2000) showed that Germany must keep its inflation rate permanently at a level of about one percent if the EU is to have an inflation rate of two percent. This means that in a situation in which the other member countries are experiencing very low levels of price increases or even stagnation as a consequence of a general weakness in growth, the restrictions imposed on Germany do not give sufficient room for manoeuvre so as to keep Germany's rate of inflation above zero. From a German point of view, the ECB's hesitant measures to ease monetary policy since 2000 have regularly come too late to help stabilise cyclical developments or to stop in a timely fashion the incipient downward movement.

The rate of inflation in Germany, as measured by the value of HICP in May 2003 as compared to the same month of the previous year, amounts to 0.7 percent. For EMU as a whole, the corresponding figure is 1.9 percent. The difference between EMU's inflation rate and that of Germany is thus even larger than one would have expected based on long-term trends. As early as 1999, Germany was confronted by a deflationary development as a result of the effects on world-wide growth of the crises in Russia and in Asia. The rate of economic growth was, however, still 1.8 percent. In addition, Germany's financial markets were in better shape. At the same time, a devaluation of the euro vis-à-vis the dollar began which stimulated German exports.

Crisis of financial markets in Germany

After the speculative "new economy" bubble burst in the spring of 2000, the crisis in the commercial banking sector became perceptibly more acute. The large amounts of bad loans and the big losses

suffered by holders of stocks and other assets made a recapitalisation of Germany's commercial banking sector more difficult.

The capital markets have since experienced sustained losses in the value of financial assets. A dramatic fall in stock prices, falling profit expectations and falling bond rates have all contributed to this destruction of financial assets. In Germany, as in Japan, and unlike the United States and Great Britain, real estate has not offered an alternative investment opportunity with an attractive yield. (IMF 2003, p. 53, fig. 12b).

Since banks and insurance companies hold a portion of their equity capital in stocks and in real estate, they as well as other private and institutional investors have been severely affected by these developments. Large downward valuation adjustments of portfolios do, however, pose problems for banks' lending activities, since the required equity ratio may not be met or may not permit lending activity in the accustomed magnitude.

Commercial banks' liquidity bottlenecks and increasing risk premiums on loans have brought about a situation in which credit is in effect rationed in Germany and this has paralysed many sectors of the German economy. The credit contraction began in the second half of 2001 and grew stronger throughout 2002. This contraction is particularly marked in the case of the big banks. Supporting actions, like the proposal of a "Bad bank", are to avoid a credit crunch at Germany's big banks; related actions, such as the true-sale initiative with the participation of the Bank for Reconstruction and Development, are designed to strengthen the liquidity situation of Germany's commercial banking sector. At the moment it is impossible to say whether these measures will take effect quickly and will serve to alleviate the credit shortage. Only the future lending behaviour of banks vis-à-vis firms and individuals will give an answer to this question. The banks' higher lending risks are leading to markedly higher interest rates for business borrowers; the losses that banks have already suffered in their lending transactions aggravate this tendency. Moreover, many commercial banks have cut back the lines of credit they extend to their business and private clients, thus creating a liquidity risk for these customers. A good part of the insolvencies registered in the past year, which reached record levels for the post-war period, were due to such credit restrictions.

Large institutional investors in the money and bond markets, like life insurance companies and pension funds, are suffering from the sustained weakness in the prices of stocks and real estate; the very low level of nominal interest rates prevailing in the OECD countries is an additional burden, and financial emaciation threatens if these markets do not turn around soon.

If a deflation, even though mild at first, were to coincide with these processes, it could very easily lead to a cumulative debt-deflation spiral.

From deflation to depression

As early as 1933 Irving Fisher (1933) analysed this process in a study of the world economic crisis; he identified inappropriate restrictive and procyclical monetary and fiscal policies in the United States and in a number of European countries as a central cause. In their comprehensive study of US monetary history, Milton Friedman and Anna Schwartz (1963) later confirmed Fisher's analysis.

G. Akerlof (1996), who recently was awarded the Nobel prize, using a model with a modified Phillips curve, has documented the dramatic effect of deflation on growth and employment when nominal wages are rigid and, at the same time, a rapid downward adjustment of wages would be necessary for macroeconomic reasons. Such an adjustment, however, is made impossible owing to social-psychological patterns of behaviour. Compared to a traditional Phillips curve model, Akerlof's explanatory approach was able to model excellently the unfolding of the Great Depression of 1929–33.

In such circumstances, what starts out as a mild deflation can turn into a runaway deflation process as a result of the slowdown in economic activity and in employment which the deflation triggers, unless expansionary and co-ordinated monetary and fiscal policies counter the deflationary tendencies. This process gains momentum when a general deflation is accompanied by wage deflation. If firms are making losses and respond to this by cutting the wages and salaries of their employees, and if this occurs on a sufficiently broad front through-

out the economy, then a price-wage-deflation spiral will be the result.

During the Great Depression, the general level of prices in the U.S. declined by 30 percent within three years. Initially, such deflationary tendencies are unexpected, but if they persist and begin to influence economic agents' expectations, then such a process can, under certain conditions, end up as a depression embracing the entire economy. In a depression the economic agents are confronted by a dynamic disequilibrium that causes most of them to abandon hope of any improvement of the economic situation. Instead of a cyclical development, a lasting confidence crisis arises, in which doubts become stronger as to whether adaption to the downward trend can overcome the recessive tendencies.

Breaking out of such a depression caused by persistently pessimistic expectations requires great efforts and gives rise to considerable costs because of the liquidity trap that neutralises interest rate policy as described by Keynes. Japan provides a warning example of just such a desperate situation, which has continued since the beginning of the 1990s.

Monetary policy consequences for the ECB

The ECB should under all circumstances strive to prevent such a development in any member country. Owing to the great weight of the German economy in the euro area, the effects of a deflation in Germany would soon spread to other member countries of EMU. The closer the integration is between Germany and a particular country, the greater the danger of contagion. It may be difficult at the moment to quantify reliably the probability of such a process arising, but given the high welfare losses which the entire economy would suffer if it did arise, the ECB and the German government would be well advised to do everything in their power to preclude this danger.

There is, at present, no risk of a sudden acceleration of inflation either in the individual member states of EMU, or in EMU as a whole. Therefore, the ECB ought to pursue an expansionary monetary policy as a precautionary measure in order to eliminate the current danger of deflation in Germany. Many observers are sharing the impression that the important economic policy makers, i.e. the decision makers in the ECB, the German government and the Bundesbank, deny this danger or consider it negligible, and that they are prepared to stick to this attitude until it is too late. Instead of pursuing a pre-emptive anti-deflationary policy – as the IMF expressly recommends – they have assumed a wait-and-see attitude, and seem prepared to persist in this until it is very late, or perhaps until it is too late.

The decision of the ECB to abandon the money supply as a leading indicator of future inflationary or deflationary potential in EMU countries doesn't solve the problem of identifying an indicator that would enable it to conduct a foresighted monetary policy. Only within EMU has the money supply proven to be an inappropriate indicator.

The warnings issued by the IMF and by Alan Greenspan should not fall on deaf ears in Europe's central bank.

Setting a price stability goal defined as a corridor for an allowed rate of inflation of between 1.5 and 3.5 percent as an officially proclaimed policy goal could serve, together with other expansionary monetary measures of the ECB, to reduce permanently the danger of deflation for Germany as a member country. This could be done without damaging the credibility of the ECB with respect to its ability to ensure price stability in EMU as a whole.

Furthermore, high volatility of the major exchange rates should be prevented by international co-ordination of exchange rate policy, under the overall control of the IMF, in order to avoid another burden for the world economy. Within the framework of Ecofin in the EU the German government can make an important contribution to this. One must wait and see whether such an agreement was prepared at the last summit meeting of heads of government in Evian or the conference of the Institute for International Finance in Berlin. For some time now a broad discussion has been going on in the U.S. concerning the consequences for monetary policy of an economic environment with low rates of inflation.

Economic policy options for the German government

The measures discussed above would give Germany and the German government a respite which could be used to carry out expeditiously the struc-

tural reforms in the labour market and the social security systems which are unavoidable and which alone are capable of ensuring a lasting and self-sustaining economic upturn in Germany.

The German government ought to appoint a task force charged with monitoring deflation; it should examine the available information with a view towards evaluating the risks for Germany and towards formulating policy options for acting in close cooperation with the ECB.

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Corporate Disclosure in a Global Age: Next Steps

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It was only a short time ago, after the Asian financial crisis of 1997–98, that the American system of corporate disclosure – the combination of Generally Accepted Accounting Principles (GAAP), Generally Accepted Auditing Standards (GAAS), the professionalism of auditors, and the rules and practices of corporate governance that are designed to ensure the timely dissemination of relevant and accurate corporate financial information – was championed as a model for the rest of the world.

How much has changed since then. A series of major corporate accounting scandals involving many former and current household names – Enron, Worldcom, Bristol-Myers-Squibb, and AOL/Time Warner, among others – rocked investors' confidence not only in the quality of financial information published by these companies, but by corporations generally. The flight from stocks helped drive their prices down by roughly 25 percent through the first half of 2002 (when uncertainties over the possibility of a war with Iraq became the more dominant force affecting stock prices).

Perhaps just as surprising as the scandals themselves, however, was the remarkably swift reaction by both the public and private sectors to address the flaws in the corporate disclosure and governance systems that the scandals revealed. Congress enacted and President Bush signed into law the Sarbanes-Oxley Act, which among other things, created a new body to oversee the auditing profession; made it difficult for auditing firms to engage in non-audit activities; and added a raft of new, tougher criminal penalties for financial wrongdoing. Less noticed, but equally important, were reforms by the major U.S. stock exchanges, the New York Stock Exchange in particular, which adopted new listing requirements: that a majority of the members of corporate boards be independent and that the hiring and firing of auditors be vested in audit committees of boards rather than in management.

The body charged with setting accounting standards in the United States, the Financial Accounting Standards Board (FASB), also reacted: by proposing a change in the rules governing the consolidation of the kind of "special purpose entities" (SPEs) that Enron abused and, more importantly, by promising to revisit the controversial issue of whether the cost of stock options at the time they are granted should be included as an expense rather than merely reported in footnotes in corporate financial statements. Although accounting for stock options was not directly implicated in any of the corporate scandals, many observers believe that excessive grants of options to corporate executives emboldened a number to "cook the books" in an effort to bolster their companies' stock price (so that they could exercise their options at high prices before they fell). If U.S. GAAP had required companies to report the grant of these options as an expense – as would have been the case had not Congress, at the behest of the business community, prevented the FASB from requiring in the 1990s – it is plausible that options would not have been so liberally granted to corporate officials, thus mitigating somewhat the incentives that led some to misreport their earnings.

Notwithstanding the various reforms – as well as the efforts under way in the private sector to improve disclosure – there is, at this writing, much skepticism about how effective all of the changes will prove to be. In part, the concern centers on the rocky start of the new audit oversight board, and the failure of the former Chairman of the Securities and Exchange Commission, Harvey Pitt, to inform other Commissioners and the White House of a potential conflict of interest involving the individual initially chosen to be the board's first chairman, former FBI and CIA Director William Webster (who has since resigned his post). The episode apparently was the last straw that led to Pitt's resignation the day of the mid-term elections. Furthermore, many wonder whether the SEC, despite the budget increase of roughly 20 percent it received in fiscal year 2003, nonetheless has sufficient resources to carry out its mandate effectively: to write rules implementing Sarbanes-Oxley, to investigate corporate financial reports, and to bring and successfully conclude all of the enforce-

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ment actions against offending companies that may be necessary.[1]

The guess here is that the reforms adopted by the Congress and the exchanges will prove more successful than the skeptics fear, but less effective than the optimists would wish. Those who concentrate on just the legal reforms overlook the fact that much in the business and political environment has changed as a result of the corporate accounting scandals. At the same, other elements of the system have not changed: notably, stock options still are not required to be expensed, while the media continue to report oddities in the earnings figures of major American companies. The widely derided practice of "earnings management" – brought to public attention by former SEC Chairman Arthur Levitt – apparently seems to persist, at least among some companies.[2]

As a result, issues relating to corporate disclosure and governance are not likely to disappear from the American political agenda, especially if the economy stays weak and stock market performance remains disappointing through the 2004 Presidential elections. Likewise, corporate disclosure should continue to be of interest in Europe, where international accounting standards promulgated by the International Accounting Standards Board are set to take effect in 2005, although EU members may endorse or reject individual international standards. Elsewhere around the world, disclosure issues may also remain salient, if for no other reason than countries that were lectured to by the United States will continue to watch with some interest as America struggles to deal with its own disclosure problems.

If corporate disclosure remains of interest, what further should be done about it? This paper attempts to provide one answer by drawing attention to a conundrum that existed well before the U.S. corporate accounting scandals of 2002, and that has since received more attention in the wake of those scandals: the disjunction between the globalization of equities markets and the continued existence of national accounting and corporate disclosure standards. On the surface, the movement toward a single global capital market – although it is still not complete, but well under way – would seem to call for a single set of accounting standards so that investors in all countries will be able more easily to compare the earnings of companies headquartered in different nations. Easier comparisons, in turn, should facilitate the allocation of capital across national borders – to those companies that most deserve it, and away from those companies that don't. Furthermore, greater transparency in financial statements, which a single set of accounting standards should make possible, in principle should lower the overall cost of capital for all companies in the capital markets by increasing investor confidence in the information available to make investment decisions. There also seems to investor demand for a single world standard, although disagreement about which one. In a survey conducted by McKinsey and reported in the summer of 2002, 90 percent of large institutional investors worldwide want companies to report their results under a single world standard, although European and American investors have very different preferences: 78 percent of the Europeans favored the international accounting standards set by the IASB, while 76 percent of the Americans preferred U.S. GAAP.[3]

At this writing, two of the main accounting standards setters in the world – FASB and the IASB – in fact are working to harmonize the differences in their standards to achieve these very goals. The IASB's proposed rule on expensing of stock options, on which the FASB also has sought comment, should provide the first major test of whether the standards-setters can realize their more ambitious objective of harmonizing all of the other standards.

I take in this paper a contrarian and skeptical view of both the likelihood that the world in fact will soon see a single set of accounting standards, and just as important, whether that is a desirable outcome. Instead, I lay out an alternative vision, one involving a competition in standards, which I believe is likely to be more flexible in the face of change and even more investor-friendly than a single set of standards overseen by a single body. I also discuss the critical issue of enforcement: even if somehow the reporting standards themselves are

[1] During the summer of 2002, both the Senate and House voted to authorize a 60 percent increase in the agency's budget, but in the end actually appropriated a 20 percent increase (after the Bush Administration signaled it preferred the lower figure).

[2] Since leaving his chairmanship, Levitt has since set forth his views about earnings management, and many other subjects, in his popularly acclaimed *Take on the Street: What Wall Street and Corporate America Don't Want You to Know and What You Can Do to Fight Back, Random House Inc., 2002.*

[3] See *McKinsey Global Investor Opinion Survey on Corporate Governance,* July 2002, www.mckinsey.com/govemance.

harmonized, if the systems for assuring their enforcement produce different outcomes in different countries, then investors still will not be able have confidence that reported figures for different companies can be easily compared. Bringing greater consistency to enforcement of standards across countries is a critical, very difficult and easily overlooked, challenge that should be addressed regardless of what one believes about the merits of harmonizing reporting standards.

The globalization of the equities markets

But first it is useful to review exactly how "globalized" equities markets are or have become. If globalization is measured simply by purchases of equities by foreigners then indeed a world capital market has been developing over time. Total cross-border portfolio equity flows among developed markets, on a net basis, now exceed $1 trillion annually.[4] Gross purchases of equities are much greater in volume. For the United States alone, gross annual purchases by foreigners of U.S. equities in the year 2000 totaled $7 trillion. The comparable figure for gross purchases by U.S. residents of foreign securities in that year was $3.6 trillion. These figures are up by roughly a factor of 10 or more over the last decade.[5]

Another indicator of the growing integration of capital markets, at least among two of the world's major equities markets, is the rising number of cross-listings by corporations whose shares are traded on both the New York and London Stock Exchanges. Companies that cross-list incur the expense of complying with the rules of multiple exchanges, but nonetheless must also believe that benefits – in terms of accessing a wider base of potential investors and being more attractive to customers and suppliers – more than justify the costs.

A substitute for cross-listings, at least for trading in U.S. and European markets, is for foreign companies to trade as an American Depository Receipt (ADR).[6] Trading in ADRs in the United States in 2000 exceeded $1 trillion, or about 17 percent of trading in corresponding local markets. In that same year, 115 DR offerings took place in the United States and Europe, a 32 percent increase over 1999.[7]

To be sure, measures of cross-border integration based solely on the volumes of flows can be misleading because markets for equities are far from perfectly integrated, even among developed economies where one would expect political and legal risks, as well as information disclosure, to be roughly comparable.[8] Rather, investors tend to have a "home country" bias, in that they typically have far lower proportions of their portfolios invested in foreign stocks than is indicated by the relative valuations of those stocks as a share of the worldwide market.[9] Although various factors help explain why investors tend to invest disproportionately in stocks listed on home country markets - including language barriers, currency exchange risk, higher transactions costs on foreign stock purchases, variations in corporate governance, and risk aversion on the part of investors to putting their money into companies with which they are not familiar – it is likely that the disparity in the kind and quality of information disclosed by companies in different countries also plays a contributing role. By implication, therefore, if publicly held firms around the world all had to play by the same reporting rules – in the way they calculate their financial position and how published data are verified and audited – some of the home country bias very likely would be reduced. The net result, at least in principle, would be an improvement in the allocation of capital across national boundaries.

Why the focus on disclosure for the benefit of equity investors? The overriding reason is that the current system of disclosure – by law and by practice – has developed to satisfy the needs of equities

[4] "The Hunt for Liquidity", *The Economist,* July 28, 2001, p. 65.
[5] William L. Griever, et al., "The U.S. System for Measuring Cross-Border Investment in Securities: A Primer with a Discussion of Recent Developments," *Federal Reserve Bulletin,* October 2001, pp. 33–50, at 640.
[6] An ADR is a negotiable instrument backed by the shares of the foreign firm, which are typically placed in a trust with a local (U.S. or European) bank.
[7] Stijn Claessens, Daniela Klingbiel, and Sergio L. Schmukler, "The Future of Stock Markets in Emerging Markets: Evolution and Prospects," *Brookings-Wharton Papers on Financial Services*, 2002.
[8] In addition to the sharp rise of cross-border flows of portfolio capital, flows of more permanent equity (foreign direct investment), as well as debt capital (bonds and bank loans) also have risen sharply over the past several decades, faster than the growth of trade in goods and services (and GDP). For one guide to the data, see Ralph C. Bryant, *Turbulent Waters: Cross-Border Finance and International Governance* (Brookings Institution Press, 2002). See also Benn Steil, *Building a Transatlantic Securities Market* (Council on Foreign Relations, 2003).
[9] Linda Tesar and Ingrid Werner, "The Internationalization of Global Securities Markets Since the 1987 Crash" in R.E. Litan and A.M. Santomero Eds, Brookings-Wharton Papers on Financial Services, vol. 1, 1998, 281–372. For an excellent summary of the literature on "home country bias", see Karen K. Lewis, "Trying to Explain Home Bias in Equities and Consumption," Journal of Economic Literature, Vol. 37, 1999, pp. 571–608.

investors in particular. A related reason is that equities markets are of increasing importance and interest, not just in the United States, but around the world. For example, in the United States, the share of households investing in stock directly or through mutual funds rose from 32 percent in 1989 to 49 percent in 1998. Excluding pension fund holdings, equities have also climbed sharply as a share of household financial assets: from a low of 11 percent in 1982 to a high of 46 percent in the first quarter of 2000, before falling back to 33 percent in the third quarter of 2001.[10]

The table illustrates that stock ownership also has risen in other countries. The increase in equity ownership in Canada looks very much like that in the United States. However, stock ownership in Europe and Japan still lags the United States significantly.

Equity investors, or at least the industry of analysts and brokers who advise them, are interested in information that enables them to project future cash flows of the companies in which they hold stock. This is because, in principle, the value of a share of stock is simply the present discounted value of future dividends, which are derived from cash flows. Accounting information contained in income and cash flow statements and balance sheets is a critical input in most attempts to project future performance of firms. To the extent the market deems accounting information unreliable, investors confront information risk in making investment decisions. Higher information risks, in turn, make stocks less attractive than alternative investments, depressing stock prices.

Furthermore, equity holders (as well as creditors) have reason to be concerned about the validity of the numbers presented to the in financial reports. They cannot personally examine the books and accounts of corporations. Nor can they directly determine that corporate assets have not been misappropriated, liabilities understated, or net income falsified.

In short, investors have a very real interest in what corporations disclose, the trustworthiness of the disclosure, and how and when they disclose. Enron and the other accounting episodes, at least at this writing, have cast a pall over U.S. equities and until confidence in the numbers returns, that pall is not likely to be completely lifted.

The case for and against a single set of accounting standards

This paper began with two of the key reasons for having a single set of accounting standards worldwide: to improve the allocation of capital across national borders and to lower the overall cost of capital for the corporate sector. The Enron affair has added, in the minds of some observers (mostly outside the United States), a third advantage: that the adoption of IAS in particular would improve the quality of corporate reporting because international standards are superior to U.S. GAAP.

Equity Ownership In Selected Countries

Country	Initial share/number	Later share/number	Definition
Canada[a)]	23% (1989)	49% (2000)	Share of adults who own directly or indirectly
China[b)]	11 million (2000)	55 million (2000)	Number of investors
Germany[c)]	3.5% (1998)	7% (1999)	Share of adults who own directly or indirectly
Japan[d)]	14% (1989)	5% (2000)	Equity ownership of individual investors
Korea[e)]	2–3 million (1990)	7–8 million (2000)	Number of investors
Norway[f)]	14% (1994)	17% (1998)	Direct or indirect ownership

[a)] *Canadian Shareowners Study 2000*, conducted by Market Probe Canada on behalf of the Toronto Stock Exchange, www.tse.com/news/monthly-22.html. –
[b)] "The Rise of a Global Shareholder Culture," Christian Science Monitor, July 2000, www.csmonitor.com/durable(2000/07/03/pl4s2.htm. –
[c)] "Go Global," Kiplinger's Personal Finance, May 2000, www.kiplinger.com/magazine/archives/2000/May/investing/global1.htm. –
[d)] "Japan's Missed Opportunity," The Globalist, June 2001, www.theglobalist.com/nor/gdiary/2001/06-29.shtml. –
[e)] Christian Science Monitor, July 2000. –
[f)] "Stock Markets Win the Masses," Christian Science Monitor, March 1998, www.csmonitor.com/durable/1998/03/25/intl/intl.7.htm.

Three arguments have been or can be adduced to support the third claim. One is the assertion that had Enron been required to report under IAS, it would have had to consolidate its many SPEs, and thus would have shown much higher leverage. This would have discouraged lenders from providing funds to the company, and while the firm may still have gone bankrupt, it wouldn't have been so large and taken down so many creditors when it did.

[10] E.S. Browning, "Where Is The Love? It Isn't Oozing From Stocks", The Wall Street Journal, December 24, 2001, p. C1.

A second argument in favor of IAS is that the IASB, at least recently, has been more out front on the stock option expensing issue than the FASB. To the IASB's supporters, this boldness demonstrates that the international board is less likely to be subject to political pressure than the FASB.

The third, and the broadest argument, advanced in favor of international standards is that they tend to be written as broad principles than as detailed rules. Somewhat paradoxically, broader discretion appears to some to be an advantage: pointing to the Enron affair, advocates of IAS claim that the excessive detail written into the U.S. rules invites clever managers, and their lawyers and accountants, to obey the letter but not the spirit of the rules. If firms instead had to follow broad principles, it is claimed, they would not be so tempted to engage in the kinds of evasive bookkeeping favored by managers of Enron and other companies involved in recent scandals.

How valid are each of these arguments in favor of a single set of accounting standards? The seemingly obvious claim that a single set of standards would facilitate comparisons of financial statements of companies from different countries in fact is undercut to some degree by one of the claims why IAS are superior to U.S. GAAP: namely, that the international standards allow for more discretion than their American counterparts. To the extent this is true, then companies reporting under this standard already have some significant degree of reporting discretion. The greater is this freedom, the less comparability there must be among financial statements of different companies. Even with the more detailed U.S. GAAP rules, companies have more flexibility in reporting their financial results than is commonly realized. Among other things, they can choose different depreciation schedules for fixed assets, make varying estimates of uncollected accounts, use different assumptions in determining the values of inventories (first-in, first-out or last-in, first out), and make assumptions necessary to estimate the cost of employee benefits that will be paid in the future. In short, because of the necessary flexibility built into both major sets of standards, companies' financial reports may be less comparable than advocates of a single set of world standards may realize or admit.

As for the alleged superiority of IAS – should they be chosen as the single set of stdandards – the verdict also is less clear than the IAS advocates claim. It may be true that on some issues – notably the expensing of stock options and consolidation of offbalance sheet entities – IAS indeed are superior to U.S. GAAP, at least at the current time. But the fact that IAS are more principles-based, and thus allow for more discretion, is not necessarily an advantage, especially in a legal system such as the one in the United States, where certainty of the rules can be important for firms and their managers and directors as a key to avoiding liability for financial negligence. Moreover, there is no reason why managers intent on manipulating earnings would be more constrained by more flexible rules than detailed guidance; indeed, it is quite possible abuses could be worse in a more flexible system.

In any event, standards-setters at both the FASB and the IASB hope to minimize any of these drawbacks associated with a single set of standards in order to improve both the quality of the existing standards and the comparability of the financial results of companies operating under a common set of standards. The new chairman of the FASB, Robert Herz, in particular, has publicly committed that the FASB will seek to harmonize its rules with IASB over the coming years.

Even if this is worthy objective, however, there is reason to be skeptical about its practicality. Although the specific differences between the two sets of standards can be exaggerated, the philosophical difference between the two is not easily bridged. The IAS principles are fundamentally different from some of the detailed guidance in U.S. GAAp. Rewriting one or both sets of standards to meet somewhere in the middle is likely to prove difficult.[11]

Of course, the practical problems could be surmounted if the FASB decided essentially to replace U.S. GAAP with IAS. But accounting standards do not exist in a static world. New business practices and especially new financial instruments – the proliferation of derivatives in recent years is a good example – constantly test the rule setters: how should the existing rules be interpreted to apply to new developments, or should the rules be rewritten to take account of them?

One danger of giving any body what amounts to a monopoly in setting standards is that, like private

[11] A listing of some of the key topics on which the two sets of standards differ is provided in the Appendix.

sector monopolies, the standards-setting institution has no incentive to move quickly. Indeed, as it is now, just look to the rulemaking processes of both the FASB and the IASB in their respective jurisdictions. Except for the recent haste in revising the SPE consolidation rule, the FASB typically has taken years before changing or updating its rules. The IASB's rulemaking process shown no greater speed. If the FASB gave way to the IASB, either by going out of existence or deferring to the international body, then IASB would have a worldwide monopoly over standards-setting. Is there any reason to believe that in such an environment, FASB would move more quickly than it does now? I have my doubts and point to the extensive delays associated with the proposed refinements of bank capital standards by the Basel Committee, a group of central bankers from the major industrialized countries, as a good example. If the Basel Committee can't speedily revise its rules for banks, which however complicated they have become are not nearly as comprehensive as the full body of accounting standards, then how can one expect the IASB, if given a monopoly, to move with haste?

Moreover, those who believe, as I do, that the main problem with FASB is that its rules can be too easily overruled by the Congress (which oversees the SEC, which in turn oversees FASB), will not necessarily find comfort in moving all standards-setting to the IASB.[12] The board of that institution has 14 members, from different countries, and thus different cultures. The size and composition of the board alone slows down decisionmaking. Furthermore, IASB, too, can be subject to political influence, and indeed, this would be more likely if FASB were to become less important or even dissolve. American interests accustomed to lobbying FASB, directly or indirectly through the Congress, would simply cross the ocean to London. In so doing, they would join companies and other interests from around the world. In short, granting the IASB a monopoly on standard-setting will not remove politics from the process; if anything, it may intensify it.

If, as seems likely, the IASB will be slow to adapt to new market-drive developments, there may be pressure within some countries for their national accounting standards-setters – assuming they continue to exist – to assert themselves by issuing "interpretations" or "clarifications" of certain international standards. This pressure is especially likely to surface in the United States, where the desire for certainty is strongly influenced by the liability system. But equal pressures may also exist elsewhere. For example, even though the EU has decided that IAS will govern reporting for stock exchange listing purposes by 2005, individual EU member states already remain free to accept or reject individual international standards. The net result is that if the IASB moves too slowly, the interpretations and even new rules set by the national standardssetters will gradually lead to a fragmentation of the international standards – or very much like the status quo. Thus, while IAS may, for a brief time, govern the world, that result is likely to be unstable, much like the inexorable decay of a radioactive element.

In sum, moving to a single worldwide set of accounting standards is far more problematic than its proponents may claim. For one thing, a harmonized set of standards is hardly assured. U.S. GAAP consists of more detailed rules than IAS; international accounting standards tend to be written in the form of broad principles (although the international standards also contain many detailed rules). Melding these approaches is likely to prove very difficult, even with the best of announced intentions of the IASB and the FASB. But even if the two standards-setters could surmount their philosophical problem, the single world body charged with overseeing standards in the future is not likely to be responsive to market developments, and if it isn't there is a good chance that a single set of standards would fragment over time. In the end, the quest for a single set of accounting standards to be maintained through time is somewhat akin to the search for the Holy Grail – a topic of interest but a goal out of reach.

Competition in standards

If the move to harmonization is as impractical or undesirable as I claim, then what is the alternative? The answer I propose here is a true competition in standards. Before outlining how this might come about, consider first the benefits of competition.

As in the private sector, competition should stimulate competing standard setters to keep pace with

[12] The best example of political influence defeating a standard, of course, is FASB's attempt in the 1990s to require expensing of stock options. The FASB has also been influenced in the past by the oil and gas and financial industries affecting those sectors.

market developments and thus help cure the foot-dragging problem that has troubled the FASB and that very likely would plague the IAS if it were given a worldwide monopoly over standard-setting. More importantly, competition is the only system that I believe is capable of diluting the role of political influence in standard setting. This is because, in a competitive environment, standard setters must please investors as well as reporting firms and their auditors for their standards to have relevance in the marketplace, and, hence, be adopted by companies.

Admittedly, competition among accounting standards-setters would differ in two important respects from competition among firms. Standard setters do not have to satisfy the test of profitability that is the yardstick of success, if not survival, of private firms. In addition, the standard-setting competition I discuss in more detail shortly would entail competition between just two standard setters, U.S. GAAP and IAS. In this sense, accounting standards setting competition would take the form of duopoly, a very limited form of competition.

These are both fair points; nevertheless, even the limited form of competition suggested here is superior to a monopoly in standards. Although it is true that standard setters are not motivated by a desire to earn profits, the members of these boards still desire to be relevant and for their standard-setting bodies to exist. In a competitive environment, both of these conditions cannot be met unless investors value the standards themselves. The duopoly problem, to be sure, is a real one. But a choice between two standards is better than a choice of only one.

A competition in standards could be introduced in one of two ways. One approach, pushed hard by many Europeans, would be for authorities in at least the industrialized countries to mutually recognize certain standards for stock listing purposes. Since as a practical matter the rest of the world outside the United States is moving toward or has already adopted IAS, this option amounts to allowing a competition only between IAS and U.S. GAAP.[13] Key to this proposal is that the United States, which currently requires foreign companies using IAS to reconcile their accounts with U.S. GAAP, would no longer insist on this requirement. At the same time, to keep companies from "gaming" the system, firms would have to continue reporting under the standards they choose for some set period of time (say 10 years).

An alternative way of introducing competition in reporting standards would be to allow more competition among exchanges by permitting investors in participating countries to access foreign stocks directly within their home country borders – for example, through computer screens based there – rather than having to engage a foreign broker to execute trades abroad. Benn Steil recommends this option, not just for reporting standards, but also for the entire system of disclosure and corporate governance rules.[14] In particular, Steil suggests a system of mutual recognition of exchanges wherein host countries, such as the United States, allow exchanges from other countries with reasonable acceptable disclosure regimes to impose their own rules on corporations whose shares are initially listed on those exchanges, but which are also traded on exchanges in the host country, provided those countries afford U.S. exchanges reciprocal rights. In this way, competition among exchanges, each with different listing requirements, would bring about competition in disclosure systems, including accounting standards.[15]

The exchange-competition model, however, has two substantive drawbacks relative to the firm-choice model. For one thing, embracing exchange competition requires a tolerance for competition among entire systems of corporate governance, insofar as these systems are the subject of listing requirements of the exchanges. In contrast, a policy of allowing firms on any exchange to choose its own reporting standard (within a predefined list) entails a much more limited form of competition. Second, in order for firms to choose among reporting standards under the exchange competition model, the firms must actually list their shares on another exchange. While this may not be as burdensome as it once was, multiple listing still does entail some additional cost. In contrast, if firms listed on a single exchange are allowed to choose

[13] Although European firms would appear unable to choose U.S. GAAP, because the European Commission (EC) has adopted a regulation requiring them to report only under IAS by 2005, it is possible that if the United States allowed companies from the EU listing on American exchanges to use IAS, the EU might return the favor at least by allowing U.S. companies to continue using U.S. GAAP if they chose.

[14] Steil, op. cit.

[15] Ibid. The main virtue claimed for exchange competition is lower trading costs. But the Council Report also suggests that competition in disclosure regimes would encourage more disclosure.

among reporting standards, they need not pay the additional expense associated with listing on another exchange simply to take advantage of its different disclosure system.[16]

Given the apparent momentum behind the current attempts to harmonize IAS and U.S. GAAP, I fully recognize that policy makers in the United States are not likely any time soon to embrace the competition-in-standards approach advocated here. Aside from the vested stake in pursuing the single set of standards, one predictable objection to a competition in standards is that it would lead to some loss in transparency arising from investors having to interpret financial reports prepared under different sets of standards.

I believe that any such fear is overstated, however. As already argued, even under a single set of standards, firms have discretion in reporting their results, which means that investors do not now have the ability to make »apples to apples« comparisons that advocates of the current system may believe are possible. Moreover, under a regime of competitive standards, private sector analysts would have strong commercial incentives to translate or reconcile reports prepared under different standards. Admittedly, in the absence of a full reconciliation requirement, analysts would not have access to all of the information required to make totally accurate translations of financial results from one standard to the other, unless firms voluntarily provided the requisite data. But estimated reconciliations are still likely to be of use to investors. And corporations would provide the requisite data for more complete reconciliations if the markets rewarded them for doing so.

Another objection against a competition in standards might be that the "market" for accounting standards, like the one for operating systems in personal computers or videocassettes, is a natural monopoly. If this were true, it is conceivable that meaningful competition would be short-lived, resulting in a single winning standard. Such an outcome is indeed possible, but is not an argument against running a competitive race in the first instance and, in the process, realizing the benefits from that competition while it lasts. In any event, it is not at all clear that competition in accounting standards would reduce to monopoly.

Enforcement of disclosure standards in a global age

I have argued elsewhere (with my colleagues) that the main problem revealed by the accounting scandals in the United States was not a defect in the accounting standards, but in the mechanisms for enforcing those standards.[17] At first blush, the failure in enforcement seems confined to the auditors who should have detected the accounting irregularities in each case. But the public debate surrounding the scandals helped spread the blame to some of the other "gatekeepers" in the corporate arena as well: members of boards of directors who failed to properly supervise management or the auditors; research analysts who "hyped" stocks when they knew better (and especially when they had conflicts of interest due to their employment at firms that stood to benefit from large underwriting or merger and acquisition fees from the same companies the analysts covered); the credit rating agencies that failed to foresee financial problems in some of the companies; the self-regulatory body governing the auditing profession (the AICPA); and the principal regulator, the SEC, which to its credit helped uncover many of the earnings misstatements but has failed to discipline negligent auditors in the past.

As noted at the outset of this paper, various reforms have since been adopted in the wake of the scandals of 2002 to strengthen each of these gatekeeper functions. One of the controversial aspects of these reforms, the Sarbanes-Oxley provisions in particular, is their application to foreign firms, especially foreign accountants, whose activities in the United States are subject to the new oversight board. Foreign firms view these provisions as an unjustified assertion of extraterritorial jurisdiction; Americans view them simply as an application of national treatment.

While this controversy may continue, a more interesting enforcement issue lying ahead, assuming the effort to harmonize accounting standards pro-

[16] Another possible objection to allowing mutual recognition of exchanges is that it could expose smaller, less sophisticated investors to greater risks (if the foreign exchanges so recognized did in fact contain higher risk stocks, with less transparent or effective corporate governance rules than may apply in the home country). If this objection were valid, it could be satisfied by restricting access to foreign exchanges doing business in a home country only to institutions and wealthy, sophisticated individuals.

[17] Benston, op. cit.

ceeds, is whether and to what extent nations and/or their exchanges will seek to harmonize accounting enforcement or compliance measures and procedures. Indeed, if the main impetus behind harmonization of reporting standards is to improve comparability of financial reports, that objective cannot be attained – even if the world accepts a single set of standards – as long as there are significant differences across (and indeed even within) countries in the effectiveness of compliance with those standards. Note the emphasis on "effectiveness"; it is not important that nations harmonize the mechanisms of enforcement – selfregulation, government regulation, corporate governance measures, and liability regimes – but instead the results of the measures they do employ.

This is far easier said than done. There are no well-defined metrics for assessing the quality of financial reporting by companies from different countries. Even if countries agreed to use the same compliance or enforcement mechanisms, there is no easy to assure that these instruments, such as regulation or liability, are implemented with equal vigor and effectiveness across countries.

In principle, enforcement results could be harmonized if nations agreed to cede enforcement of the quality of audits to an international supervisory body. But this is highly unlikely to happen any time soon because governments are not keen on giving up their sovereignty on enforcement matters. Even the Basel Committee – which has carried out the most ambitious international effort at harmonizing financial regulation to date – does no more than promulgate standards (analogous in the disclosure realm to the IASB's development of international accounting standards); the Committee does not enforce them, leaving that job to national authorities.

Before the Enron scandal broke, there was an effort within the accounting profession to bring great harmony to audits. Under the auspices of the International Federation of Accountants (IFAC), a Forum of 30 of the largest accounting firms in the world issued a proposal in September 2001 to establish a peer review system for periodically and randomly reviewing the audits by those firms of "transnational" companies. The aim of this proposal was to establish some uniformity in audit results, initially for companies doing business in different countries (and then perhaps for a wider group of firms).

The Forum proposed to assure compliance by its members in two ways. First, peer reviews of randomly selected audits would be conducted. Second, if these reviews found that the audits were significantly below GAAS or that the numbers attested to were misleading in that they violated essential GAAP prescriptions, the firms would be fined and the individuals who carried out the audit would be disciplined. In addition, member firms would pledge to dismiss their partners who were found to have been seriously negligent. The firms also would require their audit and confirming partners to sign agreements stating that they had conducted their audits appropriately, and that if the Forum decided they did not, that they would abide by any Forum sanctions (such as the order to resign from a firm and/or pay monetary damages).

Investors then could choose between statements attested to by members of the Forum, by a competing group or groups, or by other auditing firms. Clients who want audits by Forum member firms that permit them to uphold the agreed upon standards would have to pay the cost. Those firms believing a lesser audit product to be worthwhile could make that choice. The market would determine which alternative was best.

The Forum exercise continues, but in the wake of the various accounting debacles in the United States, self-regulation appears to have been discredited, at least for the time being and in the form in which it was undertaken. However, in the absence of any other constructive international effort to harmonize compliance with reporting standards, it would be a mistake to write off the Forum of 30 initiative. It may be the only practical way in the short run of bringing greater conformity to audit results, at least for a subset of companies, those with operations in multiple countries.

An alternative way of indirectly producing greater harmonization in enforcement would be through competition among exchanges, assuming national governments allow it. Exchanges with listed firms adhering to high quality accounting standards and enforcement should attract issuers and investors alike, and take market share away from exchanges with less stellar records in both these areas. Policy makers should therefore give more serious attention to promoting competition among exchanges, since this may also be an effective and practical way to bring about the greater harmonization in

and reliability of reporting that investors appear to want. Indeed, one advantage of competition among exchanges is that this could produce greater conformity across a wider class of firms than just the multinationals that are the object of the Forum of 30 exercise. The untested element of exchange competition, however, is whether the quality of accounting standards and compliance with them would be valued by issuers and investors in choosing stocks listed on competing exchanges.

Conclusion

For those interested in the subject of corporate disclosure, these are interesting – and indeed exciting – times. But not by choice. The scandals surrounding the disclosure failures and shortcomings associated with Enron, Worldcom, and certain other large public companies have put the spotlight of public attention on accounting and disclosure policies in a way many may never have imagined, or certainly welcomed.

After the dust has settled on the reforms adopted in the United States in response to these developments, policy makers in that country and elsewhere are likely eventually to turn their attention to how disclosure rules and practices ought to be changed in light of the increasing globalization of equities markets. At this writing, there is momentum behind the harmonization of the very different rules of U.S. GAAP and IAS, and perhaps the replacement of the former with the latter.

This article takes a skeptical view of harmonized standards, questioning both the feasibility and the wisdom of the enterprise. Instead, it embraces the virtues of a competition in standards, either through mutual recognition of U.S. GAAP and IAS, in particular, or through recognition of the rights of exchanges from different countries to conduct business abroad.

Meanwhile, relatively little attention has been focused on ensuring greater conformity across countries in compliance with standards. As of this writing, the only practical way of furthering this objective, however discredited in the wake of Enron, is the peer review mechanism proposed by a group of multinational auditing firms. Greater competition among exchanges might also promote more conformity of audit results across national boundaries.

Appendix

Key Areas of Difference Between IAS and U.S. GAAP

Although too numerous to discuss in detail, there are a limited number of areas in which international accounting standards differ from U.S. GAAP. This appendix lists some of the more notable examples. Aside from the philosophical difference discussed in the text, the specific differences include:

- Methods of accounting for leases
- Rules for consolidating off-balance sheet entities
- Accounting for goodwill and other intangibles
- Accounting for mergers and acquisitions
- Recording of research and development expenditures (capitalization versus expensing)
- Differences over "fair value" accounting (although both sets of standards generally embrace the concept)
- Accounting for financial instruments
- Treatment of stock options
- Line of business, or segment, reporting
- Presentation of financial results (in financial statements)