A NEOFUNCTIONALIST PERSPECTIVE ON INTERNATIONAL ACCOUNTING CONVERGENCE: ANALYSIS AND INSIGHTS

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ABSTRACT

Whilst a number of studies have examined the evolution of the accounting standard setting process across time and identified various factors affecting the development of International Financial Reporting Standards (IFRS), the literature on international accounting has proceeded without an examination of theoretical paradigms which may explain the convergence process. As accounting operates within a social and political sphere, the convergence process can be better understood by examining the framework in which this dialogue takes place. Neofunctionalism, a sociological theory used to explain European integration efforts since the inception of the Treaty of Paris in 1951, is used in this paper to analyse the current international convergence process in accounting and offer insights into prospects for convergence in the future. The paper demonstrates that the ongoing dialogue and agreement between various institutions in the convergence process, like European convergence, is incremental, as opposed to one based on sudden structural re-alignments.

Keywords: Neofunctionalism, integration theory, IASB, convergence, international accounting.
Introduction

The primary objective of this paper is to explore how neofunctionalist (integration theory) literature, predominantly that of Ernst Haas who attempted to prescribe European integration in the 1950’s-1960’s, and espoused today in the various works including Rosamond (2000 & 2005) and Schmitter (1971, 2004 & 2005), can be used as a basis to analyse the current international convergence process in accounting and offer insights into prospects for continued convergence in the future.

The convergence of accounting standards around the world has heralded a new era in global standard setting. Accounting convergence has become an essential, albeit implicit component, of the globalisation process. The International Accounting Standards Board (IASB) is working with national accounting standard setters in various countries to achieve convergence in accounting standards around the globe. An increasing number of countries are adopting International Financial Reporting Standards (IFRSs), making the IASB’s standard setting environment more open to international debate and influence. The IASB is working in an overtly political environment, where devolving standard setting power to a supra-national body, naturally engenders political pressures and controversy. The controversy surrounding the recent reforms to the standards contained in the ‘stable platform’ also indicates that the IASB standard setting process will remain politically turbulent in the near future. For example, the fair value treatment of gains and losses on cash flow hedges was, and still is, a controversial issue for European banks (Woolfe, 2006, p.3). Concerns continue to be raised as to the volatility it will introduce into the financial statements. The IASB’s compromise due to European threats to boycott the standard IAS 39 Financial Instruments: Recognition and Measurement indicated the degree to which the IASB was willing to allow political considerations to override conceptual underpinnings.

The inevitable political nature of standard setting, and other forms of regulation, has been considered over many years by a number of researchers in various jurisdictions (for example Stigler, 1971; Posner, 1974; Peltzman, 1976; Walker, 1987; Rahman, 1988; Brown and Tarca, 2001). However, whilst literature has examined the evolution of the international accounting standard setting process across time (McGregor, 1999; Street, 2006; McGregor and Street, 2007); the choice between US GAAP (Generally Accepted Accounting Principles) and IAS (International Accounting Standards) for firms voluntary adopting international accounting standards (Tarca, 2004); and the effect of the external environment and culture on international accounting development (Gray, 1988; Doupnik and Salter, 1995), the literature on international accounting has proceeded without an examination of theoretical paradigms which may explain the convergence process. The benefit that may be obtained by studying the accounting convergence process through a neofunctionalist perspective includes:

1. Integration theory or neofunctionalism may help us to explain how in the process of accounting convergence, national and supranational accounting institutions transform from heterogeneous to homogeneous based institutions, and the effect this has on institutional legitimacy and power;
2. Accounting convergence is not purely a technical affair but operates within a social and political sphere. Integration theory would allow us to examine the role that dialogue plays in the decision by countries to adopt IFRSs now or in
the future, and how certain policies and technical issues are defined and developed at the international level and the role historical processes play in this formulation process; and

3. Accounting convergence is a major factor in the current process of global economic interdependence, as it provides a common framework by which world economic activity can be measured and disclosed. Examining the sociological frameworks within which convergence takes place contributes toward our understanding of how ‘globalisation’ occurs.

The remainder of the paper is organised as follows. The first section overviews neofunctionalism and what it means. The second section articulates how this perspective can be used as a basis to analyse the accounting convergence process. The section also details one of the fundamental components of neofunctionalism, namely the ‘spill-over effect’ and the implication this has for accounting convergence. In the third section, accounting convergence is then explored along seven working functions of neofunctionalism, and specific references to the incremental changes over this time with respect to EU integration efforts are given in order to reinforce the application of the theory to the IASB’s work efforts. The final section outlines prospects for further convergence in the future with specific reference to the IASB–Financial Accounting Standards Board (FASB) work program and the consequent change in dialogue that has taken place in recent years.

Overview of the Neofunctionalist Perspective

It took a six-year war during 1939-1945 before European nations agreed to act on the need for an integrated community. Whilst it had been a concept for centuries, it had not been sought voluntarily. Instead, empires or nation-states sought continental dominance, using race, ethnicity and religion as the rationale. Post-war European powers sought to form a regional body, with appropriate checks and balances that could overcome the nationalistic tendencies that had plagued the continent for centuries (Haas, 1958). The resulting European Coal and Steel Community (ECSC) was the first body of this kind established in 1951 by the 8th Treaty of Paris. The treaty comprised Belgium, France, Italy, Luxembourg, the Netherlands and West Germany, who in 1957 then signed the Treaty of Rome to found the European Economic Community (EEC). These treaties were the pre-cursor to the European Union (EU) as we see it today. Neofunctionalism therefore has its origins in the foundation of the EEC. It is a theory of political and regional integration, the definition of which is;

“the process whereby political actors in several distinct national settings are persuaded to shift their loyalties, expectations, and political activities toward a new centre, whose institutions possess or demand jurisdiction over the pre-existing national states” (Haas, 1958, p.16).

Neofunctionalism did not, as Schmitter (2004) candidly points out “spring forth mature and complete from the brain of its founder, Ernst B. Haas” (p.46), who defined neofunctionalism as;

“a theory of regional integration that places major emphasis on the role of non-state actors – especially, the ‘secretariat’ of the regional organisation involved and those
interest associations and social movements that form at the level of the region – in providing the dynamic for further integration” (ibid).

It is explicitly a descriptive as opposed to normative theory in that it seeks to explain and predict European integration based on empirical data as opposed to prescribing how integration should occur. Its principal proponent was Ernst Haas, whose seminal work on the ECSC provided a basis for a theory on the political integration of Western Europe (Haas, 1958). Haas was concerned about how supranational institutions such as the EEC were formed and how national interests ceded to these institutions (Haas, 1964).

Haas in Beyond the Nation State (1964) argues that economic integration would lead to political integration. An important claim of neofunctionalism is that integration occurs more rapidly in areas requiring a significant degree of technical or expert knowledge because of the need to depend on technical committees for outcomes, which in turn is dependent on dialogue between participants. As such, accounting convergence poses a valid field of enquiry.

Neofunctionalism views integration as a process as opposed to a state or condition. This involves “the wholesome organic unity of society, of which professional groups and their leaders are merely a part, and in which group interests represent, not a divisive clamor, but an affirmation of the common good” (Haas, 1964, p.31). Integration is based on incrementalism or changes in small steps rather than a dramatic transformation process. Neofunctionalism emerged out of the work of David Mitrany, a political theorist who was the “chief exponent of functionalism” (Haas, 1964, p.8), an early version of integration theory. Mitrany (1943) prescribed that international as well as economic co-operation should be the most appropriate basis on which to pursue integration.

Whilst functionalism sought to separate political power from economic welfare (Haas, 1964, p.21+47), neo-functionalism argues that the two are essentially the same, however functionally specific programs aimed at fulfilling economic welfare must be given priority over political programs in seeking to fulfil integration tasks. As Haas (1964, p.47) states:

Functionally specific programs give rise to international organisations whose powers and competences gradually grow in line with the expansion of the conscious tasks, or in proportion to the development of unintended consequences arising from earlier task conceptions.

Neofunctionalism subsequently rose (Haas, 1964) and then stagnated (Haas, 1975; Moravcsik, 1993) in the 1970’s as a basis for explaining European integration. The

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primary cause was a stall in European integration efforts in the late 1960’s. However, interest re-arose in the 1980’s and 1990’s as the incentive for European integration increased due to the collapse of the Soviet Bloc within Eastern Europe and the re-emergence of independent states who sought economic, political and social benefits within a broader European Community. Although Haas eventually championed a similar notion of “managed interdependence” (Haas, 1995) he never regained the fervour for neo-functionalism from past decades. The mantle was taken up by other authors who championed regional integration, whether in Europe (Mattli and Slaughter, 1998; Mattli, 1999), Latin America (Mattli, 2005) or through work that sought to explain differences in regional laws with respect to the greenness of trade agreements (Blum, 2000; Dubal, 2001), labour agreements (Teague, 2003) and legal systems (Duina, 2004). Studies have also used neofunctionalist theories to explain the development of European Social and Labour market policy since the 1980’s (Jensen, 2000). Neofunctionalism has broadened to encompass various geographical domains and how integration occurs across nation states with respect to the various laws, treaties and governance frameworks.

Whilst neofunctionalism is essentially a theory of regional European integration, it can also be used to understand other forms of convergence. As Rosamond (2005, p.243) has stated:

> The neofunctionalist project was from the outset a comparative exercise in regional integration theory. The explicit purpose of the neofunctionalists was to utilize the pioneering European experience of integration to generate hypotheses for testing in other contexts. In short, the plan was to develop not a theory of European integration, but to arrive at a more generic portfolio of propositions about the dynamics of integration in any context.

Give the historical similarities between EU and the IASB, how then can the European neofunctionalist framework be applied to international accounting convergence?

**Applying Neofunctionalism to International Accounting Convergence**

Neofunctionalism, or regional integration theory being its alternate usage, with its emphasis on economic and political integration, can apply the current accounting convergence process, which like European integration, has significant economic and political effects for adopting countries. These include economic welfare arguments such as the increased capital flow, lower costs of capital and consequent sovereignty rights that ensue. Neofunctionalism therefore provides a rich basis on which to explain the international convergence process. Convergence, whether it applies to the Europe in a political domain, or accounting in an international context, reflects a belief that the supra-national institution (the EU or the IASB) ultimately delivers greater benefits to individual states than the states themselves.

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2 Differences between member countries as to European monetary and trade policy, including the role of the central government, resulted in the “empty chair” policies of Charles De Gaulle during 1965, which saw France boycott representation on the council of Ministers and representation in the European Parliament. The Gaullist notion of self-reliance and independence as a major power, resulted in the frustration of a number of integration efforts including issues surrounding access to European markets by American multi-nationals, and the level of subsides given to European firms (Haas, 1975; Schmitter, 2005).
Whether examining the history of European integration or accounting convergence, both processes share similar attributes. Formed in 1973, the IASC began with six associate members (Belgium, India, Israel, New Zealand, Pakistan and Zimbabwe), expanding to 11 in 1977, 13 in 1980, and close to 100 in 1998. This is similar with respect to EU, where the original 6 treaty of Rome states had grown into 27 by 2007. Early in its existence the IASC established various integovernmental working groups to co-operate with various standard setting bodies around the world. It formed a ‘comparability project’ in 1987, which sought to examine the accounting standards of various countries. This culminated in the issuance in 1988 of E32 Comparability of Financial Statements. In the mid 1990’s various countries, including Australia, had adopted a policy to ‘harmonise’ domestic accounting standards with those issued by the IASC. This change in terminology from ‘comparability’ to ‘harmonisation’ indicated a strengthening of the ties between domestic standard setting bodies and their international counterpart. This would later lead to the term ‘compatibility’ and then to the stronger ‘convergence’ terminology (see later section). This is also similar to the ‘common policies’ across various trade portfolios pursued by European states prior to EU formulation, which then became legislation after EU formulation. Various IAS were improved, and like the ESCS, which became the EEC, and then eventually the EU, the IASC was renamed the IASB. Like the EU which issues legislation in its own right that has the power to bind all members, so do the IFRS’s issued by the IASB.

However unlike Europe, where all member states have yet to ratify the the 2004 Treaty Establishing a Constitution for Europe, the IASB established a constitution early in its existence, which was subject to revision in 2000. The policy scope of the IASB is not as large as that of the EU, however this has not meant that convergence has been without controversy. The political controversy surrounding amendments to IFRSs to date, and forthcoming debate on other technical issues can, as IASB Chairman Sir David Tweedie points out, lead to “blood all over the streets” (in Hargreaves and Tricks, 2004, p.19). The lack of wholesome commitment by the US FASB to adopt IASB standards to date reflects a genuine lack of faith in not only the ability of the IASB to endorse quality standards, but also to withstand European political lobbying on technical content (the controversy over cash flow hedging being one example), and recent calls by European officials for a greater representation on the IASB (Reilly, 2005). This is similar to the continuing tussles between European powers regarding a common European defence and foreign policy, and the degree of agricultural subsides to individual nation states, which threatened to derail European integration efforts.

Spillover

One of the important conceptions of neofunctionalism is that of the “spillover” effect, which, whilst first identified by Haas (1958) in The Uniting of Europe, is more formally defined by Lindberg (1963, p.10) as;

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3 The original six member states (Belgium, France, Germany, Luxembourg, Italy, Netherlands), had grown to 9 by 1973 (addition of Denmark, Republic of Ireland and United Kingdom); 10 by 1981 (Greece); 12 by 1986 (Portugal and Spain); 15 by 1995 (Austria, Finland and Sweden); 25 by 2004 (Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia) and 27 by 2007 (Bulgaria and Romania).
“a situation in which a given action, related to a specific goal, creates a situation in
which the original goal can be assured only by taking further actions, which in turn
create a further condition and a need for more action”.

Therefore, moves toward the fulfilment of objectives end up influencing other
objectives, creating a “snowball” or “ricochet” effect. National governments may
learn and change their original positions through active secretariats supported by
organisations whose interests may be served through externalities. The spill-over
effects of accounting convergence cannot be underestimated. Convergence of
accounting systems aid international capital flows. Financial Statements are
increasingly being used as the primary basis for decision-making across all
organisations, be it ‘for-profit’ or ‘not-for-profit, and therefore the adoption of a
common set of measurement and reporting benchmarks standardizes the financial
aspects of decision-making.

Spill-overs can either be functional (technical) or cultivated (political) (Jensen, 2000,
p.73). From an accounting perspective, functional spill-over occurs when political co-
operation aimed at achieving specific goals, results in the adoption of new goals, and
consequently further political co-operation (ibid). From an accounting perspective, a
notable occurrence was *The Norwalk Agreement* in 2002 between the IASB and the
FASB in the United States, which agreed to eliminate differences and achieve
‘compatibility’ between IFRS and US GAAP. This consequently resulted in a number
of exposure drafts and commitments to reduce differences (see discussion in later
section) in areas such as Research and Development, Income Taxes, and Interim
Reporting (IASB, 2003), and has led to joint projects in other areas, notably the need
for an enhanced conceptual framework to overcome limitations relating to guidance
on measurement and whether a framework should apply to not-for-profit entities
(McGregor and Street, 2007). However, it also propelled convergence between
International Public Sector Accounting Standards (IPSAS’s) issued by the
International Public Sector Accounting Standards Board (IPASB), which are part of
the International Federation of Accountants (IFAC) and the IFRS’s of the IASB
(IFAC, 2007). Cultivated spill-overs occur when problems are intertwined for
political and ideological reasons, which consequently lead to the formation of
calitions who attempt to influence the policy agenda (Jensen, 2000). Multinational
organisations, stock exchanges, securities commissions and accounting firms benefit
from international convergence through lower costs and proliferation of business
activity, and these bodies have an incentive to influence the standard setting bodies or
convergence in general.

Farrell and Heritier (2005) argue that Haas did not outline the causal mechanisms
which underlie how integration and institutional change are achieved. They argue that
“higher order rules” are more difficult to change than “lower order rules” with respect
to institutional change. From an accounting perspective, an explanation for the
differences in the extent to which each country converges with IFRS may lay more in
the actions of political elites who resist divesting power to supranational
organisations such as the IASB, rather than the technical issues under consideration.
The economic benefits of integration must therefore be supported by deeper
ideological commitments for integration to occur.
The likely impacts of accounting convergence may also result in further spill-over effects. Possibilities include the synergies associated with the continued merger and consolidation of accounting practices worldwide as well as between professional accounting bodies themselves.\(^4\) Accounting firms and professional bodies would theoretically be subject to a common set of standards covering IFRS from the IASB as well as education, public sector, auditing and ethics standards from the International Federation of Accountants (IFAC). These synergistic effects of convergence fuel the need for additional global services. Even further spillover effects include the possibility that national standard setting bodies will no longer be justified from a financial or operational standpoint and thereby become obsolete and dissolve, or become mere administrative functions for the IASB and IFAC.\(^5\)

**Working assumptions of neofunctionalism in relation to accounting convergence**

Schmitter (2005, pp.258-260), based on the work of Haas, has identified seven working assumptions of neofunctionalism. The first is that states are not exclusive actors in the international system. Second, interests, rather than ideas or identity drive integration. Third, when a decision is made about integration, there is imperfect knowledge about the consequences. Fourth, the least controversial areas are usually the first part of the integration process, the most controversial being left later. Fifth, individuals in the integration process cannot be confined to nation states but are part of a supranational process. Sixth, integration strategies are convergent not identical, and are driven by overlapping preferences rather than common objectives. Finally, the outcome of integration cannot be fixed in advance. In this section each of these points will be considered with respect to its application to the convergence process.

The first assumption under neofunctionalism is that states are not exclusive and are not the predominant actors in the international system. The decision by some countries to acquiesce with IFRS is significant. Whilst individual countries themselves decide on whether to adopt IFRS in their entirety, this aspect of sovereignty is illusionary. As mentioned, social and economic lobby groups are an important part of the political process and can influence a standard setting body’s decision to adopt IFRS. This is similar to political and economic pressures for EU membership placed upon former Eastern Bloc countries to participate in the benefits of a consolidated European market.

In this process of accounting convergence, the influence of multinational corporations and large international accounting firms have been widely documented (Hopwood, 1994; Brown and Van der Zahn, 2005; Brown, 2006). For example, Hopwood (1994) explicitly illustrated that international accounting was an output of the world-wide lobbying pressures of the audit industry. Large multinational accounting firms he explained, have through economic and brand influence, power to command and control accounting agendas, the primary aim being self-interest through promulgation of services. Brown (2006) and Brown and Van der Zahn (2005) have argued that the process of convergence offers multinational corporations and international accounting

\(^4\) An example has been past attempts at merging the Institute of Chartered Accountants in Australia with CPA Australia.

\(^5\) Likewise, from the standpoint of European integration, under the 1985 Schengen Agreement, border controls between member countries of the EU were dismantled, and domestic currencies were abandoned in 2002 to accommodate the ‘euro’ monetary unit.
firms the means by which to keep accounting standard setting within a narrow and technical domain.

In addition to convergence on accounting standards, another sub-national advocacy group, the IFAC is responsible for issuing International Auditing, Public Sector Accounting (government and non-profit organisations), Education, and Ethics standards. In addition to the proliferation of accounting standards in recent years, the “spill-over” effects have also been evident at IFAC which has seen the establishment of the International Accounting Education Standards Board (IAESB), the International Auditing and Assurances Standards Board (IAASB), the International Ethics Standards Board for Accountants (IESBA), and the International Public Sector Accounting Standards Board (IPSASB). This is similar in many respects to the various bodies and institutions affiliated with the EU. Since 2005 the IPSASB has been active in releasing a number of standards, whilst the IESBA has updated the Code of Ethics for Professional Accountants (IFAC, 2006), not unlike the common policies and directives issued by the various EU bodies. The continued convergence of accounting will increasingly result in key issues being resolved in a wider scope outside the realm of national governments. An increasing amount of power will be devolved to these supranational organisations (such as the IASB and the IFAC).

The second aspect of functionalism is that interests rather than common ideals or identity are the driving force behind the integration process. Countries signing up to IFRS are different in terms of economic, social, environmental and cultural constructs, like European nations considering the benefits of political integration who hail from a variety of ethnic and religious backgrounds. The wealth of literature in accounting, which classifies countries according to various frameworks, is evidence of this (Mueller, 1968; Nobes, 1983 & 1998; Gray, 1988; Nobes and Parker, 2004). Furthermore, countries utilise different measurement systems (Nobes, 1983 & 1998; Nobes and Parker, 2004). In certain countries, inflation based accounting, utilising price-level adjustments, may be more predominant than historical cost, as indicated by IAS 29 Financial Reporting in Hyperinflationary Economies.

Despite these differences, the arguments for convergence based on increased accountability, capital flow and a reduction in the cost of dual reporting for multinational corporations are the driving forces for convergence across all nations, who are engaged in global economic dependence. Once converged, measurement and disclosure systems adapt and modify in order to integrate with IFRS, leading to greater systems compatibility and confidence in the reporting system within a country.

The third aspect of functionalism is that decisions about integration are taken with imperfect knowledge about the consequences, or through the pressure of deadlines or impending crises. The IASB had adopted a hectic schedule in order to finalise its “stable platform”. Over 30 standards were released in July 2004 which was to be implemented by 1 January 2005. Since then the IASB has made numerous changes to its existing standards and new IFRSs have also been issued. The IASB indicated in July 2006 that it will not introduce any new IFRS, or activate amendments under development, until 1 January 2009. Instead, discussion papers will be released to facilitate conceptual input in response to criticism that the pace of change has been too quick (Bolton, 2006, p.6). The IASB has still to complete major aspects of its
working project with the FASB, and the IASB’s own programme of developing new IFRSs seems likely to be as active and full as ever (Whittington, 2005, p.144). Therefore, the cost of implementation and enforcement of IFRSs will continue to increase and so will the level of political debate surrounding the development of the conceptual framework and IASB standards.

The time-frame for the full realisation of these synergistic effects remains to be seen. The move towards IFRSs worldwide has in some instances, been expensive. For example, research on German firms has indicated that using estimation methods over the period 1993–2002 under IFRS or US generally accepted accounting practices, the expected cost of firm equity has increased rather than decreased (Daske, 2006). In the UK, it has been reported that over 1 billion pounds has been wiped off the 2004-2005 pre-tax profits of the top 100 companies, due to the expensing of stock options under IFRS 2 *Share Based Payment* (Wynn, 2005). Chalmers and Godfrey (2006) found a wide degree of diversity in goodwill and identifiable intangible asset reporting for listed companies in Australia during 2002, indicating that adoption of IFRS will have a significant effect on the financial statements of these organisations, and firm contracts and valuations. Contrary to expectations, Van Tendeloo and Vanstraalen (2005) found that voluntary adoption of IFRS was not associated with lower rates of earnings management in Germany.

From an EU integration standpoint, the opening of borders has presented problems relating to illegal immigration the degree to which was unforeseen at the signing of the Schengen Agreement 1985, and the failure to effectively enforce intellectual property rights was not an agenda item or significant integration issue at the time of EU formulation.

The last 7 years has also seen major developments in accounting world-wide. Apart from the collapse of Arthur Andersen, there have been corporate scandals involving Enron and WorldCom. This has led to a significant reformation in corporate governance laws in different countries including Sarbanes Oxley in the US and CLERP 9 in Australia, which has changed the landscape of business.

The fourth aspect of functionalism is that functions or issue areas provide the usual basis for the integration process, commencing with the least controversial. Whilst the IASB have been issuing standards since 1973, the earlier standards dealt with non-controversial areas such as IAS 1 *Disclosure of Accounting Policies*, and bank disclosures. The first bound volume of International Accounting Standards was not published by the IASC until 1987 (IASB, 2007). The IASB/FASB Joint Conceptual Framework (McGregor and Street, 2007) and more recent standards issued by the IASB have been the most controversial, and the subject of intense political debate, including IFRS 2 *Share Based Payments* and IFRS 3 *Business Combinations* (2004), and recent amendments to the fair value option under IAS 39 *Financial Instruments: Recognition and Measurement*. The adoption and alteration of these standards were

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6 The 1985 Schengen Agreement is an agreement between European states that allow for the abolition of border controls between participating countries. The agreement also includes provisions regarding the temporary entry of persons, the harmonisation of external border controls and police co-operation between member states.
partly a response to overstated profits in the technology sector, and the worldwide diversity in treatment of gains arising on hedging contracts that had been occurring for a number of years prior to the rule change. The conceptual framework has for years failed to adequately articulate issues associated with measurement given the multitude of measurement bases currently in use. It has also ignored unique issues associated with the not-for-profit sector, which in Australia, accounts for 10% of GDP, equivalent to $70 billion (Ferguson, 2005, p.45), and despite its increasing economic power, is largely devoid of specific financial reporting guidance.

Likewise, European integration in the 1950’s began with the “low politics” of the coal and steel community, but avoided the “high politics” associated with defence and foreign relations, issues which remain to this day controversial, given they are fundamental to national sovereignty.

The fifth aspect of functionalism is that actors in the process cannot be confined to existing national states or their interest groups or social movements. There is a role for supranational persons, and persons whose careers depend on this integrative process. As the role of the IASB increases over time, members of international boards and committees will see themselves as international representatives, as opposed to national advocates. Whilst the political aspects of convergence are evident, it can be expected that gradually there will be a depoliticisation of the convergence process as decision-making within the IASB becomes institutionalised, technical issues resolved, and the authority of the IASB becomes entrenched. For active IASB projects, it is the individual that is appointed to the project teams, not a representative of the national standard setting body (Teixeira, 2005). IASB Trustees, whilst geographically based, are not representative of any single standard setting body. In February 2006, the IASB increased its number of trustees from 19 to 22 to reflect the growing importance of Asia and Europe, and away from the UK and the US (Financial Management Editorial, 2006); a move likely to cause “turbulence” in the decision-making process but one that was aimed to provide a greater political balance. The IASB has a full time Chairman, and 11 other full-time members from various countries and backgrounds, each of whom have committed to the goals of the IASB. Likewise, the ‘Council of the European Union’ has a president, Secretary General and its preparatory bodies comprise thousands of European career civil servants.

Members of committees, sub-committees, working groups, and boards of international bodies such as the IASB are made up of individuals from sovereign countries. The degree to which each individual member reinforces his/her country interests on any IASB committee cannot be dismissed lightly. More recently the IASB and the US FASB have entered into a dialogue, with a view to establishing a harmonized set of accounting standards that embrace the better aspects of the two sets of standards (FASB, 2002), despite both bodies having historically different standard setting approaches. Certainly the predominance of the US and the UK representation on the IASB is a signal of a greater weighting being placed on the Anglo-American viewpoints on accounting. It has been argued that given that the IASB is a private body, with little debate outside specialist financial circles, the convergence process is

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7 This arose due to the absence of any standard requiring the expensing of share based compensation, which only became an issue after the technology crash of 1999.
inherently political, with accounting numbers being part of the social relations between nations (Perry and Nolke, 2006).

As global financial markets become increasingly integrated via common platforms, both IASB members and committee members will increasingly see a global perspective on problem solving in accounting as opposed to national objectives. From an European Union integration standpoint, the notion of being ‘European’ is still foreign to the citizens of member states who define themselves as ‘Italian’, ‘French’, or ‘German’. This however is changing as the frameworks which support the EU become institutionalised and develop a character of their own.

The sixth aspect of neofunctionalism is that strategies with regard to integration are convergent, not identical. Actors agree upon rules and policies not because they have the same objective, but because their different preferences overlap. From an accounting standpoint the central argument for convergence has been predominantly to increase transparency, and promote capital flow between countries. However not all countries have signed onto IFRS, and those that have agreed to, will do so at different points in time. Emerging economies have historically adopted IFRSs, due to the fact that they did not have the necessary resources to develop their own set of accounting standards. More recently, developed and larger countries including Australia (since 2005), New Zealand (since 2007), China (since 2007) and the countries which form part of the European Union (listed companies since 2005) have moved towards adopting the IFRSs. The benefits of accounting convergence to adopting countries will not be immediate, and will instead be dependent upon the extent to which there are other disciplinary frameworks in place. Effective corporate governance mechanisms, adequately developed capital markets, statutory legislation with appropriate monitoring and enforcement mechanisms to deal with breaches of standards are all essential if IFRS adopting countries are to realize the full benefits of accounting convergence.

Whilst the EU has generous subside programs for economically disadvantaged regions and industries, potential member states must meet definitive conditions on human rights and currency stability (termed the ‘Copenhagen criteria’). Similar conditions do not yet exist for countries with respect to IFRS. Worldwide usage of IFRS is varied and no funding is provided by the IASB to developing countries to assist in the transition to IFRS. In some countries, such as Argentina or Columbia, IFRSs are not permitted for both listed and unlisted entities, whilst in other countries they are either permitted in full (EU) or part (China) for listed entities, whilst in other jurisdictions, such as Armenia, IFRSs apply to all listed and unlisted entities (Deloitte, 2007). A cartographic exercise is currently underway to map all countries with respect to their position on IFRS. Of the 147 countries and regions identified by ‘IAS Plus’ (Deloitte, 2007), 79 require IFRS for all listed companies in some way, 5 require IFRS for some listed companies, 23 permit IFRS but do not require them, 31 do not permit them and 9 do not have stock exchanges. No data is forthcoming on 52 countries or regions.

Whilst the degree of acquiescence by countries will shift as national concerns give way to the benefits of convergence, as with European integration, the desire to adopt global standards may be stronger for smaller less developed countries. These countries do not have the resources necessary to maintain their own standard setting.
frameworks (in the EU case the costs associated with administrative functions), and have a greater cost burden if faced with the prospect of preparing two sets of accounts than their more developed counterparts (from an EU convergence perspective, developing countries have the benefit of accessing funds and subsides through Brussels).

The US however already has a highly transparent reporting framework and is the largest capital market in the world. The incentives for integration are therefore not as prominent as with other countries. However, US based organisations that have dual listings, like their foreign counterparts, will benefit from lower reporting costs, although size would dictate that they are better able to absorb these costs than organisations from developing nations. Each country will arrive at convergence in a different way and at different time points.

The seventh aspect of neofunctionalism is that the outcome of international integration is not fixed in advance by the founding treaty or expressed exclusively through international agreements. From an accounting standpoint, international convergence is a continuous ongoing process of transformation. How the IASB manifests in terms of a supranational body remains to be seen. Street (2006) documents the politics surrounding the change from the International Accounting Standards Committee (IASC) to the IASB, and the role of the working group known as the ‘G4+1’. The G4+1 consisted of the Australian Accounting Standards Board (AASB), Canadian Accounting Standards Board (CaSB), the UK Accounting Standards Board (ASB), the US Financial Accounting Standards Board (FASB) and the New Zealand Financial Reporting Standards Board (FRSB). This group disbanded upon the formation of the IASB, but not without significant challenges to the authority of the IASC. There were concerns over the structural problems at the IASC. These included the compromise required between members to achieve a 75% vote needed for the approval of an International Accounting Standard (IAS). There was concern among the G4 that IASC members were being appointed due to their long service to the profession in their own countries rather than their technical knowledge of issues facing the IASC. Furthermore, the progress on fundamental technical issues and authorship of technical documents issued by the IASC in its name with no reference to the input of G4+1 members, led to ‘turf wars’ which threatened the legitimacy of the IASC as a body. The G4+1 considered this as undermining the working relationship between the IASC and national standard setters, and considered several alternatives to global standard setting that did not involve the IASC, including having the G4 an extension of the FASB act as the global body. This was articulated in a document Recommendations on Shaping IASC for the Future, issued by the Strategy Working Party.

Such threats were not forthcoming as the IASC agreed on a policy of greater openness and inclusion. Upon the formation of the IASB, the G4 was disbanded. Such fragility is evident in all convergent efforts, and indicates the fear associated with devolving power to a supranational body (whether it is the EU or IASB) that may have agenda different to that of individual member states. Europe has been a vocal advocate of regional interests through the emergence of the European Financial Reporting Advisory Group (EFRAG), and this has been countered by the FASB and SEC in the US. Much of the lobbying by regional bodies such as the Confederation of Asian and Pacific Accountants (CAPA) remains extremely latent. However the
continuing emergence of an Asian trading bloc may see an increase in the voice of regional advocacy bodies on the convergence process. Submissions to financial reporting projects to date have been limited to larger countries and accounting standard setting bodies in developed countries as well as international accounting firms.

It can be seen from the above analysis, that the various aspects of neofunctionalism can be applied to the current international convergence process in accounting, in order to understand how the adoption of IFRS is inherently sociological in nature. This sociological paradigm of neofunctionalism, whilst having origins in European integration theory, can be used as a basis to understand how national institutions shift their loyalties to supranational institutions such as the IASB. Given the accounting convergence process is incomplete, what are its future prospects?

**Implications for Convergence: The Road Ahead**

A significant challenge to the concept of neofunctionalism as applied to the IASB is the role of the FASB in the accounting convergence effort, and the extent to which the US will embrace IFRS’s in their entirety. Currently, domestic companies in the United States prepare their financial statements under US GAAP while foreign private issuers reconcile to US GAAP for the financial statements that they file with the Securities and Exchange Commission (SEC) if those financial statements happen to be prepared under another basis of accounting.

It has been noted that the fundamental reason for Haas losing faith in neofunctionalism as a theory of integration in the 1960’s was the “empty chair” policies of Charles de Gaulle toward the European Community (EC) in 1965. De Gaulle restricted the role of the EC, and saw it as a tool for French foreign policy (Schmitter, 2005, p.264). Haas saw this as an undermining of the theory of regional integration. Whilst the normative assumptions of French takeover were not forthcoming, and abated over time, a similar perception exists that the IASB may become a tool of one or more individual nations (De Lange and Howieson, 2006). This may result in the IASB becoming as aggressive as national standard setting bodies. Haas (1975, p.40) used the term “turbulence” in explaining problems in European convergence. His lack of faith in the European integration process was underpinned by the belief that the failure to progress European integration was due to decision making on issues becoming “fragmented” as opposed to being the result of an “incremental” process. New objectives were being implemented on older ones (Haas, 1975, p.37), resulting in an erratic shift of objectives and a loss of focus in the integration process. Whilst history indicates that European integration finally occurred, the push toward total global accounting convergence has yet to be completely fulfilled, and it would be disappointing to see that convergence was impeded due to a descent into petty politics.

To illustrate the incremental change toward supra-national authority that is inherent in neofunctionalism, it is important to point out the change in language used over time in accounting convergence, particularly in relation to negotiations between the IASB and FASB. Whilst the terms harmonisation, convergence and compatibility are often used interchangeably, they have unique meanings. The Australian Accounting Standards Board (AASB), via paragraph 2 of Policy Statement 4, ‘International
Convergence and Harmonisation Policy’ defines ‘international convergence’ as “working with other standard setting bodies to develop new or revised standards that will contribute to the development of a single set of accounting standards for worldwide use”. ‘International harmonisation’ is “a process which leads to these standards being made compatible with the standards of international standard-setting bodies to the extent that this would result in high quality standards” (AASB, 2002, p.6). In the above sense, the harmonisation process leads to compatibility of standards between countries. The aim of working with other standard setting bodies is to achieve convergence, which ultimately leads to a single set of accounting standards for worldwide use (see Figure 1).

**Figure 1: Terminology of Convergence**

| Harmonisation process | Compatibility of standards | Convergence of standards | Single set of standards |

Whilst Australia, like many other countries, committed to a single set of worldwide standards, as evidenced by the adoption of Australian Equivalents to IFRS (AIFRS) from 1 January 2005, the commitment by the FASB is as yet, not to the same degree judging by the formal language used in FASB and IASB deliberations. The Memorandum of Understanding (MOU), or the ‘Norwalk Agreement’ issued by the IASB and the US FASB in 2002 (FASB, 2002) was a ‘roadmap’ that:

“acknowledged their commitment to the development of high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting...[and to]...make their existing financial reporting standards fully compatible as soon as is practicable and...to coordinate their future work programs to ensure that once achieved, compatibility is maintained”.

This implies that compatibility was the perceived end result in initial negotiations between the IASB and FASB. As can be seen, no mention was made toward convergence which uses stronger terminology, and is the final step toward a single set of standards. While not agreeing specifically to convergence, the SEC used the term ‘eliminating the reconciliation requirement’ and specify that this is interrelated with ‘convergence’ (Nicolaisen, 2005, p.670) when referring to SEC filings. For compatibility to occur and the need for a reconciliation requirement eliminated, there needed to be a collaborative and coordinated future work program between the FASB and IASB on a variety of priority technical issues in order to eliminate differences between US GAAP and IFRS. In cases where differences cannot be eliminated then it is appropriate to develop a new common standard.

However, in February 2006 the Securities and Exchange Commission (SEC) issued a “Roadmap to Convergence”. This was a reaffirmation of the “Norwalk Agreement” in 2002, albeit using fundamentally different terminology. The IASB and FASB were to meet on a regular basis and jointly undertake, with a goal, by 2008, of reaching a conclusion about whether major differences in the areas of impairment, income tax, research and development should be eliminated through one or more short-term standard-setting projects and, if so, complete or substantially complete work in those areas (IASB, 2006). It would be expected that ‘significant progress’ be made on other
joint projects by 2008, including business combinations, consolidations, fair value measurement requirements and liabilities and equity distinctions, post-retirement benefits and revenue recognition, not to mention the joint conceptual framework. Should sufficient progress be made on these topics by 2009, then it is possible that the requirement to reconcile to US GAAP will be removed for foreign SEC filers. This implicitly implies that full convergence would be met whilst avoiding being explicitly finite about the terminology.

The IASB has numerous accounting issues on its agenda as part of its continuing Convergence Project with the FASB, including: “(1) insurance contracts – phase II of the IASB project; (2) financial reporting by small and medium-sized entities (to which an exposure draft has just been released); (3) business combinations – phase II (purchase method procedures); (4) disclosures for financial instruments; (5) standards and guidance for management commentary, financial guarantees and credit insurance; (6) cash flow hedge accounting of forecast intra-group transactions; and (7) reconsideration of the fair value option” (Thetford, 2005, p.1). The “roadmap” for convergence between the IASB and the FASB standards by 2009 outlined under the Norwalk agreement may result in both bodies competing for the ‘moral high ground’ in IFRS formulation. Both bodies have only agreed to a “common set of high quality standards” in the longer term (IASB, 2006), which is not as explicit as a “single set of standards” to guide both realms. This step by step working relationship is a slow but steady approach to ultimate convergence until as Cheney (2006) suggests, the US Securities and Exchange Commission ‘gets comfortable’.

The Norwalk Agreement finalised in September 2002 was a major step forward in convergence between the two most powerful accounting institutions, namely the IASB and the US FASB. The two bodies have agreed to remove differences between US GAAP and IFRS in order to achieve and maintain full compatibility. They have agreed to ‘harmonise’, with the intention to ‘converge’, their standards by 2009. An important factor in the convergence process is the extent to which the FASB will converge with the IASB, or vice versa. Who blinks first in the game of ‘playing chicken’?

De Lange and Howieson (2006) argue that given the history of “American exceptionalism” and its power in international affairs, the outcome will either be significant differences between the IASB and FASB or a likely dominance of the IASB by the FASB. A third option is the likelihood that the two accounting systems (IASB and FASB) remain “unconverged” as a result of fundamental disagreements surrounding complex technical issues and control of the decision-making process, including the right to veto, a situation similar to European integration in the late 1960’s. Such a position is still valid within integration theory. As Schmitter (2004) argues;

“Any comprehensive theory of integration should potentially be a theory of disintegration. It should not only explain why countries decide to coordinate their efforts across a wider range of tasks and delegate more authority to common institutions, but also why they do not do so or why, having done so, they decide to defect from such arrangements”. (p.47)
However, the IASB Chairman Sir David Tweedie has expressed the view that these two bodies will in fact merge “over time” (Bolton, 2005), as Europe consequently did in due course. However, the extent to which Europe will emerge as a capital base on par with the US remains to be seen. The argument that the US has the largest capital market, and therefore lacks the incentive to adopt IFRS, ignores the growing influence of European and Asian capital markets to counterbalance US interests.

Whilst the FASB-IASB relationship is undoubtedly the ‘main game in town’, the role played by developing countries in the convergence process cannot be ignored. Their role in standard setting may be limited unless significant intellectual effort is made toward making submissions on policy and technical documents. The lack of a contribution by developing nations to “calls for comments” by the international bodies on various technical issues including exposure drafts, can be explained either by general apathy, a lack of commitment to and engagement in the convergence process, or a lack of technical expertise in the developing country. Submissions to international bodies require an active professional body and willing and able members. It is acknowledged that developing countries incur high integration costs in that there are not the epistemic communities, with the level of technical knowledge to analyse and evaluate technical documents, and make submissions. As argued by Farrell and Heritier (2005, p.276):

Epistemic communities, characterised by a high level of technical and expert knowledge, may play a role in accelerating regional integration, because scientific views tend to converge, and facilitate the formation of policy committees.

The difficulties in adopting IFRSs in developing countries have been highlighted in recent studies using Armenia (McGee, 1999) and Zimbabwe (Chamisa, 2000) as examples. Whilst it is argued that IFRSs do bring benefits to these countries, it is not without a greater effort at training and awareness of technical standards. Research on 64 developing countries has found that literacy rates, an Anglo-American culture, and the presence of a capital market are primary factors for countries seeking to adopt IFRSs (Zeghal and Mhedhbi, 2006). Accounting information underpins economic activity and ‘wherever global business goes accounting is sure to follow’. Research on developing countries has found that IASB standards, adjusted to local conditions, can contribute to an increase in economic growth (Larsen, 1993).

There needs to be a greater commitment to research which examines the degree to which countries embrace the notion of the IASB as an autonomous collective identity, as opposed to a mere vehicle for lobbying for individual country interests, similar to studies on the EU vs. individual national entities (Herrmann et al., 2004). Research may also consider how dialogue within member countries can influence the direction of supranational institutions such as the IASB. Schmitter (2004) offers many suggestions for research from a non-specific neofunctionalist perspective, including hypotheses for how integration and transformation occurs at various levels. The convergence process in accounting currently underway at the IASB embodies many of the challenges that faced Europe 30 years ago. Whilst encountering nationalistic tendencies and “turbulence” in the integration process, the EU was eventually a reality. The extent to which every country converges with IFRS remains to be seen and many conceptual and technical issues remain to be addressed. International integration efforts in accounting are timely and are occurring at an important juncture
in history. Whilst a complex process, history has taught us that real progress is more likely to occur as a result of “incremental” as opposed to bold steps which are likely to cause “turbulence”. Understanding how those steps are taken is as important as the journey itself.
References


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