A CHANGE IN ACCOUNTING, A CHANGE IN LAW

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ABSTRACT

While the influence of accounting on the financial environment of corporations and institutions cannot be denied, scholars have yet to examine the significant effect accounting standards have on the legal system. This article aims to fill this gap in the literature by discussing the legal use of financial accounting and the impact changes in accounting standards has on fiscal and regulatory regimes that utilize accounting parameters.

Specifically, this article argues that the role financial accounting plays in the legal system endows it with a quasi-legislative capacity, which is exercised when the frequent and regular changes to prevailing accounting practices exogenously affect legal regimes that utilize accounting parameters. This article calls attention to accounting's power to affect legal regimes while suggesting measures to cope with the legal consequences caused by changing accounting standards.

"But there's a malaise about the whole thing... Suddenly the rules are changed in the middle of the game."[1]

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[1] Stewart Alsop, *President Agnew?* WASH. POST, July 29, 1973, at C6 (noting the phrase spoken by Spiro T. Agnew, the 39th vice president of the United States, while being ushered out of the vice president's office).

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I. INTRODUCTION

In modern times, financial accounting is a necessary and influential tool that plays a critical role in many contractual and statutory arrangements. Although capital market and investment decisions are probably the first interaction people have with financial accounting, accounting also plays a substantial role in the legal system. Many fiscal and regulatory regimes, e.g., taxation[2] and corporate law,[3] use economic

[2] Internal Revenue Code § 446(a) (2016) ("[t]axable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books"); *but see Thor Power Tool Co. v. Comm'r*, 439 U.S. 522, 540 (1979) (holding that the treasury, in its goal to prevent taxpayer manipulative accounting, is free to prescribe financial accounting use that clearly reflects a taxpayer's income).

[3] William P. Hackney, *Accounting Principles in Corporation Law*, 30 L. & CONT. PROB. 791, 791-92 (1965) (discussing instances where the law requires interpretation and computation in an accounting framework); Peter F. Pope & Anthony G. Puxty, *What is Equity? New Financial Instruments in the Interstices between the Law, Accounting and Economics*, 54 MOD. L. REV. 889, 890 (1991) (arguing that two key accounting constructs, liabilities, and equity, have become increasingly ambiguous concepts and therefore, challenge both accounting and the law); Lawrence A. Cunningham, *Private Standards in Public Law: Copyright, Lawmaking and the*

parameters determined by financial accounting ("accounting parameters"). The use of accounting parameters in legal regimes constitutes an underlying regulatory layer, made up of accounting standards, which merges with legal code.[4] As a result, hybrid regulatory norms – composed of legal directives mixed with accounting parameters – endow financial accounting with a significant role in the direct regulation of persons, corporations, and institutions.[5]

The legal use of financial accounting is not a new phenomenon.[6] Nonetheless, the effect financial accounting has on the American legal system, as well as on legal systems worldwide (as demonstrated below with respect to international adoption of IFRS 9 and its expected effect on dividend-distribution regulations around the world) has largely gone unnoticed by scholars. Existing literature has focused mainly on the general impact accounting standards and financial reporting has on capital markets.[7] Although some scholars have focused on the legal effect

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Case of Accounting, 104 MICH. L. REV. 291, 292 (2005) (suggesting a general framework and a mechanism for evaluating and analyzing copyrighted law standards promulgated by nongovernmental organizations).

[4] Cunningham, *supra* note 3, at 292; Hackney, *supra* note 3, *at* 821-23*;* Bernhard Grossfeld, *Lawyers and Accountants: A Semiotic Competition*, 36 WAKE FOREST L. REV. 167, 167, 172-84 (2001) (arguing that accounting principles become the new codes of conduct for corporations); *see generally* Pope and Puxty *supra* note 3.

[5] The direct regulation role financial accounting plays by its integration into the legal code is distinct for the indirect behavioral effect accounting has on the conduct of financial statements preparers who change their behavior in order to gain a favorable accounting expression, a phenomenon known in the literature as "economic consequence".

See Stephen A. Zeff, *The Rise of "Economic Consequences*," J. Accountancy 56 (Dec. 1978) (discussing economic consequences in general)*;* David I. Walker, *Financial Accounting and Corporate Behavior*, 64 WASH. & LEE L. REV. 927 (2007) (discussing evidence of, and legal aspects related to, the power of accounting to shape corporate behavior).

[6] A. A. Jr. Berle & Frederick S. Jr. Fisher, *Elements of the Law of Business Accounting*, 32 Colum. L. Rev. 573, 578 (1932) ("[y]et, day by day, lawyers and courts predicate legal effects on the results of accounting. It may fairly be said that rules of accounting are for many purposes rules of law; or, conversely, that rules of law entail rules of accounting. The respective tasks of a lawyer and accountant here intermingle so closely that neither can proceed without the other").

[7] *E.g.*, Christian Leuz & Peter D. Wysocki, *The Economics of Disclosure and Financial Reporting Regulation: Evidence and Suggestions for Future Research*, 54 J. ACCT. RES. 525 (2016) (discussing empirical studies that link disclosure and reporting activities to firm-specific and market-wide economic outcomes); S. P. Kothari, Karthik Ramanna & Douglas J. Skinner, *Implications for GAAP from an Analysis of Positive Research in Accounting*, 50 J. ACCT & ECON 246, 257-58 (2010) (using existing literature to describe a parsimonious economic theory of GAAP); *see also* Paul M. Healy & Krishna G. Palepu, *Information Asymmetry, Corporate Disclosure, and the Capital Markets: A Review of the Empirical Disclosure Literature*, 31 J. ACCT. & ECON. 405 (2001) (reviewing the empirical research on disclosure regulation, information intermediaries, and the determinants and economic consequences of corporate disclosure); Christopher S. Armstrong, Wayne R. Guay & Joseph P. Weber, *The Role of Information and Financial Reporting in Corporate Governance and Debt Contracting*, 50 J. ACCT. & ECON. 179 (2010) (reviewing literature on the role of financial reporting transparency in reducing governance-related agency conflicts among managers, directors, and shareholders).

accounting changes have on taxation or on the sovereignty of the state,[8] financial accounting's legal effects as a general phenomenon did not attract scholarly attention. Similarly, the present regulatory discussion of accounting standard-setting, currently taking place in Europe,[9] has been focused on the impact financial accounting has on capital markets and investors, and the financial burden complex accounting standards places on small companies,[10] leaving financial accounting's legal consequences out of the discussion.[11]

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[8] *Cf.,* Wolfgang Schön, *International Accounting Standards a "Starting Point" for a Common European Tax Base?*, 44 EUROPEAN TAXATION 426, 428 (2004) (discussing the legislative use of extra-legal accounting parameters in taxation)*;* Lawrence A. Cunningham, *SEC's Global Accounting Vision: A Realistic Appraisal of a Quixotic Quest,* 87 N.C. L. REV. (2008) (discussing a possible reduction in U.S. sovereignty in case IFRS will eventually apply to domestic issuers); ISRAEL KLEIN, INTERNATIONAL ACCOUNTING STANDARDS (IFRS) AND NATIONAL ACCOUNTING SOVEREIGNTY: A CASE STUDY OF GERMANY AND ISRAEL (European Forum at the Hebrew University, Jerusalem 2014). http://www.ef.huji.ac.il/publications/Israel%20Klein%20-%20for%20web.pdf.

[9] *See* Philippe Maystadt, *Should IFRS Standards Be More "European"?* (2013), (discussing a meeting of the Economic and Finance Ministers of the Member States Council, resulting in a special report which discussed some problems and suggestions with the European accounting structure); Report of the Committee on Economic and Monetary Affairs on International Accounting Standards (IAS) Evaluation and the Activities of the International Financial Reporting Standards (IFRS) Foundation, the European Financial Reporting Advisory Group (EFRAG) and the Public Interest Oversight Board (PIOB), Parl. Eur. Doc. A8-0172 (2016) [hereinafter Parl. Eur. Doc. P8_TA (2016) 0248] http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+REPORT+A8-2016-0172+0+DOC+PDF+V0//EN (showing a final report adopted by the European Union that stressed shortcomings in governance, transparency, prevention of conflicts of interest, and lack of diversity in the activities of the current organizations involved in accounting standard-setting); International Accounting Standards (IAS) Evaluation*,* Parl. Eur. Doc. P8_TA 0328 (2016) (as yet unpublished), http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P8-TA-2016-0248+0+DOC+XML+V0//EN&language=EN (adoption of the ECOFIN report as a resolution by the European Parliament which, though not legally binding, will serve as guidance and reference in future EU law-making processes regarding accounting standard-setting).

[10] *See e.g.,* Opinion of the Committee on Budgetary Control for the Committee on Economic and Monetary Affairs on International Accounting Standards (IAS) Evaluation and on Activities of the International Financial Reporting Standards (IFRS) Foundation, European Financial Reporting Advisory Group (EFRAG) and the Public Interest Oversight Board (PIOB) (2016/2006(INI)) Parl. Eur. Doc. (2016) http://www.europarl.europa.eu/sides/getDoc.do?type=COMPARL&reference=PE-576.690&format=PDF&language=EN&secondRef=02 (notes that the high level of complexity of accounting standards necessitates further cost/benefit analysis, and that a careful balance between required data disclosure and reduced requirements for SMEs must be maintained).

[11] Parl. Eur. Doc. P8_TA (2016) 0248*, supra* note 9, at § 11 (noting that "the effects of an accounting standard must be fully understood," and conversely, focusing on the understanding required in "the field of macroeconomics, and to assess the different needs of the wide variety of stakeholders, including long-term investors and companies, as well as the general public").

This article aims to fill this gap in the literature while enriching the current regulatory discourse. By discussing financial accounting properties and their effect on regulatory regimes, I argue that the role financial accounting plays in the legal system endows it with a quasi-legislative capacity that is exercised when continuous changes made to prevailing accounting practices exogenously affect legal regimes that utilize accounting parameters ("financial accounting's legal consequences"). In light of financial accounting's power to impact legal regimes, this article calls attention to its legal consequences and suggests measures to neutralize them.

The article includes three sections: In the first section, I explain what financial accounting is and discuss its impact on the legal system, and some of the characteristics that distinguish it from other non-legal instruments routinely used by the legal system. In the second section, I discuss the quasi-legislative features financial accounting possesses and the problem it constitutes for countries worldwide, by examining the influence a recently promulgated international accounting standard (IFRS 9), currently being implemented by foreign issuers trading in U.S. markets[12] and other issuers worldwide,[13] has on the classical legal doctrine used to protect corporate shareholders against over-distribution of dividends. The third section suggests three measures that can be taken in order to mitigate financial accounting's legal consequences.

II. THE ROLE OF FINANCIAL ACCOUNTING IN THE LEGAL REALM

A. *Financial Accounting*

Financial accounting seeks to present and explain the actions and behavior of commercial entities using consensual financial terms.[14] It serves a decision-making need by providing financial information regarding economic entities, such as corporations.[15] In order for

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[12] *See* 17 CFR pt. 210, 230, 239, 249 (2008) (noting that foreign private issuers may present financial statements pursuant to International Financial Reporting Standards).

[13] *See* IFRS Foundation, IFRS, Jurisdiction Profiles, http://www.ifrs.org/Use-around-the-world/Pages/Jurisdiction-profiles.aspx (for informational and detailed surveys about more than 100 countries that require domestic public issuers to report their financial results using IFRS).

[14] *See* ACCOUNTING PRINCIPLES BD. OF THE AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, CONCEPTS AND ACCOUNTING PRINCIPLES UNDERLYING FINANCIAL STATEMENTS OF BUSINESS ENTERPRISES 6 (Accounting Principles Bd. No. 4, 1970) ("Accounting is a service activity. Its function is to provide quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions—in making reasoned choices among alternative courses of action").

[15] *Id.; See also* ELDON S. HENDRIKSEN & MICHAEL. F. VAN BREDA, ACCOUNTING THEORY, 198-226 (5th ed. 1992) (discussing accounting-based decision making).

accounting to explain and communicate financial details in an understandable, efficient, and effective manner, it makes use of agreed-upon terms that embody economic and financial meaning. For example, accounting defines parameters that describe investment returns on company shares; an example of a parameter of this kind is "earnings per share" ("EPS").[16] The EPS parameter provides useful financial information to investors, conveyed through using a consensual accounting term, with which they can assess investments, and as an additional method of evaluation alongside current prices on the stock market.[17]

While functioning as a vehicle for communicating financial information, accounting performs two functions: aggregation and synthesis. Aggregation is the collection and summary of all the relevant financial information regarding the accounting entity into aggregated values. The EPS parameter, for example, contains all the information required for evaluating an investment in a company's shares, compressed (aggregated) into a single number that purports to represent how much the company earned per share of stock issued. The level of compression, i.e., the level of elaboration of the information provided to the users, is a compromise between presenting excessive financial detail, for which users do not have adequate financial justification (or resources) to process, and too few details, which makes reporting not elaborate enough to allow for informed decision making.[18] The exact equilibrium point constantly shifts, i.e., new disclosure requirements are levied or repealed through new accounting standards due to market developments and changes in investor information requirements.[19]

When aggregating, accounting does not merely summarize pre-existing information but synthesizes; thus, it actually creates new information. Part of the information provided by accounting is simply factual information, whose financial value is clear, e.g., end-of-year bank account balance amounts. However, in many instances, accounting is used to provide users with information about facts that are of a more complex financial nature. In the latter case, accounting must first establish the financial aspects ("synthesize"), and only then can it report them to the users using consensual financial terminology. For example, information about a firm's employment costs is easily aggregated into a single figure when all employees are paid in cash (assuming no retirement-benefits are

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[16] HENDRIKSEN & VAN BREDA, *supra* note 15 at 829-34 (noting that EPS represents the company's profit for the accounting period divided by the number of outstanding shares).

[17] *Id.* at 829.

[18] WILLIAM H. BEAVER FINANCIAL REPORTING: AN ACCOUNTING REVOLUTION 7-8 (1st ed. 1981).

[19] William P. Hackney, ACCOUNTING PRINCIPLES IN CORPORATION LAW 30 LAW & CONTEMP. PROBS. 791, 823 (1965).

awarded, etc.). However, when remuneration is partially paid with stock options, reporting a single compressed figure that represents employment costs requires more than just aggregating cash payments, it requires establishing the financial value of the options granted. Only after the financial value of the options is determined, can it be aggregated and reported to the users.

When determining value for non-financial factors, financial accounting synthesizes many elements into a financial value including: contractual arrangements, property rights, statuary status, etc. The synthesis of the non-financial elements into financial values, and later into accounting expressions, is not self-evident.[20] When accounting synthesizes non-financial elements, it actually determines their value.[21] Consider Shoes-Co Inc., a shoe manufacturing company, for example: their balance sheet represents, in financial terms, the company's actual possession of a hundred pairs of unsold shoes, size seven. What value should be placed on these unsold shoes?[22] Theoretically, the value can be determined according to the direct manufacturing expenses (raw material and labor costs),[23] but it can also be determined according to the direct and indirect manufacturing expenses (materials, labor, electricity, rent, etc.),[24] or the expected sales proceeds.[25] There is no precise conferred financial value assigned to shoes that have been manufactured, and not sold. Accounting decides their value according to the social function that the accounting expression aims to fulfill.[26] For example, in the case of Shoes-Co Inc.'s inventory, since the accounting expression is used to determine its tax liability (and therefore should only include realized expenses) and is important also to its investors (who are afraid of inflated values), it has long been customary (and today, mandatory according to accounting standards)[27] that Shoes-Co Inc. will evaluate its inventory as equal only to the inventory's direct and (identified) indirect production expenses

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[20] *Cf.* Ruth D. Hines, *Financial Accounting: In Communicating Reality, We Construct Reality*, 13 ACCT. ORG. & SOC'Y 251 (1988) (arguing that reality does not pre-exist financial accounting practice, but rather arises reflexively and interactively with *inter alia* financial accounting practices).

[21] *Cf.* Israel Klein, *The Gap in the Perception of the GAAP*, 54 AM. BUS. L. J. 581 (2017) (arguing that accounting standards are not neutral but political).

[22] *See, e.g.*, HENDRIKSEN & VAN BREDA, *supra* note 15, at 570-574 (positing that inventories should be recorded by accounting and presented in financial statements).

[23] *See* MURRAY F. FOSS et al., MEASUREMENT OF BUSINESS INVENTORIES 13-16 (1981) (explaining inventory measurements with detailed examples).

[24] *Id.*

[25] *Id.*

[26] BEAVER, *supra* note 18, at 16 ("the selection of a financial reporting system is a social choice").

[27] ACCOUNTING STANDARDS *Update, Inventory, Topic 330*, 2015-11 Fin. Acct. Series 1, 4 (2015).

("manufacturing costs"), and by the lesser of either its manufacturing cost or realization.[28]

B. *Accounting's Epistemological Role*

The legal system does not define and regulate all non-legal knowledge required for its regulatory functioning.[29] Rather, it uses existing "professional" terms and concepts that have been created and are regulated by other knowledge systems. For instance, when the legal system restricts highway driving speed to sixty-five miles per hour, the legal code uses pre-existing definitions created by physics; the code does not define what a mile is or what constitutes movement at a certain speed; it assumes basic recognition of these definitions and concepts, and therefore, integrates them into the legal code.[30]

Similarly, legal interactions with economic and financial realities use pre-existing accounting parameters. Financial accounting's ability to synthesize the financial aspects of non-financial facts allows the legal code to regulate – through the use of accounting parameters – the financial aspects of our environment. Financial accounting then becomes the prism through which the legal system views financial realities, and hence, a key element in many fiscal and regulatory regimes. An example of the role financial accounting plays in making financial dimensions of our environment accessible to the legal system, and the influence it gains in consequence is the American tax system.[31] Under section 446(a) of the

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[28] *Id.*

[29] *Cf., e.g.,* Hackney, *supra* note 3, at 813-23 (*inter alia* arguing that corporate law cannot feasibly use fair market value of assets to regulate distributions).

[30] *See* Cunningham, *supra* note 3, at 302-03 (discussing the use of the American Medical Association (AMA)'s Physician's Current Procedural Terminology (CPT) by U.S. federal agency coding system that enables medical personnel to identify particular medical procedures with precision); Prac. Mgmt. Info. Corp. v. Am. Med. Ass'n, 121 F.3d 516 (9th Cir. 1997) (discussing legal consequence of the regulatory mandate use of CPT code numbers on their creator copyright protection).

[31] *See also Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions - "Think Small First" - A "Small Business Act" for Europe*, *at 2-8* COM (2008) 394 final (June 25, 2008); Commission Recommendation (EC) No. 361/2003 of May 6, 2003, concerning the definition of micro, small and medium-sized enterprises*,* 2003 O.J. (L 124) 37-38*;* European Commission*, The New SME Definition: User Guide and Model Declaration* 9, 15 (2005) (Another example of the influence financial accounting gains on macro fiscal policies is presented in the European Small and Medium Sized Enterprises (SMEs) policy framework: The policy uses accounting turnover and balance sheet totals as proxies that characterize and distinguish small business eligibility for policy benefits. Thus, the legislation's objective, i.e., to encourage and protect small businesses, is actually realized via accounting norms. For example,

Internal Revenue Code, taxable income is computed "under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." [32] A recent research study conducted at the University of Chicago, Booth School of Business and the University of Illinois,[33] indicates that 79% of corporate taxpayers[34] use financial accounting, and specifically, generally accepted accounting principles ("GAAP")[35] as the basis for computing their income, and therefore, as a basis for their taxes.[36] The objective of taxing additional wealth generation within those corporations is realized by financial accounting's ability to synthesize their wealth, i.e., the additional value created by the business activity carried out through the corporation, into financial parameters.[37] The accounting standards, which regulate the process of synthesis, become part of the tax norms.

C. Accounting and Other Measurement Systems: Applied vs. Theoretical Science

Theoretical scientific disciplines, such as mathematics and physics, seek to explain and describe natural phenomena and logical concepts. As such, these paradigms create definitions and concepts that are objective and unaffected by subjective factors, such as the expected application of their scientific findings. For example, the imperial and metric systems provide measurement units which are neutral.[38] Thus, when imperial units

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if the accounting rule determining the calculation of an accounting turnover changes those businesses entitled to SME benefits will also change).

[32] 26 I.R.C § 446 (2016).

[33] Petro Lisowsky & Michael Minnis, *Accounting Choices and Capital Allocation: Evidence from Large Private U.S. Firms,* Chicago Booth Research Paper No. 14-01 (December 1, 2016), http://ssrn.com/abstract=2373498 or http://dx.doi.org/10.2139/ssrn.2373498 (indicating a GAAP-use ratio of 79% among private-companies examined in the study; however, the *preparing audited* GAAP statements percentage is lower).

[34] *Id.* (the research examined 216,898 observations which are based on schedules M-3 for entity type filers of Forms 1120, 1120S, and 1065 for the fiscal years of 2008 to 2010 at the consolidated U.S. parent level. By definition, filers of Schedule M-3 report assets of $10 million or more, hence the research's sample is based on medium-to-large firms).

[35] American Institute of CPAs Glossary of Terms, Acronyms, and Abbreviations (2014), www.aicpa.org/Press/DownloadableDocuments/Acronyms_and_Abbreviations.pdf (defining GAAP as, "[u]niform minimum standards of and guidelines to financial accounting and reporting." Generally speaking, the Financial Accounting Standard Board (FASB) is the accounting standard-setter for non-governmental entities in the U.S. market.

[36] *See supra* note 2.

[37] *Cf.* Robert Murray Haig, *The Concept of Income - Economic and Legal Aspects*, READINGS IN THE ECONOMICS OF TAXATION 54, 55-59, 61-63 (Richard A. Musgrave & Carl S. Shoup eds., 1959) (discussing what is considered income).

[38] *See also* Lawrence A. Cunningham, *SEC's Global Accounting Vision: A Realistic Appraisal of a Quixotic Quest,* 87 N.C. L. REV. 1, 78-79 (2008) (arguing that international coordination is required to guide IFRS to a similar fate of the metric system).

are used to regulate driving speed, for example, they do not affect the regulatory function. All else being the same, regulation using either a mileage-based or kilometer-based system has the same basic regulatory effect on drivers.[39]

Accounting differs from the above-mentioned measurement systems (and from theoretical/pure scientific disciplines, in general).[40] While these systems' measurements are free of subjective judgments- in the words of the 18th century French philosopher concerning the metric system, Marquis de Condorcet: "For all time. For all people."[41] - inherent in accounting measurements are subjective preference which cause the resulting accounting expressions to include non-neutral characteristics.[42] As a result, the legal use of accounting parameters has different implications than the use of neutral measurement systems. It imports accounting's subjective preferences into the legal system. In measuring corporate income, for example, financial accounting synthesizes facts surrounding the firm into financial numbers that represent monetary income generated by the firm. As part of this process, accounting preferences affect the synthesis process and the income generated. Consequently, legal regimes that utilize the income parameter (included in every firm's financial statements) are also affected.

Consider a more specific example: Granola-Co, a hypothetical Boston-based company, sells granola to customers all over the United States through their company's website. The company probably has an obligation to file tax returns in at least some of the states where it is active,

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[39] Assuming cars' speedometers would be adjusted for kilometer-based systems, no discrepancies would be created.

[40] *See* RICHARD MATTESSICH, INSTRUMENTAL REASONING AND SYSTEMS METHODOLOGY 317-18 (1978) (discussing differences between pure and applied science, focusing on methodology applicable for applied science research); RICHARD MATTESSICH, CRITIQUE OF ACCOUNTING: EXAMINATION OF THE FOUNDATIONS AND NORMATIVE STRUCTURE OF AN APPLIED DISCIPLINE 220, 222 (1995) (discussing a gap between the theory and practice of accounting arguing for normative research in accounting); Richard Mattessich, *Conditional-Normative Accounting Methodology: Incorporating Value Judgments and Means-end Relations of an Applied Science*, 20 ACCT. ORG. & SOC'Y 259, 260-61, 279 (1995) (discussing accounting's characteristics as an applied science while outlining a methodological basis for a conditional-normative accounting theory).

[41] See *e.g.,* JEFFREY HUW WILLIAMS, DEFINING AND MEASURING NATURE: THE MAKE OF ALL THINGS, x, xi (2014).

[42] *See* HENDRIKSEN & VAN BREDA, *supra* note 15, at 98-99 (identifying capital providers, i.e., investors, and to some extent, creditors, as the consumers who benefit the most from institutionalized financial information as produced by accounting standards); AMERICAN INST. OF FIN. ACCOUNTANTS, THE OBJECTIVES OF FINANCIAL STATEMENTS 57, 61, 66 (1973); AMERICAN INST. OF CERTIFIED PUBLIC ACCOUNTANTS, ESTABLISHING FINANCIAL ACCOUNTING STANDARDS 19-20 (1972); Klein, *supra* note 21, at 611-15 (discussing the political nature of financial accounting).

such as those which local sales and marketing activities are substantial enough to constitute a local tax nexus for the company.[43] Nonetheless, due to legal ambiguity regarding the company's tax liability in the different states (state legislation, in their constant attempts to "capture" and tax e-commerce activities, are constantly developing and so are local court rulings),[44] Granola-Co decides to file tax returns only in Massachusetts.[45] In economic terms, Granola-Co.'s decision saves immediate tax payments (i.e., it generates income for the firm) at the risk of future and higher tax payments (if the company's decision not to file a tax return in a certain state, for example, in California, will eventually be challenged by the California Franchise Tax Board, then Granola-Co may have to pay the tax retroactively, plus fines).

When accounting synthesizes the company's decision not to file tax returns (its "omission-position" tax position), it can focus on the immediate (although uncertain) tax savings, and express it as income for the firm; or, it can focus on the future risk of higher tax payments, and therefore express the company's decision as generating a contingent future tax liability.[46] Like the unsold shoes inventory of Shoes-Co Inc., there is no obvious or intrinsic financial meaning in such circumstances; the accounting expression given to these facts depends on the perspective chosen by the accounting narrator.

Unlike the legal use of neutral measurement systems, when financial accounting is used it brings along its accounting preferences, i.e., its subjective judgments, which are integrated into the legal system. Thus, financial accounting interpretation of the Granola-Co.'s omission-position will affect all the legal regimes and fiscal policies that use the accounting income parameter.

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[43] *See,* Andrew E. Jones, *FASB - The IRS's New Best Friend: How Fin 48 Affects the Taxpayer-IRS Relationship and Potential Taxpayer Challenges*, 25 GA. ST. U.L. REV. 767, 767-68 (2009) (discussing how a tax nexus describes a situation in which a business has a connection or a physical/economical presence in a state, and is therefore subject to state income taxes and to sales taxes for sales within that state. The amount and degree of business activity that constitutes a tax nexus varies between states. As a general rule, if a taxpayer has a nexus in a particular state, the taxpayer must pay taxes in that state).

[44] *See also* Emily L. Patch, *Online Retailers Battle with Sales Tax: A Physical Rule Living in a Digital World*, 46 SUFFOLK U. L. REV. 673 (2013) (discussing the evolution of e-commerce, adjudication of tax issues and state response); *see also* Jones, *supra* note 42, at 769-71, 799 (discussing the accounting treatment of a similar tax position).

[45] *See also,* Jones*, supra* note 42.

[46] Though, one will become income once the statute of limitations expires, and the local tax board can no longer challenge the company's decision.

In fact, the two distinct accounting treatments available for Granola-Co.'s omission-position (whether generating income or a liability)[47] can be seen as representing distinct judgments regarding the decision not to file tax returns. If Granola-Co.'s decision is expressed as generating income for the company in its financial statements, then the company's omission-position is seen as a legitimate one, at least vis-à-vis the accounting discourse; however, if the omission-position is expressed as generating a contingent liability, then over all, the position is seen as less legitimate.

Financial accounting's subjective judgments, and the preferences they cast onto financial accounting parameters, are derived from financial reporting objectives – to communicate information that supports informed judgment and improves decision-making by the accounting entity's capital providers, i.e., its equity investors and, to some extent, creditors.[48] Adherence to capital provider preferences is sometimes made at the expense of omission, or even distortion, of information that is necessary for other parties, such as domestic regulators or tax authorities, which also use financial statements.[49] However, generally speaking, the legal system knows how to deal with and neutralize accounting's subjective preferences and judgments. Moreover, and as demonstrated below,[50] the legal doctrine utilizes specific accounting preferences to achieve regulatory objectives. Generally speaking, as long as accounting standards are unchanged, legal doctrines utilize accounting measurements for regulatory purposes while

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[47] *See* Jones, *supra* note 42, at 768-69, 773 (explaining the difference between IFRS, which allows such positions to be recognized as reducing tax expenses, and US GAAP, which requires them to be expensed).

[48] FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NUMBER 8: CONCEPTUAL FRAMEWORK FOR FINANCIAL ACCOUNTING 1 (2010); INTERNATIONAL ACCOUNTING STANDARDS BOARD, THE CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING 2010 9 (Int'l. Accounting Standards Bd. 2010) (defining the objective of financial reporting "[t]he objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity."); *see also supra* note 47, at 769-72 (showing how this objective varies in some cases, as in the accounting treatment of uncertain tax positions).

[49] *See e.g.*, James R. Repetti, *The United States*, COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS 173, 190 (Hugh J. Ault & Brian J. Arnold eds., 2010) (noting conservatism is one of the measurement principles of financial accounting and is biased in favor of rapid recognition of expenses and delayed recognition of income, while in contrast, tax systems usually seek the opposite i.e. income is recognized as soon as it is reasonable to expect the taxpayer to pay, but expenses are recognized only to the extent that they can be matched to recognized income).

[50] *See* discussion *infra* Section 3.A.

filtering out the disturbing, unwanted nuances created by the investor perspective taken by accounting.[51]

Another feature that distinguishes financial accounting from disciplines, like physics or mathematics, is the direct effect accounting's objectives have on the profession's definitions and concepts, and the resulting frequent changes thereof. As mentioned, financial accounting, i.e., IFRS, US-GAAP, is designed to inform investors about the accounting entity's financial status;[52] all accounting definitions and rules are derived from this pre-determined objective.[53] Consequently, as investor information requirements change,[54] so do accounting definitions and concepts. Thus, unlike the scientific concept of length and the definition of a meter, which have remained more or less the same for centuries,[55] the accounting concept of corporate income, for example, is constantly developing and changing.[56]

Changes in accounting cause complications for the legislative use of financial accounting. Changes in accounting standards, i.e., promulgation of a new accounting standard, usually means that revised accounting parameters are provided to legal regimes. As changes to financial accounting occur independently of changes in the legal code or in regulation, the legal doctrine implemented in the code and the regulation stays the same, i.e., the legal use of accounting parameters remains the same, although the parameters themselves are revised. Thus, when accounting standards are changed after a legal doctrine is set to utilize accounting parameters, a mismatch is created between the doctrine's expected accounting measurement and the one actually provided through accounting parameters.

When such mismatches occur, legal regimes are affected and financial accounting, through the revised accounting parameters provided to the legal system, gains quasi-legislative capacity and reshapes the legal norm.

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[51] *See e.g., infra* note 101 and accompanying text.

[52] *Supra* notes 42, 48.

[53] BEAVER, *supra* note 18, at 16 ("the selection of a financial reporting system is a social choice").

[54] Jack O. Hall & C. Richard Aldridge, *Changes in Accounting for Changes*, J. OF ACCT.: BUS. & INDUSTRY/FIN. REPORTING (Sept. 21, 2017, 5:23 PM), https://www.journalofaccountancy.com/issues/2007/feb/changesinaccountingforchanges.html.

[55] *See generally* WITOLD KULA, MEASURES AND MEN 120-21 (R. Szreter trans., 1986) (analyzing how the definition of a meter, although it has changed a few times, has remained relatively constant since its initial development).

[56] *See, e.g.,* HENDRIKSEN & VAN BREDA, *supra* note 15, at 308-42 (discussing different income concepts); Lynn L. Rees & Philip B. Shane, *Academic Research and Standard-Setting: The Case of Other Comprehensive Income,* 26 ACCT. HORIZONS 789 (2012) (discussing the development of reporting other comprehensive income).

III. THE LEGISLATIVE POWER OF FINANCIAL ACCOUNTING

A. IFRS 9 and the Capital Maintenance Doctrine

The issuance of "*IFRS 9 Financial Instruments*" (IFRS 9),[57] a new accounting standard currently being implemented[58] by foreign issuers trading in U.S. markets[59] and all public issuers in more than 100 non-US countries around the world,[60] and the effect such issuance is expected to have on the legal regime that protects company shareholders from over-distribution, is an example of how, through changes in accounting standards, a legal regime is changing. Due to changes in accounting alone, a given company, which was legally precluded from distributing dividends, may now declare a dividend without any real change other than the one occurring in the accounting standards.

B. Creditors' Protection Regime

Dividend distribution by many foreign issuers, for example, Ferrari the Italian sports car manufacturer, traded on the New York Stock Exchange,[61] are regulated by the continental "capital maintenance" doctrine.[62] According to this doctrine, dividend distribution is subject to two cumulative tests: a "balance-sheet test," which allows distribution to shareholders provided that the company's nominal capital and restricted reserves will not be diminished as a result; and a "retained earnings test"

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[57] INT'L. ACCT. STANDARDS BD., IFRS FOUNDATION, IFRS 9 FINANCIAL INSTRUMENTS A325 (2014).

[58] *See IFRS 9 – Financial Instruments*, IASPLUS.COM, https://www.iasplus.com/en-us/standards/international/ifrs-en-us/ifrs9 (last visited Sept. 20, 2017).

[59] Acceptance from Foreign Private Issuers of Financial Statements Prepared In Accordance With International Financial Reporting Standards Without Reconciliation to U.S. GAAP, Int'l Series Release No, 1302, SEC (July 2, 2007), https://www.sec.gov/rules/proposed/2007/33-8818.pdf; *supra* note 12.

[60] IFRS, *Who uses IFRS Standards?*, http://www.ifrs.org/use-around-the-world/use-of-ifrs-standards-by-jurisdiction/ (Last visited November 11, 2017); *supra* note 13.

[61] *See* FCA Group, *Questions and Answers Regarding the Ferrari Spin-Off*, FCAGROUP.COM, https://www.fcagroup.com/en-US/investors/past_corporate_actions/Ferrari_separation/Ferrari_Separation_QA.pdf (last updated Jan. 3, 2016).

[62] *See,* e.g., Josef Arminger, *Solvency-Tests – An Alternative to the Rules for Capital-Maintenance within the Balance Sheet in the European Union*, 2 ACRN J. FIN. & RISK PERSPECTIVES 1, 2-3 (2013) (discussing and criticizing the European regulation of dividend distributions); KPMG, *Feasibility Study on Capital Maintenance* (2006) (reviewing different versions of the regulatory tests, together with a comparative analysis of the tests' usage in selected countries).

according to which the "[p]rofits (gains and losses) of prior periods are taken into account for the measurement of the ceiling for distributions." [63]

These two tests utilize a distinction between a company's capital and its retained earnings to assure two discrete conditions are met for dividends to be distributed. First, the distribution must not create an actual risk to the company's ability to repay debts as they become due (solvency requirement); the solvency requirement is, by nature, prospective, it requires the distribution not to diminish capital reserves and therefore, guarantees future solvency by these reserves. Second, the retained earnings test is a retrospective test, it assumes that if the company did not generate profit, i.e., there are no retained earnings available for distribution, the company has not accumulated additional financial value, and as a result, the entity's capital is what is actually being distributed. Capital, as discussed, is the pre-existing value invested in the company, which is designed not only to remain as a cushion for company creditors but also to allow the ongoing functioning of the company and therefore, should be maintained as working capital and not be distributed in the ordinary course of business.

The two conditions prevent a distribution that can harm the entity or its stakeholders.[64] Financial accounting provides the ground for the two tests by a capital/earnings differentiation, which it implements in many of its measurement methods. The ones related to the measurement of financial investments are included in IFRS 9.

C. Income Versus Other Comprehensive Income

Generally speaking, changes in the value of financial investments, e.g., a company's purchase of a portion of another company's shares, are recorded in accounting using one of two methods:[65] either as (1) generating periodic earnings (or losses),[66] which affect retained earnings; or, (2) as not generating current earnings but rather "other comprehensive

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[63] *See, e.g.*, ARMINGER, *supra* note 62 (explaining that in addition to the two accounting-based tests, a general fiduciary duty is usually owed by the company and its directors to creditors and constitutes another regulatory control over distributions).

[64] See *Burnes v. Pennell* (1849) UKHL, 9 ER 1181 *reprinted in* JEAN MARGO REID, LAW AND ACCOUNTING: PRE-1889 BRITISH LEGAL CASES 1 (2013) (considered the original source of the Capital Maintenance Doctrine); Stephen Alevras, *Doctrines and Rules Associated with the Payment of Dividends: Some Historical Reflections*, 67 *Gov. Directions* 164, 166 (2015).

[65] INT'L. ACCOUNTING STANDARDS BD., s*upra* note 57.

[66] *See id.* (explaining the changes in the investment's fair value, or current market price, included in the income statement of the investing company a method known as: "fair value through profit or loss").

income" ("OCI") that does not affect retained earnings (bur rather, other reserves in the company's capital).[67]

From an information supply perspective (which is, as mentioned, the formal objective of financial accounting),[68] allowing some investments to be recorded as generating periodic earnings (and losses) and not others, is justifiable, since it allows a better understanding of the entity's financial results.[69] Not all investments have the same financial significance for the company's investors; short-term changes in stock value of a strategic investment, for instance, a company investing in its own main supplier, an investment which the company does not intend to sell in the near future, does not have the same financial meaning for investors as do changes in stock value of speculative investments that the company buys and sells in the ordinary course of business. Therefore, under financial accounting recognition, changes in the value of a strategic investment are separate from changes in ordinary investments. Although the latter are reported as generating earnings or losses together with all ongoing business results,[70] changes in the value of strategic (or long term) investments are presented separately as part of the report on OCI and not as generating current earnings or losses.[71]

The major difference, relevant to this discussion, between the two recognition methods is found in their distinct effect on the company's retained earnings, and as a result, on the company's ability to distribute dividends under the capital maintenance doctrine. Recognizing changes in an investment's value as current earnings or losses affects retained earnings; recognizing them as OCI does not.

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[67] *See* Principles of Accounting, Available for Sale Securities, PRINCIPLESOFACCOUNTING.COM, www.principlesofaccounting.com/chapter-9/available-for-sale-securities/ (last visited Sept. 19, 2017) (explaining that this method is generally known as "available for sale" or "AFS").

[68] CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING, *supra* note 47.

[69] *See* Rees & Shane, *supra* note 56 at 791; *see also,* THE CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING §4.27 (Int'l. Accounting Standards Bd. 2010); *International Accounting Standard No. 1 (IAS 1) Presentation of Financial Statements* §86 (Int'l. Accounting Standards Bd. 2011) (discussing the informative advantage achieved by disclosing multiple components of financial performance in making projections of future financial performance); ACCOUNTING PRINCIPLES BOARD OPINION NO. 9, REPORTING THE RESULTS OF OPERATIONS §9-14 (Accounting Principles Bd. 1966) (discussing the different views on the subject of separating OCI from regular earnings).

[70] IFRS 9 FINANCIAL INSTRUMENTS, *supra* note 56, at §§ 5.7.1, 5.7.5.

[71] *See* Jan Klaassen, *An Accounting Court: The Impact of the Enterprise Chamber on Financial Reporting in the Netherlands*, 55 The Acct. Rev. 327, 336 (1980) (discussing a famous accounting issue, adjudicated in 1979 in the Netherlands Enterprise Chamber, SOBI *vs. Pakhoed Holding NV*, concerning an accounting question: How should a strategic investment in another company be presented, and consequently measured?).

D. IFRS 9's Effect on the Retained Earnings Test

Among other new developments, the new IFRS 9 standard is about to change the accounting rule determining how the sale of a financial investment is recorded on the company's books. Under existing accounting practices,[72] when an investment is terminated, all cumulative past changes in the investment's value must be recorded as having generated revenue or loss, even if it was previously recognized as OCI.[73] This practice makes the distinction between ongoing recognition of changes in value as earnings and losses, or as OCI, almost meaningless for dividend distribution. Eventually, all investment losses, whether or not recognized as such when they occurred, are now recognized as such and therefore, affect retained earnings and the ability to distribute dividends.

In contrast, under IFRS 9 when an entity terminates an investment, only the difference between the carrying amount of the investment (measured at the date of sale) and the consideration (actually received at sale) are recognized as revenue or loss.[74] All past decreases in value, which were previously recognized as changes in capital reserves (i.e., OCI) do not need to be recognized as losses when the investment is terminated. In accounting jargon, no "recycling" is required. As a result, under IFRS 9, the value of company investments can decrease, be recognized through OCI (i.e., as mere changes in capital reserves) in prior periods of realization, and never be recognized as a loss that affects the ability of the company to distribute dividends, even if the investment is eventually terminated at a loss.

This change is significant, specifically for the regulatory retained earnings test, and in general for the capital maintenance doctrine. The legal retained earnings test has become practically irrelevant under the new accounting practice; companies can incur losses, and yet be seen as accumulating additional financial value (resulting from other sources). Although capital maintained has irrevocably decreased due to final realization of the investment, the ability to distribute dividends remains intact.[75] Since the financial value of these companies has decreased due

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[72] INT'L ACCOUNTING STANDARD 39, FIN. INSTRUMENTS: RECOGNITION AND MEASUREMENT §55(b) (Int'l Accounting Standard Bd. 2001); IFRS 9 FINANCIAL INSTRUMENTS, *supra* note 56, at A321.

[73] INT'L ACCOUNTING STANDARD 39, FIN. INSTRUMENTS *supra* note 72, at §55(b).

[74] IFRS 9 FINANCIAL INSTRUMENTS, *supra* note 56, at §§ 3.2.12, B5.7.9.

[75] In addition, IFRS 9's new realization rule diminishes the effect realization losses has on bonus payments (as computed under contracts which do not account for exogenous changes brought about by IFRS 9). Thus, executives are no longer required to personally bear the cost for some actual losses caused by reckless investments. Per the executives' bonus schemes,

to real losses (although unrecognized as such according to the new standard), what will actually be distributed is companies' capital. As a result, the protection provided to the entity's shareholders from over-distribution is heavily curtailed.

The case of Koor Industries Ltd., an Israeli publicly traded company that opted for early adoption of IFRS 9 (allowed by the IASB), further demonstrates how IFRS 9 can be used to bypass the retained earnings requirement.[76]

The updated mandatory deadline to implement IFRS 9 is 2018; nevertheless, the IASB allows early adoption of the standard.[77] An additional accounting change presented by IFRS 9 is the introduction of a new measurement model that reduces the number of accounting treatment categories available for financial investments (as compared to IAS 39 model). To compete with this change, when IFRS 9 is applied for the first time, entities are allowed to reclassify investment and change their recognition category from recognition through profit and loss to recognition through OCI, and vice-versa.

As the main objective of financial accounting is to provide investors with information, reclassification in accounting is usually retrospective: Investors must compare current financial results to previous results, inferred according to the same accounting treatment. Therefore, if a financial investment is reclassified, from a measurement category reflecting the investments' value changes through the profit and loss statement, to a measurement category reflecting the value changes as capital fluctuations (OCI) all past reported losses must be restored as if they had not occurred.[78] This retrospective reclassification of existing investments paves the way for eliminating past reported losses and for retroactive repeal of their ability to affect dividend distribution.

In 2011, Koor was unable to distribute dividends due to losses incurred from Credit Suisse stock investments. It then opted for voluntary implementation of IFRS 9 to eliminate past reported losses.[79] In this

computed using periodic earnings, some realized losses are not considered as losses, but rather only as OCI.

[76] *See* Yoram Gabison, *Koor Masked NIS 2.4 Billion in Losses from Credit Suisse Stock*, (20 December 2011) http://www.haaretz.com/misc/iphone-article/koor-masked-nis-2-4-billion-in-losses-from-credit-suisse-stock-1.402509 (last accessed Aug. 4 2016).

[77] *Supra* note 58.

[78] *Id.*

[79] *Supra* note 76.

manner, it was able to bypass existing legal limitations (utilizing pre-IFRS 9's accounting treatments) and regain the ability to distribute dividends.[80]

IV. ACCOUNTING FOR CHANGES IN ACCOUNTING

Financial accounting is deeply woven into the U.S. legal system. By way of illustration, the United States Code and the Code of Federal Regulations integrate more than 300 explicit references to generally accepted accounting principles (GAAP), making them the primary instrument for legally binding financial measurements and presentation.[81] Meanwhile, as argued in the previous section, these measurements are changing, due to newly promulgated standards, resulting in changes to the legal norm.

Avoiding any changes to accounting standards is not a realistic option. Maintaining updated financial accounting that adequately copes with changing information requirements by financial statement users is necessary for efficient capital markets. However, when new accounting standards are promoted by the accounting standard-setters, e.g., when the Financial Accounting Standard Board (the "FASB"), the organization endowed with powers to promulgate accounting standards in the U.S.,[82]

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[80] However, in order to prevent that misuse of IFRS 9 by the company, the local Israeli regulator (ISA) promoted a special regulation that prevented the company's plan. *See* Yoram Gabison, *Neeman Blocks IDB's 'Creative' Accounting on Dividend Payments*, 9 April 2012 http://www.haaretz.com/ business/neeman-blocks-idb-s-creative-accounting-on-dividend-payments-1.423326 (last accessed Aug. 4, 2016).

[81] Searching for the expression "in accordance with generally accepted accounting principles" in the USCS material and Code of Federal Regulations (CFR) databases in LexisNexis produce 89 and 246 results (respectively), where the expression is used within the legal code.

[82] Admin. Policy on Financial Statements, Accounting Series Release No. 4, [11937-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶72,005, at 72,005 (Apr. 25, 1938); *see* Statement of Policy on the Establishment & Improvement of Acct. Principles and Standards, Accounting Series Release No. 150, 3 SEC Docket 275 (Dec. 20, 1973) [hereafter: ASR No. 150] ("The commission has historically looked to the standard-setting bodies designated by the accounting profession to provide leadership in establishing and improving accounting principles"); *Statement of Policy Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, Sec. Act Release No. 8221* (2003), http://www.sec.gov/rules/policy/33-8221.htm (released after the Sarbanes–Oxley Act of 2002 (Pub. L. 107–204, 116 Stat. 745) amended the securities acts to include an explicit authority for the SEC to relay on private standard-promulgators); George Mundstock, *The Trouble with FASB*, 28 N.C.J. INT'L L. & COM. REG. 813, 822-823 (2003) (criticizing FASB role as a private accounting stand-setting); Jacob L. Barney, *Beyond Economics: The U.S. Recognition of International Financial Reporting Standards as an International Subdelegation of the SEC's Rulemaking Authority*, 42 VAND. J. TRANSNAT'L L. 579, 584-587 (2009).

releases exposure drafts or public comment documents,[83] financial accounting's legal consequences should be taken into consideration.

Financial accounting's legal consequences might not, and (according to the FASB's consistent stand) should not affect accounting standard-setters' considerations.[84] It is argued that affecting the information financial accounting conveys for objectives other than serving investors' needs, would subject financial reporting to political pressure and make reporting numbers unreliable and therefore, useless to investors.[85] Assuming the "sanctity" of financial reporting is accepted,[86] and financial accounting's legal consequences are excluded from the standard-setting process, accounting's legal consequences can be dealt with at the legal system level. Three means may be proposed for legislators/regulators as methods for mitigating undesirable expected effects on legal regimes resulting from newly promulgated accounting standards: amending legal doctrine; freezing existing measurements vis-à-vis the legal regime; or, in drastic cases, overriding the new standard.

A. Amending Legal Doctrine

One course of action regulators can take, to cope with changes to accounting standards, is to amend the regulation to neutralize accounting changes' effects. Under such a scenario, for every change in the accounting standards that affects a legal regime, the regulator will amend regulation to account for the change and thus neutralize its effect on existing regulations and fiscal policies. An amendment can be carried out by adapting the existing legal doctrine, *ex-post*, to account for the altered measurements imposed by accounting standards.[87]

Amendments to the legal doctrine can take two forms. An amendment that reshapes the legal doctrine *in principle*, and in practice,

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[83] *See Exposure Drafts & Pub. Comment Documents, http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176157086783* (last accessed Aug. 4, 2016).

[84] *See* ROBERT VAN RIPER, SETTING STANDARDS FOR FINANCIAL REPORTING: FASB AND THE STRUGGLE FOR CONTROL OF A CRITICAL PROCESS, 23-24 (1994) (citing former FASB chairmen arguing that standards should portray economic reality, without implying an agenda).

[85] *Id.*

[86] *See cf.* David Solomon, *Accounting and Social Change: A Neutralist View*, 16 ACCT. ORG. & SOC'Y 287 (1991) (arguing that accounting is meant to provide information as free of bias as possible; though accounting may sometimes fail to achieve the faithful representation of economic phenomena, that should be its goal); VAN RIPER, *supra* note 84, at *passim*.

[87] *See Simplifying the Subsequent Measurement of Inventory*, FINANCIAL ACCOUNTING STANDARDS BOARD, http://www.fasb.org/jsp/FASB/FASBContent_C/ProjectUpdatePage&cid=1176164229807 (last visited Sept. 20, 2017).

weakens its reliance on the accounting parameter. For example, in order to mitigate the disturbing effect of IFRS 9 on dividend distribution regulation, the legal code can be amended for the legal regime to include alternative or additional tests that overcome IFRS 9's dismissive effect on the retained earnings test, e.g., a general requirement that distributions will have no negative effect on the company's ongoing activities.[88]

Another form an *ex-post* amendment can take is *ad-hoc* amendments, which subject the specific accounting parameters, one affected by the change, to specific adjustments that neutralize the change and *de-facto* reverse its effect on the accounting calculation. For example, as a response to the change of IFRS 9's investment losses recognition rule,[89] the legal code can be amended to include a requirement for the retained earnings parameter to be adjusted whenever used for dividend regulation, so that all losses are included whether recorded as such or as OCI under the accounting treatment.[90] However, amending the legal doctrine with *ad-hoc* amendments for every accounting change can eventually lead to a situation in which all the ad-hoc amendments comprise a separate accounting system. It can be argued, that this is already the *de-facto* result, which the Treasury's abundant tax regulation created. Due to the Treasury's regulations, companies are required to maintain two sets of books: one for investors, prepared according to accounting standards only and another, prepared according to accounting standards with their *ad hoc* adaptations stipulated in the tax regulation.[91] Obviously this reality is not ideal.[92]

Whether amending the legal doctrine in *principle* or *ad-hoc*, once a new accounting standard is proposed, regulators should negotiate with

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[88] *Circumstances in which a Dividend Might be Paid,* CORPORATIONS ACT 2001 SECT 254T, http://www.austlii.edu.au/cgi-bin/viewdoc/au/legis/cth/consol_act/ca2001172/s254t.html, (last visited Oct. 4, 2017) (showing that in Australia, the retained earnings test was repealed in favor of a broad retrospective-prospective solvency test which incorporates a requirement for the distribution to be "fair and reasonable to the company's shareholders as a whole").

[89] IFRS 9 FINANCIAL INSTRUMENTS, *supra* note 56, at A321.; *see also supra* text accompanying note 74.

[90] Gabison, *supra* note 76; Yoram Gabison, *Neeman Blocks IDB's 'Creative' Accounting on Dividend Payments*, 9 April 2012 http://www.haaretz.com/ business/neeman-blocks-idb-s-creative-accounting-on-dividend-payments-1.423326 (last accessed Aug. 4, 2016) (summarizing the reaction of the Israeli legislature, which in response to Koor Industries Ltd.'s action amended the legislation to include an explicit clause that requires the retained earnings test to include financial investments' losses even when they are not recognized as such under IFRS 9).

[91] See *supra* text accompanying notes 32-35.

[92] *See e.g.,* Celia Whitaker, *Bridging the Book-Tax Accounting Gap*, 115 Yale L.J. 680, 688 (2005) (criticizing current reality, while arguing for a system of near-total accounting conformity that uses financial income, as reported to investor, as the almost exclusive starting point for taxable income).

accounting standard-setters, i.e., the FASB, and even the Securities and Exchange Commission ("SEC"), for a delay in the standards' effective date that will allow legal amendments to be completed. Otherwise, a loophole will be created in the legal regime.[93]

B. Freezing the Accounting Treatment Utilized in the Regime

A different course of action which regulators can take, either to cope with *ex-post* changes or as an *ex-ante* legislative policy to prevent possible prospective accounting effects, is to freeze the accounting parameter vis-à-vis the regulation, so the regulatory use of the parameter will not be affected by prospective changes in accounting standards.

When an accounting parameter required by regulation is said to be "frozen," a regulation's reference to that accounting parameter becomes a reference that is not directed to the accounting parameter as presented in the company's financial statements, prepared under current accounting standards, but rather to an alternative and fictitious parameter that must be calculated according to the accounting standards that were in force when the regulation was set (the time the parameter was frozen, so to speak). *Ex-post freezing* of a regulatory regime's accounting parameter can be applied explicitly through an amendment to a specific regime's regulation code. However, regulators might also try to present it as the required and justified interpretation of an un-amended regulation code. In cases where accounting concepts are used for definition, e.g., "'[i]ntangible assets,' (as defined by generally accepted accounting principles,")[94] or become integrated in contracts,[95] such an interpretation might seem reasonable, or might even be required to prevent questionable *ultra-vires* delegation of legislative authority.[96]

As an *ex-ante* legislative policy, intended to prevent possible prospective effects due to changes in accounting standards, *ex-ante freezing* can be carried out by embodying the accounting standard's text

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[93] *See generally,* Gabison, *supra* note 76.

[94] *See* Transactions Between Member Banks and Their Affiliates, 67 Fed. Reg. 76560, 76573 (Dec. 12, 2002); *see also*, note 89 (explaining that The Board of Governors of the Federal Reserve System has determined that the GAAP definition of intangible assets may be under inclusive and therefore decided to omit the definition form the final rule).

[95] *See infra* notes 98-102 and accompanying text (discussing accounting's legal effects on contracts signed with the federal government).

[96] *See* Arthur Andersen & Co. v. SEC, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶96,374 (D.C. N.D. 111. 1978) (failing in an attempt to challenge ASR No. 150 (*supra* note 80), the court characterized the release as only a method the SEC will use to evaluate accounting principles and not as a substantive rule, and therefore no unconstitutional delegation was made).

into the regulation code,[97] or by an explicit reference to a specific published version of an accounting standard that represents the binding accounting standard.

Freezing accounting parameters can also be a very useful solution for mitigating the risk of changes in accounting leading to unexpected and (possibly) expensive consequences for federal contracts and awards. Although the recently legislated Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards[98] provides an elaborate and meticulously defined government-wide framework for managing grants endowed to non-federal entities (and hence, supposedly reduces improper payments of federal dollars),[99] the regulation relies on many accounting parameters. For instance, in order to regulate contractors' costs related to software development and use, the regulation uses financial accounting's model for software cost capitalization.[100] Although, capitalized software costs and all other costs meticulously set by the regulation are subject to regulatory limits to prevent over-expensing, etc.,[101] using the GAAP software capitalization model as a standard for allowable expensing by non-Federal entities[102] exposes the regulation, and existing grant payments under signed contracts, specifically, to prospective changes in accounting standards: The GAAP software capitalization model can change – e.g., require expensing costs that are not expensed under the current model – and *de-facto* bypass existing limits imposed by the regulation and even alter payments under existing signed contracts.

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[97] *See also* Cunningham, *supra* note 3 (discussing the implication of private standards embodiment regulation on copyrights).

[98] Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards, 79 Fed. Reg. 75871 (Dec. 19, 2014) (to be codified at 2 CFR pt. 1, 25, 170, 180, and 200) [hereinafter: Uniform Administrative Requirements].

[99] Uniform Administrative Requirements, 78 Fed. Reg. 78590-01 (Dec. 26, 2013) (to be codified at 2 C.F.R. pt. 200, 215, 220, 225, 230) ("To deliver on the promise of a 21st-Century government that is more efficient, effective and transparent, the Office of Management and Budget (OMB) is streamlining the Federal government's guidance on Administrative Requirements, Cost Principles, and Audit Requirements for Federal awards. These modifications are a key component of a larger Federal effort to more effectively focus Federal resources on improving performance and outcomes while ensuring the financial integrity of taxpayer dollars in partnership with non-Federal stakeholders").

[100] *Id.* at 75871-01 ("[a]cquisition costs for software includes those development costs capitalized in accordance with generally accepted accounting principles (GAAP)"); *but see Id.* (defining acquisition costs for equipment to include "net invoice price of the equipment, including the cost of any modifications, attachments, accessories, or auxiliary apparatus necessary to make it usable for the purpose for which it is acquired," no accounting model is involved).

[101] *See e.g.,* 2 CFR § 200.436 (2016) (setting the rules for allocating costs for usage periods).

[102] *E.g.,* 2 CFR § 200.449 (2015) (defining the contractor's costs that are allowed to be expensed and therefore reimbursed during the contract).

In order to mitigate such exposure *ex-ante*, the regulation could have frozen the current GAAP capitalization model vis-à-vis the regulation. As such action has not yet been taken by the regulator, when a change to the accounting model does occur and affects the regulation in general, and signed contracts specifically, the other option the regulator will face is to argue that the accounting model which applied when the contracts were signed (or, perhaps, regulation was enacted) must continue to be applied instead of the new model.

It seems as if freezing may provide an adequate solution for mitigating financial accounting's legal consequences. Nevertheless, the main disadvantage in freezing accounting parameters, either as an *ex-post* solution or an *ex-ante* policy, is that it excludes all prospective accounting developments that can serve the legal regime's objectives. Some future changes in accounting might benefit the regulation; e.g., accounting's software capitalization model can become more accurate in allocation costs of actual use of software developed. Prospective changes do not necessarily mean that contractors under federal grants will be able to increase their expenses. However, unlike the unlimited discretion a regulator can have in choosing to amend the legal doctrine *ad-hoc*, once a frozen statute is put in place, all future changes are excluded.

C. Overriding

The third and most dramatic means that can be taken to overcome accounting effects on regulation is to override the new accounting standard. The main regulator holding such powers is the SEC. However, the SEC's main regulatory objective is to protect investors;[103] therefore, its regulatory power to prescribe independent accounting measurement and override FASB standards[104] would not provide an adequate solution in situations where the objective of better informing investors creates legal mismatches with peripheral regimes that are not intended to promote investors' needs.

Other regulators besides the SEC, such as the Federal Communications Commission ("FCC"), are also empowered with the authority to compel their regulated entities to maintain accounts according

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[103] *Compare* Stephen A. Zeff, *Political "Lobbying" on Proposed Standards: A Challenge to the IASB,* 16 ACCT. HORIZONS 43 (2002) (exploring the usual circumstances in which the SEC did intervene, after being heavily pressured by the government) *with* 15 U.S.C. § 77(b) (2016) (defining the commissions need to consider investors, efficiency, competition, and capital formation).

[104] *See* Zeff, *supra* note 5; Zeff, *supra* note 103 (noting the SEC did override a FASB accounting treatment for an objective other than protecting investors).

to their promulgated rules.[105] In cases where that authority is used,[106] these rules override all other accounting standards.[107] Thus, when amending legal doctrine is practically impossible, e.g., due to political circumstances, and freezing the existing accounting treatment is impractical, e.g., the change is so fundamental that it would require the companies to maintain another accounting system, a solution might be found in overriding the new accounting standards with a new regulatory standard that will apply in lieu of the new GAAP standard.

The main drawback of such a solution is that it would cause the accounting treatment of some regulated companies to be different than non-regulated companies, as well as companies governed by other sets of regulations, for which the relevant regulator did not override the accounting standard. Although for some industries, e.g., telephone service providers and utility companies, this is customary practice, it is not ideal because investors' ability to compare these companies' financial results with other companies from other non-regulated sectors and similar foreign companies (which are not subject to the domestic regulator's standards) is heavily curtailed, and therefore should be used only when other options carry greater negative effects.

V. CONCLUSION

The use of accounting parameters in legal regimes and fiscal policies endows financial accounting with a quasi-legislative capacity, causing legal regimes to be exposed to exogenous changes initiated by changes in accounting standards.

Distinct from other scholarly disciplines such as math or physics, financial accounting is an applied science. It is intended to fulfill a pre-designed objective and as such, is characterized by subjective measurements, which also cause it to change frequently in order to meet its users' needs. The reality of a biased measurement system that is constantly changing distinguishes the legal use of financial accounting from other disciplines of knowledge, and at the same time, complicates it when accounting standards change. While accounting standards change and lead to revisions in accounting parameters, the legal doctrine still uses

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105 *E.g.,* 47 U.S.C § 220 (2012).

106 *E.g.,* 47 CFR § 32.1 (2018); *see also Verizon v. FCC*, 770 F.3d 961 (D.C. Cir. 2014).

107 *See* 47 U.S. Code § 220(g) (2012) ("After the Commission has prescribed the forms and manner of keeping of accounts, records, and memoranda to be kept by any person as herein provided, it shall be unlawful for such person to keep any other accounts, records, or memoranda than those so prescribed or such as may be approved by the Commission or to keep the accounts in any other manner than that prescribed or approved by the Commission. Notice of alterations by the Commission in the required manner or form of keeping accounts shall be given to such persons by the Commission at least six months before the same are to take effect.").

the parameters as if they had remained the same. As a result, a change in accounting parameters becomes a change in the law.

In order to cope with financial accounting's legal consequences, I propose three different courses of actions for regulators: amending legal doctrine; freezing accounting measurements vis-à-vis the legal regime; or, overriding the new accounting standard. Every action has its own advantages and disadvantages. While amending legal doctrine does not affect financial reporting, it requires the regulation to be revised, sometimes repeatedly for every new change to accounting standards. On the other hand, freezing an accounting treatment, either as an *ex-ante* policy or an *ex-post* legislated solution (or as an interpretive legal argument) requires only a one-time action, but it disables future desired developments in financial accounting standards. Overriding changes in financial accounting standards can be an effective solution; however, it curtails comparability among firms.

Having provided measures that can mitigate financial accounting's legal consequences, this article now calls for their implementation by the regulator.

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