Local or Global Accounting? Perspectives on International Accounting, Politics and the Polity

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A Political Economy Explanation for Country Variation in IFRS Adoption – A Comment on ‘The International Politics of IFRS Harmonization’ by K. Ramanna

Abstract: The study of Karthik Ramanna has opened a fascinating field for further studies on the politics of accounting standard-setting. Explaining the degree and timing of International Financial Reporting Standards adoption, however, may not only be done from a perspective combining international power and cultural distance. This short comment outlines a complementary political economy explanation by linking accounting standards to basic models of comparative capitalism.

Keywords: accounting standards, political economy, comparative capitalism, IFRS, IASB

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The point of departure of Ramanna’s (this issue) article is the observation that countries vary in the degree and the timing of their commitment to International Financial Reporting Standards (IFRS). This is an intriguing and important observation, the more so as existing literature has only focused on the general rise of IFRS (Botzem, 2012; Botzem & Quack, 2009; Nölke, 2005; Martinez-Díaz, 2005), while ignoring variance between countries. The observation is substantiated with three cases that are both varying in their speed of IFRS adoption, as well as their ability for negotiating carve-outs, i.e. Canada (early adopter), China (early adoption with carve-outs), and India (several adoption delays). The article furthermore develops an explanatory framework for these observations, based on two dimensions, i.e. the countries’ cultural proximity to the existing powers at the International Accounting Standards Board (IASB) (assumed to be the EU, in particular Britain) and the countries’ potential political power.

I would like to raise questions about the explanatory framework, based on my background in international and comparative political economy. On the one side, from an international political economy perspective, it remains doubtful that India should be classified as country with “low potential political power”. To be sure, India is less powerful than China – but then nearly every other country is (except for the United States). However, Ramanna’s argument would probably hold well for much smaller countries. More specifically, the reason given is that India’s “domestic political interests are not as well aligned as China’s to speak with a strong voice internationally” (p. XX, see also pp. XX–XX). First, this is an argument not only about a country’s political power but also over domestic institutional fragmentation. Second, India has demonstrated that it can be a powerful actor in international economic relations over the last few years, in spite of a long-standing tradition of a rather passive foreign policy (Ramanna, this issue, p. XX). Particularly in international trade relations, India – together with Brazil – has been the core driving force in the Global South, inter alia responsible for the breakdown of the 2003 WTO negotiations at Cancun (Hurrell & Narlikar, 2006). The same is true for global environmental negotiations and various other issue areas (Michaelowa & Michaelowa, 2012). Thus, the claim that India is not powerful enough to negotiate IFRS carve-outs (if it really wants to) warrants further study. Besides, there are several studies highlighting an intense degree of fragmentation within the Chinese foreign economic relations bureaucracy as well (e.g. Overbeek, 2012; Schmidt & Heilmann, 2012). Thus, the argument that powerful countries are more able to negotiate carve-outs with regard to IFRS than powerless countries is intuitively convincing, while the exact explanatory range of the argument should be tested more systematically; the same applies for the issue of domestic fragmentation.
Further testing should also apply to the second hypothesis, drawing on cultural proximity. While the concept of cultural proximity is intuitively convincing for the similar positions of Britain and Canada, a more systematic test is challenging: “To objectively verify this claim requires an *ex-ante* metric of culture” (Ramanna, this issue, footnote 28). Ramanna refers to Hofstede (2001) as an example for the quantification of culture and quotes Hofstede’s scores of Canada, the United Kingdom and the EU as supporting evidence. While Hofstede’s taxonomy is still quite prominent among business scholars, it would be very difficult to find a political economy or international relations scholar that would explain the position of a country in international economic issues by relating to this score. It seems rather bold to extrapolate from a business value survey to the foreign policy positions of national governments. A complementary explanation for the timing of the adoption of IFRS as well as the urge to negotiate for carve outs may be derived from the comparative capitalism research framework that is used by scholars of comparative political economy (and recently among accounting scholars as well, see Walker, 2010). This framework draws upon the idea that a variety of forms of capitalist economies exists and that these economies have been experiencing idiosyncratic patterns of development. Central to this framework is the notion of institutional complementarity, which refers to “situations in which the functionality of an institutional form is conditioned by other institutions” (Höpner, 2005, p. 331, see also Ramanna, this issue, footnote 1). Thus, substantial changes in one institution may have wide-ranging consequences for other institutions and, consequently, for the model as a whole. Correspondingly, governments will seek to preserve their core institutions against pressures of global economic institutions, such as the IASB.

Within the comparative capitalism approach, the most frequently used frame of reference is the “Varieties of Capitalism” distinction between Liberal Market Economies (LMEs) and Coordinated Market Economies (CMEs), as introduced by Hall and Soskice (2001). LMEs are characterized as “Anglo-Saxon” and often illustrated with the case of the United States, whereas CMEs are characterized as “Rhenish” and often illustrated by Germany. In each model, accounting standards have specific complementarities with other institutions.¹ Accounting standards as contained in the German *Handelsgesetzbuch* (Corporate Codified Laws and Regulations) complement the interrelated elements of the CME model. These standards generally favor stewardship and prudence, making reference to an historical cost accounting model that is in line with long-term corporate development and shareholding. These prudent accounting standards, combined

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¹ For a more detailed discussion of the argument in this section, see Perry and Nölke (2006).
with CME corporate governance and corporate financing arrangements, have allowed CME companies to follow long-term strategies such as investing heavily in production and human resource development. This has been crucial for maintaining the CME competitive advantage of using highly skilled labor to produce high quality, and often specialized, products (Heidhues & Patel, 2012). At the same time, the German Handelsgesetzbuch accounting standards facilitated the long-term bank loans provided by Hausbanken (House Banks), another key institution of the CME model. Hausbanken may be considered as *insiders* to the firm within the CME model – for example, they are represented on the Aufsichtsrat (Supervisory Board). Because of this, Hausbanken and other blockholders have alternative ways, besides statutory accounts, of gathering information about the internal processes and performance of the firms in which they invest. There is therefore somewhat limited attention given to accounting statements that makes accounting information publicly available, within CME capitalism. Rather, accounting reports are utilized in the CME model to provide prudent information about the ongoing financial position of business firms, reassuring bankers that there is sufficient revenues and collaterals to protect their loans, e.g. by utilizing low book values of assets, overstated liabilities, and “hidden reserves” (Ball, 2004, p. 103, see also Biondi, 2011; Richard, 2005). In contrast, accounting reports play a much more central role within LMEs, where investors are usually *outsiders*. Here, publicly available accounting information is crucial to the investment decisions of financial market actors. The introduction of IFRS based on fair value accounting techniques – both by the UK-based IASB and by the US FASB – can therefore be consistent with the basic features of the contemporary Anglo-Saxon model, since fair value accounting is supposed to strengthen the position of shareholders vis-à-vis managers (Barlev & Haddad, 2003, p. 384).

From this perspective, one should expect major differences in IFRS adoption within the European Union, in spite of Ramanna’s claim that the EU is the main

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2 House banks (also called main banks or principal banks) traditionally provided long-term capital to companies. In exchange, they often received seats on the supervisory boards of these companies.

3 In the dual board corporate governance structure, the members of the supervisory board are elected by the shareholders (and often workers). The members of the supervisory board, in turn, elect the management board that is charged with day-to-day business.

4 Hausbanken were able to exercise substantial voting rights, based not only on their own shareholding, but also on voting on behalf of shareholders that were depositing shares with banks, see Brickwell (2002).

5 This is not to deny that there is also a relevant history of arguments against fair value accounting from within the LME framework. See, e.g. Holthausen and Watts (2001), Benston, Bromwich, Litan, and Wagenhofer (2003), or Kothari, Ramanna, and Skinner (2010).
power backing IFRS. On first sight, however, Ramanna’s claim seems highly reasonable, given the crucial role of the EU – and its decision (taken in 2002) to force European listed corporate groups to adopt IASB-based standards from 2005 onwards – for the near global adoption of IFRS. A closer look, however, indicates substantial tensions within the EU, particularly regarding the IASB initiative of promoting IFRS for (not exchange-listed) state-permeated market economies (SMEs). After continued controversy, the proposal to comprehensively introduce IFRS for small- and medium-scale companies for mandatory use within the EU was shelved in 2011, inter alia due to resistance by medium-scale German companies based on the formation of an “accounting standard pressure group” that was funded by a number of major German Mittelstand companies in 2006 (Verband zur Mitwirkung an der Entwicklung des Bilanzrechts für Familiengesellschaften). The largest German multinational companies, however, during the last two decades have left behind many features of the CME model and embraced the LME model of corporate finance, including the application of IFRS. Due to the limitation of IFRS to listed companies, the European Union is able to jointly back the IFRS project, whereas an extension of IFRS to all companies has been blocked by conflicts between CMEs and LMEs.

Outside of the European Union, IFRS strongly appeal to industrialized economies following the LME model, including Australia, Canada, and New Zealand. The LME/CME-distinction also fits with the placement of Japan in the quadrant where Ramanna expects a tendency for seeking IFRS carve-outs (p. XX), Japan being the only major CME outside of the European Union.

Given that the formulation of models of capitalism for emerging economies is still under construction, an explanation of the specific IFRS adoption behavior of China and India is more challenging and should be considered preliminary. From the perspective of comparative capitalism, both economies arguably belong to the same camp of SMEs, if compared with CMEs and LMEs (Nölke, 2012). Major Chinese and Indian companies usually are either dominated by families or by the state, in any case by national owners and not by global capital market actors. These ownership structures lead to obvious complementarities with corporate finance, as far as they make

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6 For a more detailed discussion of this issue, see Nölke and Perry (2008). Another case of intra-EU tensions is discussed in Section 7.1 of Ramanna’s article.

7 Streeck and Höpner (2003). Stock market capitalization of German companies increased from 25% of GNP in 1990 to 64% in 2007. Still, only a quarter of the largest German companies today can be clearly classified as being capital market-oriented (Gerum, Mölls, & Shen, 2011).

8 For China, see e.g. Biondi and Zhang (2007) and Baker, Biondi, and Zhang (2010); for India, see, e.g. Khanna and Palepu (2005) and Chakrabarti, Megginson, and Yadav (2007).
Chinese and Indian companies less vulnerable to short-term fluctuations on
global capital markets as well as to short-term profit expectations of inter-
national investors than companies in the LME model. Instead, they rather
rely on internally generated funds or long-term domestic bank loans, thereby
being more similar to the traditional CME companies. This allows Chinese or
Indian companies to build up a reserve of slack resources as a financial
cushion for the case of unforeseen crises in turbulent markets, an obvious
advantage during periods of financial turmoil. At the same time, transpar-
ency of corporate financial statements for sake of minority shareholders
information and protection is not a major concern for these companies,
similar to the traditional, i.e. pre-1990 German, Italian, or South-Korean
model (Shinn, 2001, p. 6). Given the rather different outlook of IASB-spon-
sored accounting standards, we may expect an increasing number of conflicts
over these issues, similar to those witnessed between the IASB and German
small-scale enterprises. In fact, more recently, the Indian standard setters
have started the same approach of seeking nationally specific carve-outs for
IFRS adoption that have been highlighted in case of China. Correspondingly,
an approach for explaining IFRS adoption based on a comparative capitalism
framework comes to predictions that fit well with the empirical observations
made by Ramanna: “Just as elements in IFRS are ill suited to Chinese
markets, Indian companies suffer from some discordance between IFRS as
issued by the IASB and international standards that would be optimized by
their domestic conditions” (p. XX).

To conclude, the study of Ramanna has opened a fascinating field for
further studies on the politics of accounting standard-setting. Explaining the
degree and timing of IFRS adoption, however, may not only be done from a
perspective combining international power/internal fragmentation and cultural
distance. This short comment has outlined a complementary political economy
explanation by linking accounting standards to basic models of comparative
capitalism.

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this comment.

9 This observation is generally well-known for the case of China. For India, see Mohan (2008),
Borchert and Mattoo (2009), and Goyal (2012).
References


**Citation Information**