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Part I

Transformations of Statehood in Accounting: The Framework

It is a truth universally acknowledged that the increasing integration of the world economy leads to the demise of the nation state. No matter how little known a policy area may be, this truth is so well fixed in people's minds that convergence of business systems must be the right conclusion for the matter in hand.

There are relatively few studies that systematically enquire whether institutional settings of nation states do indeed converge and whether new governance modes emerge, possibly on a global scale, that supersede national regulations, or curtail the traditional role and discretion of nation states. This book aims at contributing to the evolving research on the role of the nation state and addresses the field of accountancy, in particular the field of financial reporting. We will analyse if new, possibly global structures emerge that cope better with the effects from globalization than national solutions and whether these structures complement or supplant the nation states' regulation. We provide three detailed country studies for prominent capitalist economies, which are organized along the inner logic of the financial reporting process. For our analysis, we consider the following countries: Germany, the United Kingdom (UK) and the United States (US). We chose these countries as they allow a rich contrast due to their institutional set-up.

Relevance and quality of financial reporting are closely related to domestic corporate governance systems, which appear in two types: outsider systems and insider systems. When there is a separation of decision-making between the suppliers of money to the firm and users of money in the firm, that is when financiers are not involved in managerial decision-making, one speaks of an outsider system. Insider systems are those in which financiers of a company have a say in managerial decision-making. This is particularly pronounced when the function of the financier and the function of the manager coincide – a case that often happens in family-owned, medium-sized firms. These insider and outsider governance systems normally correspond to a particular legal system: insider systems are based on code law; outsider systems typically have a common law tradition. Insider systems can mostly be found in Continental European countries, and Germany is a prominent example. Anglo-Saxon countries tend to have outsider systems. For such systems and countries, the US is an exemplar. Including the US and Germany in a study on the transformation of accounting systems is thus an obvious choice. However, changes in both systems might not only be due to different economic needs of adaptation. The regulatory environment also needs to be taken into account. To control for the effect of EU membership, we consider a further Anglo-Saxon common law country that is exposed to Europeanization in the same way as Germany: the UK. When the UK's accounting regulation displays tendencies similar to Germany then Europeanization, and not corporate governance, is the likely cause for change. When Germany transforms and the UK remains stable then the underlying corporate governance systems can be identified as the reason for re-configurations.

For the three countries, our study contrasts the national regulatory models of accounting that were present in the golden-age nation state with today's situation. In this context, we define the golden age as the heyday of the nation state, first observable in the OECD world of the 1960s and early 1970s, which lasted until around the 1980s (Hobsbawm 1995; Leibfried and Zürn 2005). In this period, nation states were indisputably responsible for the four key functions of statehood: they set law, provided legitimacy, intervened into the private spheres of their citizens and economic actors to provide welfare and supplied key resources like security (Hurrelmann *et al.* 2007; Leibfried and Zürn 2005). This does not imply that statehood followed an identical model in the OECD world during that period, but such a distinction sets the OECD countries apart from the non-OECD world, where the nation state did not necessarily bundle these four dimensions. Since the 1980s, statehood is, however, changing, making the golden age an obvious starting point for an analysis of transformation processes.

In our analysis, we restrict ourselves to organizational changes in the national accounting regimes and in particular its financial reporting regimes. We are thus mainly interested in *how* accounting was and is actually governed. We do not look at *what* information the accounting systems produce but *who* forces companies to do so. Additionally, we consider only accounting mechanisms for listed firms because major changes took place only for these entities. In the long run, however, it is likely that these changes will affect the unlisted, mainly small and medium-sized companies as well.[1]

Throughout the study, we focus on financial reporting as the most dynamic part of accounting, which we separate into its two constituent parts 'disclosure' and 'enforcement'. In the area of disclosure regulation, our focus is on the function of setting rules, and particularly on the actors in the development of Generally Accepted Accounting Principles (GAAP) that have to be followed by listed companies. When we refer to accounting rules within this book, we usually imply the specific rules on recognition and measurement, as these rules determine the content of the key financial reporting instruments, namely 'balance sheet' and 'income statement'. Accounting rules are usually developed by more than one organization, and standard-setting describes how most of these rules evolve. Designated standard-setters such as the International Accounting Standards Board (IASB) now play the most prominent role here, but further interventions of either governmental or non-governmental organizations are often present in the process of developing accounting rules. These other actors, of whom public accountants and stock exchanges are an important subgroup, will therefore also be considered in some detail. For the area of enforcement we apply the same logic. Again, we are interested in *how* enforcement is organized, for instance which mechanisms are applied and which actors are responsible for the verification of accounting information. This also implies that we are not interested in the actual contents of enforcement rules, but in the way in which they emerge.

The remainder of the book is organized as follows: In Part I, Chapter 1 embeds the analysis of accountancy in the wider corporate governance debate and presents the analytical tools that we are going to apply in the descriptive parts of our study. Chapter 2 introduces the three national accounting models and reviews the most important changes in the two core areas of accounting regulation, namely disclosure and enforcement.

The following two parts cover these areas of accounting in closer detail. Part II of the book deals with disclosure regulation. Chapter 3 looks at early changes in accounting standard-setting that have weakened the traditional model of the golden-age nation state. In Chapter 4, we consider the new role of transnational arrangements in disclosure regulation, namely the supply of International Financial Reporting Standards (IFRS) and how the European Union (EU) legitimizes their application. The informational needs of stock markets and the balance between private and public approaches to satisfy them are considered in Chapter 5.

Here, it will be of particular interest how the nation state deals with the transformation of the business model of stock exchanges.

Enforcement is studied in Part III of the book. Chapter 6 begins with a discussion of auditing as the traditional enforcement device, and analyses why nation state arrangements seem sandwiched between societal and transnational arrangements. The nation state's strongholds are enforcement agencies that are increasingly mandated to ensure credibility of financial reporting. Their role will be covered in Chapter 7.

It is still an open question whether the power of the nation state has increased or decreased in the process of globalization. Part IV of the book studies this question by presenting two findings that seem to be contradictory at first glance. Financial globalization and cross-listings seem to curtail the power of the nation state, and they increase the leverage of businesses lobbying for 'global' solutions. We discuss this in Chapter 8. In Chapter 9, we look at an example that signals the exercise of seemingly increased regulatory powers: the Sarbanes–Oxley Act (SOA), which was passed by US Congress in 2002 but also applies outside US jurisdictions. This chapter provides evidence that such regulatory action is likely to affect regulations in other countries. This seems to signal that at least some nation states gain in power when the economic world globalizes. Both cases will also allow us to take a closer look at whether regulatory races go 'to the bottom' or 'to the top'.

The final part, Part V, of the book relies on a quantitative concept to pull together the identified changes in disclosure and enforcement regulation. This allows us to measure to which extent convergence in the systems in regard to 'privatization' and 'internationalization' took place and whether the corridor of nation state solutions has actually narrowed.

1
Accounting: A Socio-economic View

1.1 The localization of accounting: Business and regulatory contexts

To those uninitiated to the world of accounting, the use of different accounting information sets, the choice of which depends on the respective business contexts, may be perplexing. Many expect one single truthful report about a firm or a project and not a possible diverse set of numbers with the comment 'it depends'. For the accountant, it is sometimes perplexing to find out in how many ways and with which motives the state can get involved to regulate aspects of accounting, and that many institutions thought of as 'genuine' to the accounting world operate in the long shadow of the state. The following brief sketch may thus serve as an introduction for both the accountant and the non-accountant.

Accounting is typically subdivided into three clusters or systems: tax, financial and managerial accounting. While one could think that the three coincide if not for the sake of truthful reporting then at least for the sake of efficiency, this is not the case. Each accounting system serves a different purpose and therefore determines a different pattern of timing the inflows and outflows of cash into a profit and loss account. Thus, the same real-world situation can be 'transposed' into accounting reports that differ from one another. A managerial accounting system, for instance, can be optimistic about future cash flows and report them as profits before the cash has actually been received. When judging the performance of managers, a likely future cash inflow is a good measure of their actions. However, if tax accounting systems apply the same logic and determine taxable income and the tax due on cash flows not yet received, then the taxpayer may in certain instances have to take out credit as the actual funds for the tax payments have not yet materialized. Therefore tax accounting systems are likely to be structured around the actual cash flows, which coincide with the ability to pay. From this argument it is obvious that accounting cannot be the same for all purposes – tax, financial or managerial – rather to the contrary, the accounting rules change with the purpose. Of course, there will not be a wholesale change of all rules; many of them will look similar and some of them will even have influenced one another. The important idea is that different principles guide the formulation of accounting rules.

Of all three systems, the tax accounting system is the least interesting in the context of this book, even though we concern ourselves with changes in statehood. This is surprising only at first glance. While it is true that the state is keenly interested in receiving tax income from businesses, the governance of the tax accounting system has been relatively stable for a very straightforward reason: the state by and large determines the rules for the recognition of taxable income by means of tax law and minor regulations. While the contents of these rules are often subject to change, their organizational mode tends to be stable. And while there may have been some internationalization for some sources of revenue, the mix between the roles of public and private actors did hardly change from the golden age until today. One could even argue that tax accounting does not lie at the heart of what accounting stands for as its sole purpose is driven by the state's revenue motive and the state is the only addressee of the reports, and typical accounting deals with multiple audiences and a trade-off of their informational demands. This will become evident in examining the remaining two clusters, the managerial and the financial accounting systems.

Managerial accounting operates at the entity level, and its results are not distributed to an outside audience. Its purpose is to determine the cost and profit contributions of single products, product lines or managers. Its addressees are the decision-makers in all their capacities: not only as superiors when they use this data for evaluation, but also as subordinates when they use it as a guide to determine which decisions are (seen to be) in the company's interest. Financial accounting, in turn, reaches from the entity level to the outside. It is often described to report 'financial performance' to a wider audience of stakeholders such as owners, creditors, suppliers, employees and the general public. This wide array of stakeholders often found in the textbooks is rather unhelpful as it excludes nobody (maybe with the exception of the tax authorities), mixes their respective interests and clouds the understanding of the accounting issues at hand.

While financial accounting builds the bridge from the entity – the firm – to the outside, it is a matter of debate to which outside group financial accounting is primarily addressed.

One possible set could be the financiers of the firm. The rather old-fashioned term 'financier' is used to describe those that hold a longer-term financial interest in the firm. This interest may arise by supplying equity capital or by granting (longer-term) credit, and financiers typically provide resources directly to the entity. Investors make up the second possible group to which financial accounting may be addressed. They consist of shareholders and, inasmuch as their primary interest is in trading these financial instruments, the holders of corporate bonds. The key difference between 'financiers' and 'investors' is the motive and the time horizon for their investments. Investors buy property rights from other shareholders, do not contribute a significant amount of resources directly to the entity, and release their invested capital not with the cash flows generated at the entity level but by selling their shares. Cash dividends, the investor's share of the entity-level cash flows, make up only a small fraction of the overall takings. The majority comes from the appreciation of the stocks, which are cash flows expected in the future. While standard financial economics cannot recognize this difference – with perfect markets and profit-maximizing investors these differences are simply assumed away – institutional set-ups reflect it: the organization of financial accounting and also the state's involvement in regulation differ with respect to these groups.

Financiers with a long-term interest in a firm build an economic entity that is more than just a 'nexus of contracts'. Within this institution, conflicts arise over the use and distribution of the cash flows; and these conflicts need to be resolved between the financiers. This can be done by statute, but the state often gets involved using company law – by prescribing rules for incorporation, by assigning voting rights, by determining rules for sharing cash flows between equity financiers themselves on the one hand and between them and creditors on the other – and the state sets rules for the wind-up of the firm. The state has an interest in financial accounting as soon as the company law makes use of accounting rules, for instance in determining what is profit and how to distribute it.

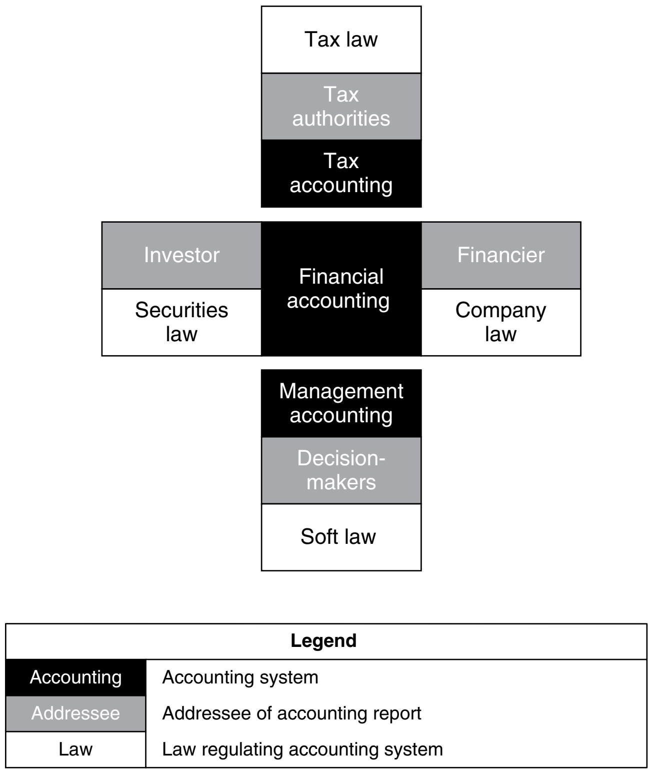
Shareholders who invest in the short term only have a perfunctory interest in the entity as such: they are interested in the returns that they can generate with their investment, and most of their returns will be derived from cashing in on stock price appreciation, and this is trading in future expected cash flows. For them, the investment is also more part of a portfolio to which a particular share contributes a risk-and-return profile. This means that the shareholders are keenly interested in being well informed about firm characteristics in regard to future cash flows as they enable them to trade shares in an informed manner. Trading shares requires a different set of information than resolving conflict between financiers. Agents, for instance institutions where shares are traded, may be requiring rules for disclosure. The state, if it gets involved at all, tends to use securities law to assist these types of investors. When reliable information about financial performance of a firm is necessary for informed trading, the state is likely to regulate accounting.

Surprisingly, even management accounting is no stranger to state intervention. As managerial accounting determines what are 'good decisions' within a firm it is not immediately obvious why the state should intervene to provide a higher level of welfare. Here, state intervention has often taken the route of soft law, formulating rules of sound management practice. Exemplars are corporate governance codices, which often refer to how information should be used and presented. If these codices address concerns of outside stakeholders they also have a possible impact on financial reporting and need to be considered in this context. By and large, though, the state abstains from regulating management accounts, and this is the reason why management accounting will be of subordinate concern in our study.

As Exhibit 1.1 shows, not only does accounting serve a number of purposes, the state can also get involved in accounting using different entry routes and pursuing different purposes. The long shadow of the state falls on all systems of accounting, but changes in statehood will become most manifest in one area: financial accounting. In tax accounting the role of the state is too fixed; and in managerial accounting the role of the state is only peripheral. We therefore choose financial accounting as the object of our analysis.

Unfortunately, state intervention, being the result of a political process, never falls neatly into one of the categories of company law, securities law or governance regulation. It may use company law to order dissemination of information to shareholders; it may use corporate governance rules to influence financial reporting; it may use securities regulation to provide mechanisms of good corporate governance. Sometimes the state intervention will rely on some positive correlation of instruments, improving, say, conflict resolution in firms (a company

Exhibit 1.1 Localization of accounting



law issue) and at the same time improving as a side effect the quality of financial reporting on capital markets.

At the same time, securities law will not only extend to accounting, but also regulate other matters of investor protection such as insider trading, and company law may be relying less on accounting to distribute claims to property but more on providing voting rights or representation in decision-making bodies. In the extreme case, company or securities law may be silent about accounting altogether. There are reasons why the law may be silent: the state does not care for the well-being of investors or financiers or the state is satisfied with the arrangements privately found in the markets. If this is not the case, some regulation will be likely to be in the statute books. We will formalize this argument later as outcome, supervision or operating responsibility of the state.

1.2 The policy fields of financial reporting

From a functional perspective, financial reporting can be separated into its functional components. This is the production and dissemination of information, which we refer to as disclosure, and its enforcement. Enforcement encompasses all mechanisms to ensure that the disseminated information is materially correct. Both policy fields require decisions as to which role the state, societal and private actors should play to provide public welfare.

The disclosure regime

All information disseminated by a company could be understood as disclosure. Disclosure would then comprise quantitative and qualitative reports, for instance on human relations or sustainability, and it would encompass matters as diverse as marketing or investor relation communications. Such an all-embracing concept of disclosure does not allow for much precision. We will therefore use the term 'disclosure' in a narrower sense: disclosures are communications intended to disseminate information on the financial state of a firm to a wider and non-specified audience (Merkt 2001). We do not only narrow down our analysis to quantitative, namely financial, aspects. Our definition also implies that disclosure and information are distinct categories. Once a disclosure is made, nobody can be excluded from its access. While information can also be provided through private channels, all disclosures are available for the general public. Disclosures thus aim at enhancing information available for an anonymous and general public.

Making corporate information available for the public helps alleviating information asymmetries and is thus an important mechanism to reduce agency problems, which occur for instance between managers and shareholders or between creditors and lenders. Due to the lack of other contractual solutions capital markets in particular need disclosures. Hence, companies which strongly rely on such markets get incentives to provide disclosures and to supply actual or potential investors with information relevant for making their decisions. For them, disclosures are necessary to participate successfully in capital markets. The state shares an interest in disclosures as soon as the efficiency of capital market becomes a political concern.

The 'interest' of the state does not imply immediate action by setting legal disclosure standards or by intervening in some other way. Private incentives for the demand and supply of information may suffice to initiate disclosures because incentives to divulge information increase when a company becomes more dependent on equity or debt financing via capital markets. However, this has not been put to the test recently: even though private incentives for providing information exist, one finds legal minimum disclosure requirements in practically every country since the early 20th century. This may be because the private incentives are deemed to be weak. However, disclosures mandated by legal regulation do not fully crowd out voluntary disclosures. Both exist side by side. While voluntary disclosures have supplementary character and can be defined as all information disclosed additionally to mandatory requirements, mandatory disclosures ensure that there is a minimum amount of publicly available information (Healy and Palepu 2001). The latter protects individual investors from concealment of material, for example substantially price-sensitive information, by the firm (Wüstemann 2003). Such regulation increases the overall welfare that capital markets bring about: assuming semi-strong information efficiency of capital markets, prices include all publicly available information. Hence, even relatively uninformed investors are price-protected when there is a sufficient amount of information embedded in the prices of the securities traded (Scott 2006).

Information is disclosed through different channels. Financial reports, an end product of the accounting process, are the most important source of such disclosures. Once published, accounting information in these reports is used for different purposes by various groups of stakeholders, particularly investors, creditors and employees. Supporting decision-making is now seen as the most prominent use, and examples for decisions based on accounting information are decisions to invest or disinvest equity capital or to lend money.

This functional view is the most common but not the only one on accounting. To provide an insight into the scope of possible roles of accounting, we mention but two. These views are not typically acknowledged in mainstream accounting research, but may be illuminating from a social science perspective. Here, some authors assert that the role of corporate disclosures is not only to report on economic entities but also to contribute to 'constructing' them (Borger 1999; Hines 1988). Obvious examples are economic entities that get visible only through accounting, namely groups. Property rights, in the strict legal sense, arise from ownership of company shares. However, a company's ownership of subsidiaries gives shareholders a further, but only indirect claim to those economic assets that the company owns in turn. Economic ownership is therefore broader than ownership in the legal sense as it encompasses the property rights to the subsidiary firms owned by the mother firm. This concept underlies consolidated accounts, in which all assets and claims are reported in the context of economic ownership. As a legal entity, groups do not exist, but the accounts see through the legal arrangements and make all the claims, including the indirect ones, visible. In this sense, accounts create the economic entity. The second role has to do with the part that financial accounting plays in internal (self-)regulation. The obligation to render accounts requires a somewhat effective management. The emergence of accounting, at least in code law countries, can partly be explained by the paternalistic aim of the state to force merchants to inform themselves about the economic situation of their businesses (Leffson 1975).

The enforcement regime

Disclosure regulation cannot be considered in isolation from its enforcement regime (Ball 2001): the information and control rights provided by the disclosure system can be put to work only if they can be effectively enforced. In the context of financial reporting, enforcement serves the purpose of safeguarding the faithful representation of disclosures. Its economic function is to add credibility to disclosed statements. As a full verification of accounting information would be too costly, enforcement is in fact a system of sanctions and partial checks.

The most common form of enforcement in accountancy is auditing, where private auditing firms verify the correctness of a company's financial statements on a contractual basis. Sanctions are incentives to abstain from disclosing fraudulent information. These are set by imposing fines, increasing litigation risk and establishing personal liability, for instance by making false disclosures a punishable offence. These sanctions are often accompanied by institutionalized policing arrangements including the operation of enforcement agencies that either examine random samples of financial reports or investigate them in cases of suspicion. Societal actors may also pursue enforcement strategies, for instance by applying ethical rules and conferring or withdrawing membership status.

1.3 The function of accounting within the varieties of capitalism

Recent research on the varieties of capitalism stresses the system-dependent importance of financial reporting and disclosure systems for economic decision-making (Werner 2008). The different accounting practices are based on the way in which an economic system is organized and how business operations are financed and controlled. We first present the overarching argument, and then consider how this argument applies to Germany as an 'insider' economy on the one hand and the UK and the US as the 'outsider' economies on the other. The future of these systems are considered at the end of this section.

The argument for different functionalities: Some theory

The style of the national corporate governance system furnishes contracting parties with system-specific information claims that are transmitted by the disclosure system (Wüstemann 2003). As the corporate governance system itself depends on the type of the national business system, the disclosure regime is complementary to the 'variety of capitalism' existent in a particular nation state (Ball 2001). The relationship between corporate governance and disclosures is, for instance, described in Sloan (2001), who argues that 'financial accounting provides financiers with the primary source of independently verified information about the performance of managers. Thus, it is clear that corporate governance and financial accounting are inexorably linked. Indeed, many of the central features of financial accounting, such as the use of historical costs, the reliability criterion, the realization principle and the conservatism principle are difficult to understand unless one adopts a corporate governance perspective.'

The formation of meaningful prices on capital markets rests on disclosures. They are thus necessary preconditions for the existence of well-functioning capital markets. Disclosures also play a role in corporate governance by providing economic actors with reliable measures for contracting. Such measures are, for instance, used for equity and debt contracting and, equally important, for contracts with managers (Bushman and Smith 2001; Lambert 2001; Sloan 2001). Lastly, disclosures enable stakeholders to enforce their claims in better ways, for instance in lawsuits (Hay and Shleifer 1998; La Porta *et al.* 1998). The particular 'variety of capitalism' now defines the role that disclosures and, in particular, financial reports play in the coordination efforts of the economic actors. This explains why countries with insider economies have a financial reporting system different from those with outsider economies. The concepts of code law and common law countries are often used somewhat interchangeably with the concepts of insider and outsider economies. While one cannot deny a correlation between these two organizational forms, conclusions must be drawn from the underlying economics, which are not captured in the procedural notion of 'code' and 'common' law. We therefore prefer the concept of insider and outsider economies to the differentiation between code and common law countries and use this typology wherever appropriate.

The implications of corporate governance on financial reporting will be discussed in the following subsections. Here, we refer to Germany as a typical example of a country with an insider-style corporate governance system and to the UK and the US as typical outsider systems.

The functions of accounting in insider economies: The case of Germany

Germany has an insider-style corporate governance system. In the terminology of Hall and Soskice (2001), Germany follows the model of a coordinated market economy. This type of capitalism is characterized by a broad range of non-market-based forms of coordination. The authors note that 'non-market modes of coordination generally entail more extensive relational or incomplete contracting, network monitoring based on the exchange of private information inside networks, and more reliance on collaborative, as opposed to competitive, relationships to build the competencies of the firm' (Hall and Soskice 2001). Accordingly, external equity financing through capital markets was comparatively less developed in Germany, especially for small and medium-sized companies. German firms traditionally relied to a large extent on internal and debt (bank) financing. Evidently, these financing patterns go hand in hand with relatively weak capital markets. As the German social security system is by tradition of the pay-as-you-go kind, this arrangement slowed down the development of capital markets further.

The absence of an active market for corporate control can be regarded as one of the preconditions for the emergence of the particular German corporate governance system. Its near-non-existence, which lasted over decades (Hackethal *et al.* 2005; Schmidt 2003), fostered network-like relationships and a long-term rather than a short-term cooperative orientation (see, for example, Hall and Soskice 2001). Ownership concentration in German companies is traditionally high, and this appears to be the typical solution when investor protection is poor (La Porta *et al.* 2000; La Porta *et al.* 1997). With low investor protection, the demand for holding only small stakes in a firm is also typically low. This depresses market prices for shares and makes external equity financing relatively unattractive, reinforcing the traditional financing pattern. Holding large proportions of shares ('blockholdings') also enables investors to realize control benefits, which can be explained by obtaining information and control rights, for example through representation in the supervisory boards (La Porta *et al.* 1998).

Germany's typical corporate governance institutions translate into its accounting system. Generally, the demand for high-quality accounting information is lower because blockholders or banks, which are important providers of finance, already have timely access to information through other channels than financial reporting (García Lara *et al.* 2005). The most important stakeholders in insider-oriented corporate governance regimes are thus less dependent on the availability of public disclosures. Instead of relying on public disclosures and financial reporting, insider systems feature a 'system of legally mandated and explicit reporting and disclosure duties within the firm, which disseminates decision relevant information to key contracting parties (but not to the public)' (Wüstemann 2003). Insider economies are often found in code law countries. Ball *et al.* (2000) argue that in these countries 'the demand for accounting income (. . .) is influenced more by the payout preferences of the agents for labor, capital and government, and less by the demand of public disclosure'.

The functions of accounting in outsider economies: The UK and the US

The corporate governance systems in the US and the UK are typical outsider control systems. Both countries have, originating from the UK, an Anglo-Saxon common law tradition. In regard to the national business systems and again following the terminology of Hall and Soskice (2001), both countries can be described as liberal market economies. In such economies, markets play a greater role in the coordination of economic actors. This also translates into typical financing patterns of firms domiciled in such countries. (Anonymous) investors have to be supplied with high-quality information that enables them to meet their economic decisions such as buying, holding or selling shares. Such information can be found in financial reports. As outside investors cannot rely on internal levers of control, their protection is of particular concern for the efficiency of liberal market economies. These business systems thus feature a high degree of institutionalized investor protection. The latter is *inter alia* ensured by a developed disclosure system, which is typically accompanied by a strong enforcement regime.

Through this sort of regulation, benefits from controlling large proportions of shares decrease. Stocks thus are typically held more widely in liberal market economies. A higher degree of institutionalized investor protection hence contributes to the development of larger equity markets compared to insider economies (La Porta *et al.* 1997). This also coincides with the existence of an active market for corporate control, sometimes also denoted as takeover market. The control mechanism works in the following way: if performance is poor, market values of the firm will fall, and this makes the poorly performing firm a takeover target. After the takeover, the new owners are likely to replace the top managers or to change business strategies to increase share prices. This constant threat is likely to make managers focus on achieving good returns on their strategies. The existence of active takeover markets thus also contributes to a higher degree of investor protection.

Evidently, the role of financial reporting for economic decision-making must be more pronounced in outsider corporate governance systems. Anglo-Saxon accounting was thus described as being 'micro-orientated and judgmental, reflecting business practice and professional rules' (Alexander and Archer 2003). However, whether the differences between Anglo-Saxon and Continental European countries are that clear-cut has recently been an issue of debate (see for example Alexander and Archer 2003; Nobes 2003) and will also be analytically addressed in Part V of this book.

Similar challenges and different pressures

Generally, both outsider and insider models have their merits and shortcomings. While it is currently fashionable to believe in the superiority of outsider models, it is noteworthy that even in the 1990s some authors saw comparative advantages of insider systems in the German or Japanese style (Porter 1992). For instance, Wever and Allen (1992) argued that 'Germany's ability to design a cohesive economic and social system that adapts continuously to changing requirements goes a long way toward explaining the country's competitive success.'

An important empirical observation is that both insider and outsider models displayed a stable existence over a long time. Both were successful solutions to the respective requirements that they had to meet. From this perspective, both systems were functionally equivalent to each other, at least to a large extent. The occurrence and retention of both systems can be explained by their optimal adaptation to the respective infrastructural environments, particularly typical financing patterns and the respective corporate governance systems, and by path dependency (Wüstemann 2003).

It is now often opined that the process of economic globalization in particular necessitates a shift towards an arm's length financing system (Hall and Soskice 2001; Leuz and Wüstemann 2004). When there is, due to globalization, strong reliance on (equity) markets and a need for lower capital costs, liberal market economies have comparative advantages. This may lead to a convergence in the varieties of capitalism, which means that different political and economic systems adjust to imitate the one 'best-suited' model (Strange 1996). Even though we do not explicitly address the question as to whether there is a worldwide convergence of corporate governance and business systems, it is likely that changes in the respective disclosure and enforcement systems provide evidence for such an underlying process: a stronger reliance on equity financing requires the externalization of information, thus strengthening disclosure and enforcement.

In that vein, Hansmann and Kraakman (2001) predict the 'end of history of corporate law' as Continental European company law will converge to the US model. The presumed convergence is to occur because insider models are not able to cope with needs emerging through globalization: worldwide integration led to massive demands for new capital even from companies in insider economies (Kübler and Assmann 2006). Particularly, large and internationally acting corporations were facing increasing transparency demands of global investors when they wanted to raise fresh capital. These demands could only be met with difficulty due to poor disclosure regulation in the home market. The ensuing transparency, induced by outside capital, led to increasing market pressures, which also necessitated to reconsider traditional business practices founded on networking and long-lasting (but not necessarily efficient) relationships. Changes also affected banks, which played an important role in the governing coalition of insider economies (see, for example, Hackethal *et al.* 2006). Their strategic reorientation towards investment banking rather than credit provision made them leave the governing coalition, again reinforcing the need for big industrial companies to increasingly collect funds from equity markets.

1.4 Governance modes and the role of the state

To analyse whether actors within the accounting regimes have taken on new roles or discarded their old ones, we refer to the categories put forward in Streeck and Schmitter (1985). In their seminal work on the analysis of governance in different policy fields, they distinguish between three major bases of social order: market, with its guiding principle of dispersed competition; the state with hierarchical control; and community with 'spontaneous' solidarity.[i] In the ideal market solution, entrepreneurs seek to maximize their profit in exchange for a good or service provided to their customers on a transactional basis. The ideal state mode of organization is bureaucratic in principle – allocation decisions are made hierarchically. In the community ideal, finally, leaders of societal groups seek esteem, while their followers cherish the sense of belonging to the group as such (Streeck and Schmitter 1985). Although each of the three principles is said to have its own integrity and tendency towards reproduction, contemporary social order is in fact a continuous struggle of the three for 'the allegiance of specific groups, for the control of scarce resources, for the incorporation of new issues, for the definition or rules regulating [behaviour], and so forth' (Cummins *et al.* 1994).

As Puxty *et al.* (1987) note in their early application of this governance framework to accounting, the identified modes do not appear in their pure forms but rather in differently balanced combinations. Schuppert (1990) acknowledges that the variety of different governance modes is much broader than the 'state', 'community' and 'market' archetypes suggest. Adopting an actor-centred view, this finding is also true for the type of governance observable in disclosure and enforcement regulation. First, disclosures are in all jurisdictions based on legal stipulations, mostly in the form of company and securities law. However, these legal stipulations are not sufficient for providing detailed technical rules on how to prepare financial disclosures. Such guidance has to be provided by further actors, who traditionally varied across countries. These actors are, respectively, associated with (or rooted in) the three governance modes described.

In the state sector, agencies, courts and to a smaller extent bodies under public law, for instance mutual stock exchanges, may play an additional role in setting disclosure rules. Enforcement can also be enacted by state agencies, courts and bodies under public law, with courts being important for the evolvement of litigation risk. Communitarian involvement in accounting governance includes responsibilities of actors like official (private) standard-setters, unofficial/factual standard-setters or influential academics and practitioners. In regard to enforcement, communitarian governance can be exercised by institutions that are necessitated by company law, such as (supervisory) boards and their committees, as well as the statutory audit. While these institutions are stipulated by law, they do not fully belong to the state sector as only private actors are involved. Finally, markets also play a role in governance when there is a strong reliance on private contracts and arrangements. A real-life configuration will be made up of a combination of these components and actors, both in disclosure and in enforcement.

The traditional analysis of governance modes keeps silent on the territoriality of the respective actors. It has, however, to be kept in mind that both private and state governance can be exercised from a national or an international base. In the golden age, governance was generally localized at the national level, and this was also true for the localization of disclosure and enforcement. Two patterns of change show up in this context (Zürn and Leibfried 2005). The first may be denoted as 'transnationalization', referring to a combination of privatization and internationalization. The second can be called 'supranationalization', which can be characterized by a combination of internalization and involvement of actors rooted in the state sector. Obviously, Europeanization must be regarded as a special case of supranationalization.

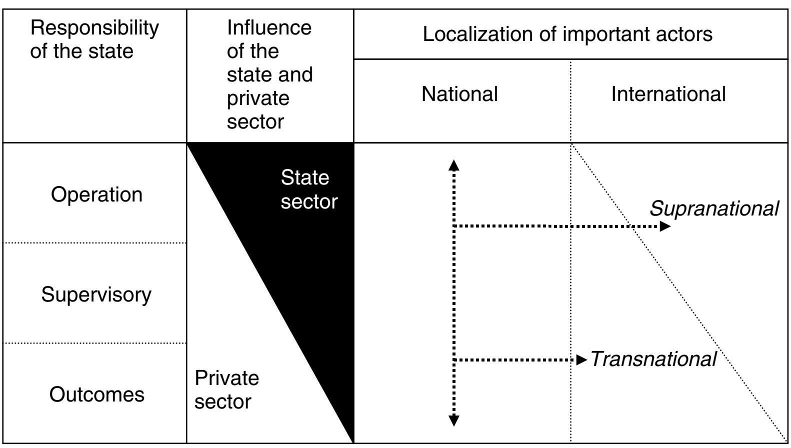
The specific constellation of a governance mode cannot be construed without reference to the state. It is the state that decides which options are admissible in the first place. As soon as the state rules out an option, it is unattainable for the governance configuration. The state may, for instance, decide to crowd out all communitarian (societal) regulation by setting its own detailed rules or it may decide not to allow an internationalization of competencies. In this context, the decisive question is, whether the state takes on responsibility for the regulation of a particular policy field and, if so, of which kind this responsibility is?

State responsibilities can be classified into three different levels (Schuppert and Bumke 2000): operation responsibility, supervision responsibility and outcome responsibility. When taking on operation responsibility, the state performs relevant services for the provision of a normative good[1] such as welfare or security through its own administrative agencies. Supervision responsibility means that the state takes legislative decisions on the provision of a normative good. Supervision responsibility necessitates cooperation with societal or private actors in a particular policy field (Grimm 1990; Schuppert 1990). This can be interpreted as an incorporation of the addressees of law into the sphere of the state, which has become increasingly noticeable. Observations include that law becomes less hierarchical, that law-makers increasingly try to convince or persuade constituents instead of forcing them to follow specific rules and that there is an increasing amount of soft law, that is non-binding regulation (Ritter 1990). Supervision responsibility does not imply a state's own operational activities but delegating the regulation to third (mostly self-regulating) parties who guarantee a certain level of provision in respect of normative goods. The state might not intervene at all as long as self-regulation leads to satisfactory outcomes.

When taking on outcome responsibility, the state is expected to intervene if a normative good is put in jeopardy. Taking on outcome responsibility only leads to a very low level of intervention in general. It should be noted that the state can, in fact, rarely completely discard this sort of responsibility. The outlined concepts are summarized in Exhibit 1.2. It offers a comprehensive analytical framework for enquiries into accounting governance and shows possibilities of change. It will be used here to contrast the different governance modes and hence to capture the effect of the recent transformations of the British, the German and the US disclosure and enforcement systems.

In regard to the policy fields of disclosure and enforcement regulation, we expect to find opposite trends in insider and outsider economies. In insider systems such as Germany, we suppose that due to globalization a retreat of the state from bearing operation responsibility will be observable. This also implies that we expect an increasing participation of private-sector actors in the governance of the respective policy fields. However, applying the term ‘privatization’ to this phenomenon may be too simple as private involvement can also occur in addition to existing regulation. It is the total amount of regulation and the sharing pattern of responsibilities for the policy fields between public and private actors that is decisive in this issue. Only if the state sector’s traditional responsibilities are simply transferred to the private sector talking about privatization is justifiable.

Exhibit 1.2 Framework for analysing possible shifts in accounting governance



In outsider systems, we expect that state responsibilities increase in such a way that a *laissez-faire* approach of the golden age – inasmuch it existed in the first place – is abandoned in favour of the state taking on the supervision responsibility for the provision of normative goods. This implies that the state sector plays an increasing role in the governance of disclosure and enforcement, at least by mandating private actors that previously regulated without a nation state's remit.

The expectation that outsider economies will witness more state involvement seems counter-intuitive only at the first glance. Two reasons make state involvement more likely. First, capital markets have become important for societal arrangements beyond the provision of finance, for instance in providing funds for retirement. A malfunction or even a collapse of the markets would have severe repercussions for the nation state, which bears the responsibility for its citizen's economic welfare. The second reason is the increasing cross-fertilization of regulatory regimes. Regulation has become somewhat contagious: if it exists in one state, it is likely to appear eventually in the other. The crisis theory of regulation provides a pertinent explanation: politicians have to demonstrate to their electorate, who is increasingly aware of other existing arrangements, that 'everything' has been done to avert the crises and 'all' safeguards have been applied for the future.

Taken together, these developments make convergence of regimes very likely. Convergence then may take the form of shared transnational and supranational solutions.

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