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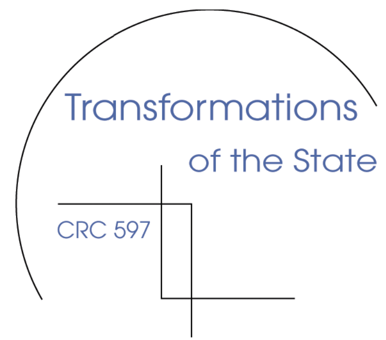

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Accounting and the Welfare-state: The Missing Link

Tim-Frederik Oehr
Jochen Zimmermann

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ABSTRACT

In recent years, accounting regulation has been internationalized with the extensive use and adoption of International Financial Reporting Standards (IFRS) by nation-states, which points at least to a formal convergence between accounting regulatory systems. However, major differences between national accounting systems persist. In this paper, it is argued that a country’s accounting system is influenced by the type of the welfare-state. This allows us to see accounting in a broader social perspective. The societal attitudes influencing the accounting system are captured by using the Esping-Andersen (1990) classification of welfare states. To show that there is a connection between the typology of welfare-states and the way in which various corporate constituencies’ interests are balanced, we compare Germany as an example of a conservative welfare-state and the UK as an example of a liberal welfare-state. This comparison shows that the type of welfare state exerts an influence on the system of accounting and, therefore, can be seen as an explanatory variable for persisting differences between accounting regulatory systems.

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Accounting and the Welfare-state: The Missing Link

1 INTRODUCTION

Recent years have witnessed substantial changes in the accounting systems of OECD states. Institutional changes have led to transnationalization, which is characterized by a combination of both privatization and internationalization, of the way in which accounting standards are set. Accounting witnesses the ever increasing use of International Financial Reporting Standards (IFRS) by listed companies, and the international acceptance of the private International Accounting Standards Board (IASB) as a standard setter has consistently grown. In 110 countries IFRS are either required or permitted for the consolidated accounts of listed companies (IASCF 2007).

At first glance, this development points to a global convergence in accounting regulation, but the rapid changes conceal that major differences between countries persist. The informational needs of investors and a tendency towards system efficiency press for further convergence, while neo-institutional theory suggests that peculiarities in the legal and financial systems form barriers.[1] However, there remains a question of why major differences in accounting prevail between countries within the same single legal and/or financial system. In particular, the regulation of company accounts (other than consolidated accounts) is still very country-specific. This observation points to an incomplete explanation and an omitted variable problem.

This paper argues that both explanatory variables – the legal and financial system – that account for differences between accounting systems in traditional theory are endogenous. Their particular shape in a country is rather influenced by the predominant type of welfare-state, which implies a mediated influence of the welfare-state on accounting. We posit that differences in the type of welfare-state have shaped differences of accounting systems as societal motives and value judgments – which are often ignored in the traditional literature – play a substantial role in determining accounting systems. Capturing societal attitudes by using the Esping-Andersen (1990) classification of welfare-states, we show that the societal attitudes expressed in welfare-state regimes are reflected in a country’s prevalent aims and goals of accounting. They, in turn, determine how those sets of company accounts important to society are regulated: liberal welfare-states emphasize the information function and leave the regulation to private bodies; conservative and social-democratic welfare-states emphasize the distributive

[1] In this regard, we refer to the neo-institutional concept of path dependencies. Institutions matter and differ between countries. As existing institutions shape patterns of change, history matters. This induces path dependencies that explain why national peculiarities might persist even though learning of economic agents should lead to convergence of economic systems (see e.g. Schmidt and Spindler 2002; Pierson 2001).

nature of accounting and allocate the regulation to the states. Convergence thus occurs only in the area that is irrelevant for the regulatory impetus of the welfare-state: group accounts that do not serve a legally binding function. The heralded convergence, thus, masks a fundamental schism that persists between different welfare-state regimes and societal attitudes.

We have organized the argument as follows. The second section provides the neo-institutionalist arguments for convergence and persisting differences in accounting. The role of the welfare-state and its impact on accounting is outlined in chapter three. Chapter four contrasts an empirical example analyzing the emergence of reporting instruments and reporting rules in Germany and the UK.

2 Changes in Accounting Systems: The Usual Suspects

2.1 Causes for Convergence

The reasons why accounting systems are converging have been widely discussed in the literature. For ease of argument, we follow the taxonomy of Genschel et al. (2006) and distinguish between three categories of driving forces: material, institutional and normative driving forces. For each driving forces we will present a brief example.

The most important material driver for convergence is the globalization of capital markets (Hopwood 1994; Busse von Colbe 2002). Global investors and globally operating firms demand consistent accounting standards; for instance, companies expanding their cross-border activities need additional capital to finance their ventures. When the demand for external financing for international companies exceeded the capacity of their home country’s capital market, they strove for foreign cross-listings to fulfill their capital needs (Flower 2004). However, those companies discovered that foreign regulatory authorities did not accept their financial accounts, which were prepared according to national standards. Hence, companies had to prepare two set of financial accounts, which was both costly and confusing for corporate constituencies since the reports often presented different data for key items like profit. A notorious example is Daimler Benz in the 1990s (Radebaugh et al. 1995).

The proceeding IFRS ‘revolution’ is now self-enforcing. Not only has it forced countries away from a legalistic approach of standard-setting (Cunningham 2005), but has also put countries that have believed in the outstanding quality of their standards under pressure, in particular the US (e.g. Eaton 2005). Even for a large country such as the US, a stand-alone accounting system no longer seems tenable: the Securities and Exchange Commission (SEC) recently announced that US companies will also be allowed to prepare financial accounts according to IFRS from 2011 onwards (SEC Press Release 184, 2008).

Institutional driving forces are particularly noteworthy in Europe, as many changes in accounting regulation are due to the harmonization endeavors of the European Union. Major steps towards a Europeanized accounting regulation were undertaken by the European legislator with the Fourth (78/660/ECC) and Seventh (83/349/ECC) Directive. The Directives aimed to make the financial accounts of European companies more comparable and equivalent (83/349/ECC, 2), which were designed to reduce the transaction costs for preparers and users of financial accounts. Indeed, the directives partly shifted continental European countries closer to the Anglo-Saxon model of accountability, and countries like the UK to a more legalistic framework by requiring a minimum regulation in company law. However, the intended goal of achieving overall comparative accounts was not fully attained due to the administrative discretion embedded in the directives. An often cited example of the prevailing of national peculiarities in this respect is the transposition of the ‘true-and-fair-view’ principle into national laws (Ordelheide 1996).

Thus, substantial differences in accounting still remain. A major alignment of accounting across Europe was achieved by concentrating on a subset of companies and a subset of accounts, namely consolidated reports of listed groups. The IAS-Regulation (EC 1606/2002) required European listed groups to publish group accounts according to IFRS. From 2005 on, approximately 7,000 European listed companies were required to harmonize their accounting practice. The IAS-Regulation also shifted the competence in standard setting to a transnational regulator, the IASB, and retained an veto right at the European level by means of an endorsement process (Zimmermann et al. 2008).

Normative driving forces mark the third and last set of pressures for harmonization. Two trends stand out: demands on regulators that arise from accounting scandals, cases of fraud and company crises, as well as a general trend to delegate decision making to private experts, sometimes referred to as neo-liberalization. Scandals, frauds and crises raise public doubts about the quality of national regulations, and regulators react with new initiatives which mostly effected a change in the prevalent configuration of accounting (Bhimani 2008). Crises happen and challenge national regulators for legislative actions. There are several examples for accounting crises that caused national or international reactions: a popular example is the fall of Enron in 2001 and WorldCom in 2002, which lead to the enactment of the Sarbanes-Oxley Act that extensively tightened the regulation for listed US firms (Engel et al. 2007). Sarbanes-Oxley also had transmission effects on regulators in other countries. Europe, for instance, enacted a reformed Eighth Directive in 2006 (2006/43/EC). Reactions to accounting crises have a potentially twofold effect. First, the system in which the crisis has occurred is revised due to public concerns. The countries concerned tend to enact reforms which are modeled on the regulation of another country whose system is regarded as superior. Second, the

appearance of accounting scandals in another country might put pressure on regulators when the regulatory systems are similar. Consequently, accounting scandals can cause national and international reactions. In both cases, the driving force for different solutions is the uncertainty about the stability of particular system elements or the stability of the system as a whole. When national regulators start searching for norm-sets in apparently better working systems, they imitate and adopt seemingly superior system elements from others, and convergence ensues.

Besides ideal forces emanating from crisis, convergence in accounting is sometimes considered to be part of a general neo-liberalization trend across the globe (Rodrigues and Craig 2007). Neo-liberalization depicts the political economic idea that a framework characterized by strong private property rights, free markets, and free trade best advances the human well-being (e.g. Harvey 2005). It is postulated that free markets lead to efficiency, a more equitable distribution of economic resources, and, moreover, the maximization of economic wealth (Everett 2003). Tied up with this extension of market relations is the preference to withdraw the state and delegate decision making to private experts. In this vein, international convergence of accounting regulation is consistent with the ideology of neo-liberalization. Nation-states with a long tradition in accounting standard-setting gradually handed over their organizational responsibilities to committees of experts such as the IASB (Zimmermann et al. 2008). This usually relates to the presumption of making the capital markets work (more) efficiently (Graham and Neu 2003).

The above briefly discussed forces have had a lasting and thoroughgoing effect on the accounting landscape across the globe. Some of the forces are continuously applied, e.g. globalization, and others are applied in progressive stages, e.g. crises. The interplay of these forces has mandated that nation-states rethink the appropriateness of their accounting systems. In general, these forces affect the make-up of financial reporting for capital markets. The convergence of accounting systems becomes evident through the highly visible turning to ‘information accounting’ and privatization processes happening across the globe.

2.2 Causes for Differences of Accounting Systems

The sweeping convergence for capital market reporting stands in sharp contrast to the regulation of private companies and individual accounts. In the case of the EU, only five of the 27 Member States have implemented the IAS-Regulation to use IFRS also for the consolidated accounts of non-listed groups or for individual accounts of listed and non-listed companies (EU 2008). Cyprus and Malta, for instance, require all companies to use IFRS for any type of account. All other countries have implemented some mix of these options. Some countries permit listed and non-listed firms to use IFRS in individ-

ual accounts, but additionally require them to prepare their individual accounts according to local Generally Accepted Accounting Principles (GAAP). In Germany, for example, individual accounts still have to be prepared according to the national commercial code and the state still sets accounting standards for all accounts other than group accounts of listed firms. Other countries, such as the Netherlands, leave the selection between IFRS and local GAAP to the firms. The same stipulations are also observable for consolidated accounts of non-listed companies. These differences between accounting requirements for non-listed firms and individual accounts are not unique to the EU but can also be found in the rest of the world.

The reasons for international differences have been keenly debated since the beginning of the 1970s. Much of the contributed literature assumes that the accounting system in a country is a function of its environmental factors (e.g. Choi and Mueller 1984; Gray 1988; Nobes and Parker 2008; Roberts et al. 2008). From the broad debate, the country’s legal system and financial system have emerged as primary variables of interest. Both of these variables gained major importance concerning accounting regulation in the 1990s. Salter and Doupnik (1992) introduced the legal system as the analytical starting point for international accounting differences, while Nobes (1998) introduced the financial system. However, both characteristics, which we will discuss in turn, lead to a similar clustering of countries (Nobes 1998).

The legal system

Legal systems are generally distinguished into two categories: continental-European code law systems and Anglo-Saxon common law (or case law) systems (e.g. Nobes and Parker 2008).[2] As accounting regulation is a part of the national legal system, this has several implications for accounting regulation within a country, particularly to which extent accounting is subject to the law. For instance, in code law countries accounting rules are to a large extent a matter of the company law or commercial code (La Porta et al. 1998). In contrast, in common law countries accounting standards are traditionally based on accounting practices by accountants; laws are only of minor importance for accounting regulation.

Further differences lie in the functions of financial accounts. Even though all corporate laws contain similar basic characteristics (Hansmann and Kraakman 2004), code and common law systems have varying ideas about important characteristics of companies, relevant problems to be solved and the legal instruments addressing those problems (Heine and Kerber 2002). Consequently, code and common law countries turn to accounting solutions to a varying extent. Most pertinent to accounting regulation is how

[2] The group of Anglo-Saxon countries includes, for instance, Australia, Canada, New Zealand, the UK, and the US.

corporate payouts to shareholders are determined or restricted.[3] In most common law countries, financial accounts are virtually meaningless for direct payout restrictions. For the determination of distributable profit, company law refers to a separate solvency test (Sellhorn and Gornik-Tomaszewski 2006). Hence, accounts have mainly an informational function. In code law countries, this informational function of company accounts is only of subordinated importance (Leuz 1996). In fact, in most code law countries individual accounts serve as the basis for further legal consequences. In Germany, for instance, the corporate law directly refers to the balance sheet profit as distributable profit. Usually, payout restrictions are implemented through conservative recognition and measurement rules to avoid the extensive distribution of profits, for capital maintenance reasons and for creditor protection objectives (Haller 2003b).

The financial system

The academic literature also argues that a country’s financial system is an important determinant for the development of international differences in accounting (Nobes 1998; Ball 2001). This is largely because the accounting system is seen as a subsystem of the financial system (Leuz and Wüstemann 2004). Concerning the financial system, credit-based and market-based financial systems are mainly distinguished with reference to the micro- and macrostructure of the capital market. The microstructure refers to the distribution of supply and demand of funds within an economy, whereas the macrostructure determines the overall importance of capital markets in a country (e.g. Leuz and Wüstemann 2004). In countries where the capital market plays an important role as a means of savings or due to private pension schemes, e.g. in the UK or the US, individuals will need more market-driven information about the performance of their investment than individuals in economies with a different saving behavior and pension system, e.g., Germany, France or Italy (Boersch-Supan and Winter 2001). This is also reflected in the financing and ownership structure of companies and the appearance of capital market companies. Capital market-driven systems also tend to show a lower level of debt and credit financing.

The prevalent type of financing empirically maps into different ownership structures (Franks and Mayer 1994). Equity financed companies show a dispersed ownership, with equity investors being the major outside stakeholders. Debt financed companies tend to be owned by large block-holders (insiders) with creditors/banks as major stakeholder (Dutzi 2005). In bank-based countries such as Germany or France, banks as lenders of capital also often nominate company directors and are, therefore, able to become in-

[3] Another example of the close connection between corporate law and accounting is the case of bankruptcy (Kirsch 2003).

volved in a company's decision-making process. This shows that the latter countries tend to establish an insider control system, which makes the demand for extensive market-driven information near redundant (Franks and Mayer 2001). Outside equity investors will have too small a stake in the company to influence corporate decisions in the same manner and are therefore dependent on disclosed information.

The different capital and ownership structures induce different needs for accounting regulation. Investors, as major stakeholders of companies in market-based outsider systems, request accounting standards that meet their information requirements. Such economies have usually delegated standard setting for group accounts to private bodies, e.g. the Financial Accounting Standards Board (FASB) in the US. Contrarily, in bank-based insider economies the demand for informational accounting standards is lower. Creditors, as major stakeholders, demand standardized creditor protection in the form of legal rules (company law). The state has responded to these demands by supplying desired protections in the form of company law, in addition to conservative accounting standards that restrict payouts and maintain legal capital. In these economies, individual accounts have a much greater importance and standards for them are typically set by the nation state.

Over time, larger, listed groups in insider economies have structured themselves in a similar fashion to companies in outsider systems. This can explain why in most insider economies two parallel accounting systems have evolved: information accounting in consolidated accounts and conservative practice in single accounts. The state can, without much loss in regulatory competence, design standards for conservative accounting in company law, while delegating its responsibility for standard setting for group accounts of listed groups to (international) private organizations. Large listed firms can now comply with the demand for internationally accepted accounting rules, but the legal system remains virtually untouched when the state continues to set accounting rules for single accounts.

Due to historical circumstances, group accounts are not enmeshed in the legal system. Their point of reference is the business as an economic unit and not a legal entity, which is the case when looking at single accounts. The sole purpose of group accounts is to inform stakeholders about the performance of the economic entity in the past period, as they are more informative than the parent's single accounts. By unifying the financial situation of the related legal entities, shareholders, for instance, can evaluate the best possible future returns or the riskiness of their investment. Thus, group accounts do not fulfill any function beyond the information function and for this reason the basis for the information processing is interchangeable. In contrast, whenever single accounts are mandatory for companies, they play a role that exceeds the pure information function. Namely, they refer to the financial situation of the business as a legal en-

tity, which makes them a useful instrument to claim judicial consequences, for example capital maintenance or liquidation issues in the case of bankruptcy. They are also of use for other economic policies measures, such as the determination of the taxable income, which can be done only exclusively on the level of the legal entity. In this regard, single accounts constitute a complementary part of the legal framework which is why the basis of single accounts is not as easy exchangeable as than that for group accounts.

2.3 Critical Analysis and Hypothesis Development

Comparative accounting research has identified convergence and remaining differences between accounting systems with regard to explanatory variables, as well as providing insights for the evolution of differences, their persistency, and their continuation in the (near) future (Nobes and Parker 2008). Nevertheless, the discussed explanatory variables lack a satisfying explanation for the cause-and-effect chain of developments in accounting and particularly an analysis of the exogenous driving forces. For instance, the institutional feature “legal system” describes differences of accounting systems solely on a technical basis. More importantly, a legal systems approach delivers no explanation why, for example, group accounting for listed firms converges to a uniform model of accounting when the legal system itself is not subject to change.

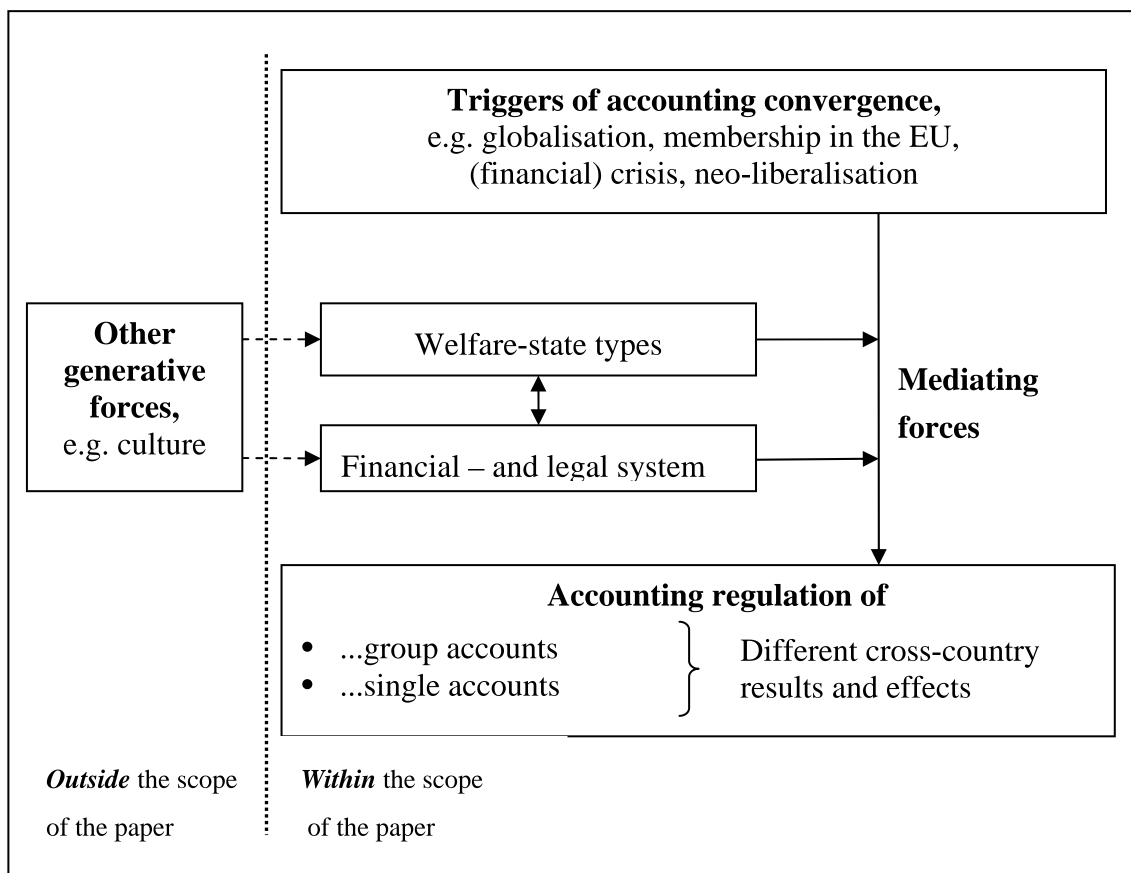
The unsatisfactory performance of the legal systems as an explanatory variable explains the recognition of the financial system. The changing financing behavior of larger companies in insider systems – converging with that of firms situated in outsider systems – provides an explanation for the convergence of group accounting of listed companies. However, the financial system cannot explain why the treatment of single accounts diverges, as there are a substantial number of privately-held companies and family-owned businesses in outsider countries. Moreover, the problem of endogeneity is never properly addressed. Both variables – the legal and financial systems – are assumed to be exogenous variables. However, the academic community discusses which of the two the ‘true’ exogenous variable is. Nobes (1998) considers the financial system to be the decisive factor for explaining accounting differences. The exogeneity is, however, disputed in the ‘law and finance’ literature. La Porta et al. (1997) argue that the ownership structure and the financing behavior of firms are causally determined by the legal system and, in particular, by the degree of investor protection. In this regard, the exogeneity of the financial system is questioned, while the legal system is seen as the true exogenous variable (La Porta et al. 1998).

The discussion over which variable is dominant does not consider why both variables display similar emergence in certain country clusters: Common law countries usually exhibit an outsider market-based economy, whereas code law countries usually have an insider credit-based economy. One possible explanation for this phenomenon might be

the endogeneity of both variables. For instance, legal systems are unlikely to have emerged as a historical coincidence; they rather underlie prevailing ideas of justice and a social demand for a certain degree of control by the state. The parallel appearance of the legal and financial system therefore points to the existence of a further determining variable that captures ideas of justice and societal demands on the state. This can be portrayed by the type of welfare-state. This, in turn, argues for a mediated influence of the welfare-state on accounting, leading to the hypothesis that the type of welfare-state entails a certain form and functionality of accounting.

Figure 1 illustrates the explanatory model. Accounting regulation is considered to be the dependent variable underlying a transformation process. This transformation process is caused by the earlier discussed driving forces which are affected and mediated by country-specific socio-economic factors such as the legal or financial system or, as we argue, the type of welfare-state. These factors are influenced by generative forces, but these lie beyond the scope of the explanatory model described here.

Figure 1: The extended explanatory model



By putting accounting in the context of different welfare-state types, a broader perspective apart from the legal and financial system should by gained. This perspective will consider how differences in the type of welfare-state exert an influence on accounting

regulation. The welfare-state in this paper is *inter alia* used as a proxy for local beliefs or ideas to illuminate how the type of welfare-state exerts an influence on accounting regulation. Especially the distributive effects emanating from accounting regulation shall be highlighted, as well as accounting’s function in balancing interests between corporate constituencies. This provides us the opportunity to discuss the persisting divergence between accounting systems in a broader societal-orientated context: societal motives are captured and we attain a more comprehensive and general understanding of causality.

Moreover, the impact that the welfare-state type may have on changes of the accounting landscape could be answered in a more satisfactory fashion, i.e., the question why different countries exhibit different speeds of change in their accounting regulation. Additionally, relating the welfare-state to accounting potentially not only allows us to explain differences between country’s accounting systems on a societal basis, but also between countries which are in similar clusters of the legal or financial systems. This would back up the argument that the welfare-state matters.

3 WELFARE-STATE EFFECTS ON ACCOUNTING REGULATION

3.1 Differences in the Type of Welfare-state

Welfare-state interventions are an important dimension of modern state activities which most OECD countries had implemented by the end of the 1970s (Hurrelmann et al. 2008). However, the term welfare-state is difficult to define, as it constitutes an umbrella term incorporating a variety of governmental measures that possess distinctive characteristics (Pierson 2001). Welfare politics are constituted by through active interventions of the state into economic and societal proceedings aimed at the enhancement of the population’s well-being in social, material and cultural respects. First and foremost, state interventions protect especially weaker members of the society against consequences caused by the risks of life. Nohlen (1996) defines the welfare state as a descriptive concept of a certain type of state activity and he subsequently labels countries as welfare states in which the state plays an active role in the regulation of economic and societal proceedings, as well as spends a considerable amount of resources for social-political purposes. Although interventionist activities are observable in all OECD countries, the degree to which states intervene into economic processes differs significantly.

The differences in state interventions have led to an identification of different types of welfare-states. According to the seminal work of Esping-Andersen (1990), one can distinguish between liberal, conservative and social-democratic welfare-state regimes. An important distinguishing factor is determined by the degree of de-commodification

of the input factor labor. Esping-Andersen (1990) understands de-commodification as the extent to which individuals are able to maintain an appropriate economic situation independent from their participation in the labor market. Policies have a de-commodifying effect if (social) rights grant the provision of (social) benefits which equates to the decoupling of social security from the market. To relate welfare-states to the previously mentioned regimes, Esping-Andersen (1990) assigned scores to different elements of social security systems for the year 1980 and used the sums of the scores to classify the countries according to the regime-types. Furthermore, the indicator not only gives information about the institutionalization of social security, but likewise acts as an indicator for the nature and location of social safeguard, i.e. the public-private mix.

Liberal welfare-states are representative of a very low degree of de-commodification, whereas conservative and social-democratic types show a comparably higher degree, with social-democratic regimes reaching the highest level. Within liberal welfare societies, the protection against the basic risks of life happens through voluntary efforts of individuals on private insurance markets (Schmid 2000). The role of state interventions into the market is limited to providing basic services to needy individuals after means-tests. In principal, state activities are restricted to setting up prerequisites to guarantee the efficiency of the privately organized social system. Typical examples for liberal welfare-states are Anglo-Saxon countries such as the US or Canada. On the contrary, conservative states like Germany and France apply a statutory insurance system on private insurance markets. The institutionalization of the state-organized obligated insurance is used to secure the individual’s economic status. The financing of such a system mostly follows the principle of equivalence, whereas social services largely depend on employment and contributions (Ostheim and Schmidt 2007). In social-democratic societies such as Sweden, interventions into the market allocation are the most thorough by implementing extensive redistributive social policies and providing public services to all citizens. Consequently, the three welfare-state types reflect the trust welfare-states put in the allocation mechanism of the market.

The classification of welfare-state regimes by Esping-Andersen (1990) has been proficient in the welfare-state research until today. It has induced a comprehensive body of research dealing with, for instance, the regime-types itself or statistical analysis of welfare-state policies (e.g. Ragin 1994; Gornick 1999; Scharpf 2000; Pierson 2001). In general, the affiliation of countries to the three categories as well as the number of welfare-state types is discussed in that research. Similar to research into other welfare-state dimensions, the degree of de-commodification has also been the subject of studies examining the change of the welfare-state from the 1960s to the early 1980s (considered as the ‘golden age’ of the welfare-state). The central question is if policy changes affected a convergence of the de-commodification indicator. However, the indicator is

relatively robust to changes, showing that the different models of welfare-states are stable over time (Schmid 2000). Recent empirical studies have also confirmed the evidence for the stability of the de-commodification level (see Scruggs 2004; Scruggs and Allan 2006). The causes for the persistency of the welfare-state types are seen in path-dependencies due to domestic factors which lead to different reactions and effects dependent on the type of welfare-state.

Complementing the institutionalism approach, the role of ideas in affecting policy-making has recently gained importance (Starke 2006). It is argued that differing normative ideas consisting of accepted values, attitudes and other shared expectations may account for national policy variations by limiting the span of alternatives that are considered as acceptable and legitimate (Katzenstein 1996; Campbell 2002). Esping-Andersen (1990) already began discussing this idea by relating the welfare-state types to different ideological concepts of the state. Accordingly, Esping-Andersen (1990) not only demonstrate the principles of social security, but also that the extent of allocative and distributive activities is determined by the unique legacy of state building and socio-political ideals and values (see also Rokkan 1999).

Liberal states are built on the moral concept of freedom (Siegel 2007). Typical for liberal welfare-states is, therefore, subsidiarity emphasizing self dependent actions and self-determination by individuals, rather than state interventions (Seliger 2001). It postulates that the state should not intervene into markets and that the individual freedom should not be curtailed through social constrains. Moreover, it is expected that market forces will lead to the best possible individual and macro-economic result, as wells as to an adequate coordination of interests. Therefore, the dominating goal of state activities is based on the extension and protection of the individual freedom of choice. In this view, state interventions best occur to provide a framework for the market to function efficiently. In contrast, conservative societies are characterized by a paternalistic state tradition as well as the ideal of social justice. Additionally, social-democratic societies have a universalistic conception of the state dominated by the ideal of equality (Peters 2002). In the latter two types, it is assumed that the allocation mechanism of the market – even when it functions efficiently – does not lead to an evenhanded distribution of information which leads to distributive state interventions.

In principal, these findings can be solidified into two diametrically opposed socio-political guiding themes: individualism and collectivism (e.g. Lüthje 1931). Individualism refers to liberal states, while collectivism refers to conservative and social-democratic welfare-states. Thus, the socio-political guiding themes represent different interpretations of welfare. The idea of individualism highlights the interests of individuals and defines social welfare as the aggregation of individual welfare functions. Contrarily, the idea of collectivism highlights that the society itself can pursue its own inter-

ests to which individual interests have to be subordinated. Hence, collectivism implies that the individual and social welfare function exist independently from each other (Hemmer 1983). In countries with a collectivistic background social welfare is therefore not defined as the maximization of individual interests, as the interests of the community is placed at the forefront. Accordingly, these social motifs will also determine and legitimate state interventions in other political fields, as the expectations of individuals for the quality of state intervention will rely on these ideals.

3.2 Accounting and the Welfare-state: The Ideal-type

Section 2 shows that the form and function of accounting is to a considerable degree interrelated with the legal and the financial systems. However, the appearance of the legal and financial systems tends to have strong parallels with the type of welfare-state. Liberal individualist welfare-states, e.g. the US, usually exhibit an outside market-based economy and belong to the common law tradition (Jang 2005), while collectivist welfare-states, e.g. Germany, usually have an insider credit-based economy and belong to the code law tradition. Clustering countries by the type of welfare in connection with the functionality of accounting would lead to a comparable country cluster. This, in turn, indicates the possible endogeneity of the main explanatory variables for accounting differences and strengthens the hypothesis of a mediated influence of welfare-state regimes on the form and functionality of accounting. Assuming this relation, differences between national accounting systems can be discussed on a more societal-orientated basis. The inclusion of general social motives allows for a stronger contrast between the fundamental ideas underlying accounting in different welfare-states. This provides a broader perspective on the demand for state intervention in accounting and also on the issue of why changes in accounting occur more rapidly in some countries than in others.

Accounting is often described as a pure technique of numeration, because financial data about an organization is collected, processed and reported (e.g. Morgan and Willmott 1993). Accordingly, accounting handles data about the inflows and outflows of company resources, the resources controlled by the firm (assets) and the assigned rights to resources by third parties (liabilities) (Demski and Christensen 2003). However, by creating financial reports, the management of an organization renders a story of what has been done in the past in order to rationalize and justify their decision. Accounting tells a story about the financial history of a firm and informs interested parties about the current situation of the firm, as well as how it might continue to perform in the future.

The process of transforming business transactions into numbers is always driven by the decision about which transactions are recognized in the financial report and how these activities are valued. Decisions about valuation methods gain special importance

as they can affect major corporate constituencies in different ways, either positively or negatively (Zeff 1978). The (social) consequences of accounting are also pronounced by Ordelheide (2004), who argues that accounting driven actions exhibit an influence on the welfare of society members. For instance, an overly optimistic valuation could cause the addressees of financial accounts, such as investors, to reach an incorrect investment decisions. Yet, creditors could also be negatively affected by an overly optimistic valuation, as they rely on this information when they grant credits. The information transmitted through financial reports can also affect trade relations between companies as well as labor relations, e.g. the decision of employees to join a company or not. Thus, the information role of accounting has a substantial effect on the decisions of individuals and on the allocative efficiency of several markets. It follows that information suggested by accounting has to fulfill at least two criteria to be decision useful for major stakeholders: (1) information has to be reliable and (2) information has to be relevant to forecast the future developments of the firm (Wagenhofer and Ewert 2007).

In addition, valuation gains importance when accounting is used to define the payout potential of firms and therewith the amount of money distributable to the shareholders. This is especially interesting for corporate constituencies that are already in a relationship with a firm, as several conflicts of interest between these ‘corporate members’ exist, for instance the conflict between creditors and shareholders. Creditors, compared to shareholders, have an asymmetric loss function (Watts 2003). This means that they are fully affected by negative events, e.g. tight liquidity positions or insolvencies, as their claims will be curtailed, but they do not benefit from exceedingly good performances of a firm because of their fixed claims. Creditors will therefore give the securing of their creditor claims a higher priority than the aforementioned informative character of accounting. Similar are the claims of other constituencies, such as employees or suppliers. Employees’ wages might be reduced or they could lose their jobs, which would seriously negatively impact their welfare. So, these constituencies will demand disclosure of conservatively measured profits to restrict the outflow of funds to shareholders to maintain capital. Referring to this, the interests of shareholders are in the opposite direction, as their dividend payouts dependent on the calculated profit which would be curtailed by overly prudent measurements (Moxter 1984). Hence, whenever accounting serves as the basis for calculating payouts, there needs to be a balance determined between restricting and securing payouts. Nevertheless, conservative measurement rules can dilute the informational function of accounting, which then mainly affects (future) investors if financial reports are assumed to be their main source of information.

This reveals that accounting is not just a technique of pure numeration or a monetarily organized means to an end flow immune to questions of societal and economic policy. On the one hand, accounting is an instrument to endow corporate constituencies

with useful information for decision-making to safeguard the efficiency of markets. To cope with that function a ‘fair’ presentation of the companies’ situation would be needed, which would imply a fair valuation of the assets and liabilities (i.e., market values) is used to calculate profits. However, this would particularly accentuate the desires of capital market participants. On the other hand, accounting can be institutionalized as a mechanism to fashion the relationship between individuals. To cope with that function, the underlying valuation of assets and liabilities would have to be more conservative (i.e., book value) in order to calculate profits. Consequently, it is obvious that both functions represent a trade-off concerning the valuation standards.

From a welfare-state perspective, states must decide which role accounting should fulfill in the society. Either states highlight the informational role of accounting and accept that this may cause an unequal distribution of information requirements between corporate constituencies, or states directly intervene in the balancing of interests by defining valuation rules and, thus, making itself a ‘lawyer’ of certain constituencies. Presumably, the decision will not be arbitrarily, but will be influenced by the prevalent societal motives and the expectations of individuals in a welfare-state. Consequently, there would be a connection between the degree to which the state favors one of the corporate constituencies and the welfare typology of Esping-Andersen (1990) comparable to the degree of institutionalizing of social safeguards.

Therefore, the ideal model of accounting in liberal welfare-states would be based on the informational function, whereas the ideal model of accounting in conservative or social-democratic welfare-states would be based on the balancing of interests. This is concluded from the specific characteristics of state interventions embodied in these welfare-states. In liberal welfare-states, e.g. the US or the UK, policies are constructed to promote the sovereignty and rationality of individual actors. The informational role of accounting, therefore, would promote the self-determination of individuals in reaching rational decisions. Furthermore, a distributive intervention of liberal states by balancing interests through state intervention would be contrary to the otherwise purely allocatively motivated interventions to protect the market environment (macro-economic perspective). Moreover, interventions in accounting that gear towards the balancing of interests would curtail the individual leeway in favor of societal interests, which would be inconsistent with the individualistic attitude of liberal states.

In contrast, conservative and social-democratic welfare-states emphasize the state as the venue of rationality (Jepperson 2002). Interventions take place on the assumption that the market process does not lead to a righteous provision of all interests and, as such, the state acts in a paternalistic and distributive manner to compensate for uneven distributions within the society. Correspondingly, the balancing of interests through the definition of conservative valuation rules would promote this approach of state interfer-

ence as the relations among different corporate constituencies could be configured in a way to protect certain groups (micro-economic perspective). Furthermore, the balancing of interests would be in line with the collectivistic attitude of conservative and social-democratic welfare-states.

The aims and goals of accounting determine, in turn, the dominant set of account in the respective welfare-state type. If the predominant regulatory goal is the informational role of accounting, such as in liberal welfare-states, this function is mainly fulfilled by group accounts. Setting different standards for single accounts or ascribing single accounts the function of balancing interests would cause a conflict of objectives. If single accounts are mandatory in liberal welfare-states, they will also fulfill only an informational role. Therefore, one-level accounting systems will be predominant in liberal welfare-states. In conservative and social-democratic welfare-states, the conflict between balancing interest and information accounting can be solved by implementing the informational function of accounting in group accounts while the single accounts continue to balance interests. Hence, the emergence of one-level and two- level accounting systems within nation states is potentially explainable with the different types of welfare-states. Moreover, the differences in the welfare-state type may also explain the divergent relevance of single accounts and diverging accounting requirements for non-listed companies between nation states.

4 Case Study: The UK and Germany

In order to consider the impact that the type of welfare-state has on accounting regulations, we will examine a brief history of the accounting requirements of companies in two different types of welfare-states, namely the UK as a liberal welfare-state and Germany as a conservative welfare-state.[4] An example of material differences of accounting standards will be analyzed by comparing the accounting requirements for internally generated intangible assets.

[4] Drawing on empirical evidence, the classification of the UK as always clearly liberal welfare-state is questionable because the UK turned from a leader in the de-commodification score in 1950 to a laggard in the 1980s (Hicks 1999). However, the provision of social security was to a much lesser extent legally protected and tax-financed than in traditional conservative welfare-states which allowed for comprehensive cutbacks in the UK (Schmid 2000). This arises from the fact that the UK was historically dominated by the ideal of liberalism even before the shift in the 1980s (Esping-Andersen 1990).

Accounting Requirements in the UK Welfare-state

Until the 20th century, accounting regulation in the UK followed more or less a *laissez-faire* approach (Parker 1990). Even after this changed, however, accounting remained only slightly regulated (Napier 1995). In general, financial accounting was only obligatory for businesses with limited liability. However, even for such companies, accounting was mainly seen as a private affair between the company and its stakeholders. Accordingly, recognition and valuation rules existed only in a rudimentary form (Roberts et al. 2005). The overall guiding principle for the preparation of accounts was the requirement to present a ‘true-and-fair-view’ of the company, with a strong focus on the information needs of investors (Walton 1993).

In the UK, the first legal stipulations for financial reporting were established with the Companies Acts of 1900 and 1907 (Roberts et al. 2005). Although companies were required to prepare an audited balance sheet, the selection of valuation and recognition measures for transactions, as well as the format of financial reports, remained in the power of the directors. This remained largely unchanged until the 1980s, when significant changes began to occur due to the UK membership in the European Community (EC). The Companies Act of 1981 implemented the Fourth and Seventh EC Directive (78/660/ECC and 83/349/EEC), which brought accounting principles and valuation rules into company law for the first time. The transposition process of the EC Directives also led to some formal requirements for the preparation of single and group accounts, as the Directives aimed at creating a minimum level of comparability between accounts across the EC. Nevertheless, the British legislator managed to introduce the common principle of accounting in the UK – the ‘true-and-fair-view’– in the directive as overriding principle for the UK (Wittsiepe 2008). Therefore, single and group accounts kept their role as a pure informational instrument for investors. Although single accounts have some relevance for income distribution, it is not legally binding that only the balance sheet profit is distributable to investors, in fact, the directors of the company establish the value they wish to distribute (KPMG 2006). This means that the accounting profit determines neither an upper nor a lower limit of distribution. Since then, accounting standard-setting in the UK has usually followed the developments of standards in the US and by the IASB (Paananen and Parmar 2008).

In 2005, the framework of accounting regulation in the UK changed as a response to requirements of the EU (EC Regulation No. 1606/2002), which requires all listed European companies to prepare group accounts according to IFRS from 2005 onwards. Additionally, the Companies Act of 2006 allowed all British listed companies use IFRS for preparing single accounts and declared that companies with limited liability can opt to report under IFRS or under UK-GAAP (Deparment of Trade and Industry, UK 2003). Quite recently, the British standard-setter decided to issue accounting standards contain-

ing wording directly from the IFRS in order to reduce the differences between the sets of standards. Therefore, there is good evidence for a one-level system because there are very few, if any, differences between the accounting requirements for singe and group accounts, as well as between listed and unlisted companies. For a summary of the accounting requirements in the British welfare-state see Table 1.

Table 1: Accounting requirements of UK firms

	Companies with limited liability		**Other businesses (without limited liability)**	
	Listed	**Unlisted**		
Group accounts	IFRS mandatory	IFRS or UK-GAAP (similar to IFRS)	No regulations	No regulations
Single accounts	IFRS or UK-GAAP (similar to IFRS)	IFRS or UK-GAAP (similar to IFRS)	No regulations	No regulations

Accounting requirements in the German Welfare-state

Until the 1980s, the accounting requirements of German firms were built mainly on the German Commercial Code (*Handelsgesetzbuch – HGB*) and two related legal acts: the Stock Corporation Act (*Aktiengesetz*) and the Publicity Act (*Publizitätsgesetz*) enacted in 1965 and 1969, respectively. This framework followed a micro-economic perspective of regulation and was geared towards the regulation of the relations between the company and its constituencies (Eierle 2005). In general, the applied accounting rules were based on the principle of prudence (i.e., conservative valuation) and single accounts were used to calculate the distributable income. Only some larger groups, such as groups with a stock corporation as parent, had to prepare group accounts. However, the accounting rules that applied to group accounts were also based on the prudence principle, which resulted in single and group accounts tending to not differ (Zimmermann et al. 2008).

In 1985, the German government made major revision to the German commercial code by implementing the EU Accounting Directives Act (*Bilanzrichtliniengesetz*), which contained both the Fourth and Seventh Directive. Although, the Fourth Directive introduced the ‘true-and-fair-view’ concept as general standard for financial reporting, the German legislator chose a very modest approach for transformation (Haller 1992). The legislator resisted breaking with its own accounting principles based on prudence and maintained accounting regulation more in line with its own tradition than with the ‚true-and-fair-view‘ (Ordelheide 1996). This was possible due to the discretionary leeway embedded in the Directives. However, the directives did lead to some major changes, as almost all relevant national accounting rules were shifted to the Commercial Code (Haller 2003a). Thus, the basic accounting rules were codified and made applica-

ble to all business (albeit with some relaxations for certain business types) to ensure a uniform commercial income determination. Moreover, the implementation of the directives enlarged the requirement to prepare group accounts also according to unlisted companies with limited liability, i.e. *Gesellschaften mit beschränkter Haftung* (GmbH). Nevertheless, the implementation of the directives did not fundamentally alter the traditional German micro-economic perspective of regulation, since the basic measurement and recognition principles remained unaltered.

The next decisive reforms of the German accounting law occurred in 1998 and in 2000, respectively, when the German legislator enacted the Capital Raising Act (*Kapitalaufnahmeerleichterungsgesetz*) and the Qualifying Partnership Act (*Kapitalgesellschaften- und Co-Richtlinien Gesetz*). These acts focused on the macro-economic perspective (Haller and Eierle 2004) by highlighting the informational function of accounting in group accounts. All publicly traded groups were allowed to prepare group accounts according to internationally accepted accounting standards (i.e., either IFRS or US-GAAP) instead of using the rules of the German Commercial Code. This caused a stronger differentiation of accounting requirements within Germany between listed and unlisted companies and also between single and group accounts. The differentiation between single and group accounts occurred because the micro-economic perspective of single accounts still served as the basis for the calculation of dividends. In the 2004, The German legislature enacted the Accounting Law Reform Act (*Bilanzrechtsreformgesetz*) in response to the requirements of the EU (EC Regulation No. 1606/2002) and, thus, required all listed groups to prepare their group accounts according to IFRS from 2005 onwards. Additionally, the German legislature now allows unlisted groups to choose between the IFRS and the German Commercial Code. Furthermore, all companies are now allowed to publish single accounts according to IFRS in the German Federal Gazette. However, the German Commercial Code remains mandatory for the preparation of all companies’ single accounts (two-level system), since single accounts still prevail as basis for the calculation of the distributable income (Eierle 2005). For a summary of the accounting requirements in the German welfare-state see Table 2.

Table 2: Accounting requirements for German firms

	Limited liability companies		**Other legal forms**	
	Listed	**Unlisted**	**Listed**	**Unlisted**
Group accounts	IFRS mandatory	IFRS or HGB	IFRS mandatory	IFRS or HGB
Single accounts	HGB mandatory	HGB mandatory	HGB mandatory	HGB mandatory

Referring to the historical development of the accounting requirements, it is obvious that single accounts in the German welfare-state play a decisive role, whereas single

accounts in the British welfare-state play are of minor importance. In the UK, the informational role of accounting is central. This is reflected by the fact that single accounts in the UK are almost extraneous to the determination of distributable income, but also that companies are allowed to use IFRS in single accounts, which mainly aim at investor protection. This seems to back the argument that liberal welfare-states only act to protect the functionality of markets (here: the capital market) to ensure that the allocative mechanism works. Additionally, liberal welfare-states tend to be characterized by a one-level accounting system in which the same recognition and valuation applies for single and group accounts. In Germany, the welfare-state interferes more comprehensively, which is in line with the ideals of conservative welfare-states. The balancing of interests is of primary interest for the state, although the informational role of accounting has gained importance in the past. The legislator solved the trade-off by implementing the informational function in group accounts, which led to a two-level accounting system since the fundamental principle of prudence is kept for single accounts. This shows that the type of welfare-state has explanatory power for the divergence of single accounts as well as for the evolvement of one-level and two-level accounting systems.

Comparing Material Differences between IFRS and German HGB

The effect of the prudence principle, which serves as basis for the German accounting regulation, will be examined by a short and certainly simplified example. In this regard, the differing recognition and valuation rules for the internally generated intangible assets of the IFRS and the German Commercial Code will be contrasted and the impact on accounting numbers will be discussed. Intangible assets exhibit a central relevance for the economic life, particularly with regard to the wave of technical developments; e.g. patents, software or expenditure for research and development (Schmidbauer 2004). However, the recognition rules for intangible assets and especially for internally generated intangible assets differ significantly when looking at the stipulations of IFRS and HGB. Internally generated intangible assets are, e.g., products, process technologies or software which can constitute a large fraction of a firm’s value. The recognition of intangible assets therefore generate decision useful information, as shown in certain empirical studies (e.g. Hepers 2005; Bentele 2004).

According to IFRS, expenditures for internally generated intangible assets can be distinguished into costs that arise either during the research or the development phase. The research phase is defined as the independent and scheduled search for scientific or technical knowledge. During this phase, the incidental costs should be recognized as expenses in the profit and loss account. However, the expenses that occur during the development phase, which is defined as the application of the new findings or knowledge, must be recognized on the asset side of the balance sheet. For the recognition of

development expenses, several requirements need to be cumulatively fulfilled under IFRS, e.g. technical feasibility of completing the intangible asset or the intention to complete the intangible asset and use or sell it. However, the requirements are afflicted with considerable discretionary leeway, which grants space for earnings management. So far the requirements seem fulfilled the expenses of the development phase must be recognized in the balance sheet which results neither in profit or loss. Accordingly, the research and development process only partially reduces the company’s profit.

In contrast, the German Commercial Code generally forbids the recognition of internally generated intangible assets. All expenses that result from the research and development process are recognizable in the profit and loss account. Consequently, the profit squeeze is higher compared to the IFRS regulation. The stipulation is interpretable as an outcome of the underlying principle of prudence of the German accounting standards. Regardless of the future prospects of the research and development process, the German legislator presumes the imaginable worst case: the total loss of the venture.

In academic literature, this principle is often labeled as *unconditional conservatism* (Beaver and Ryan 2005). This is particularly important when the accounting profit is tied to the distributable income, e.g. to the investors through dividends. Due to the non-capitalization of internally generated intangible assets, the realization of profits is postponed untill the future, when the intangible asset is actually sold. Consequently, the expectation of the discounted present value of cash-flows to investors is downsized as likewise the distribution of liquid funds is postponed until the future (Fülbier et al. 2008). The recognition of research and development costs directly in the profit and loss, therefore, protects corporate constituencies whose payments do not depend on the profit of the period but on the financial solvency. This direct mechanism of conservatism is missing in the IFRS. This example backs up the argument that conservative welfare-states are by far more interested in the balancing of interests through accounting than in its pure function as an informational instrument, as is the case in liberal welfare-states.

5 Conclusion

The above analysis supports the idea that different kinds of welfare states, according to the typology of Esping-Andersen (1990), tend to result in different kinds of accounting regulatory structures. Our presented empirical example indicates that there is a connection between the manner in which a given state chooses to balance the interests of various corporate constituency and into which category the state would fall in Esping Andersen’s typology (1990). Conservative welfare-states, exemplified by Germany, rank the role of accounting in balancing interests as higher than its informational role. In comparison, liberal welfare-states, exemplified by the UK, emphasize the informational role of accounting. In this regard, accounting regulation is by no means a purely techni-

cal process that is meaningless to questions about socio-political and economic policies, but a societal institution influenced by the values and ideals of the welfare-states. The established connection between the welfare-state type and accounting has explanatory power for differences in accounting regulation, particularly with regard to the degree of state influence in accounting. On this basis the divergent relevance of single accounts between welfare-states can be explained as well as the diverging accounting requirements for non-listed companies. Furthermore, the convergence process and persisting divergence in accounting regulation can be evaluated against the background of different socio-political objectives. The welfare-state type as an explanatory factor, therefore, sheds further light to the comparative accounting research literature.

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