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The political economy of financial harmonization: The East Asian financial crisis and the rise of international accounting standards

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ABSTRACT

In the aftermath of the East Asian financial crisis, western nations established a new international financial architecture that relied upon enhanced financial transparency and international financial standards, including international financial reporting and auditing standards, to govern an expanding and crisis-prone international financial system. This paper examines the West's response to financial crisis in the late 1990s and its implications for the rise and diffusion of international accounting standards from a theoretical perspective that blends institutional analysis and political economy. The aim is to understand how the history of accounting has both shaped and been shaped by transformations in the late 20th century international political economy where financial capital and the power of the financial sector play an increasingly central role in the process of accumulation.

Introduction

Since the mid 1990s, the institutional arrangements governing financial accounting and auditing practice, which were organized at the national level by state regulators and professional associations for the better part of the 20th century, internationalized at a surprisingly rapid pace. This transformation is evident in the development and widespread diffusion of international financial reporting standards. Standards set by a supra-national body, the London-based International Accounting Standards Board (IASB) and its predecessor, the International Accounting Standards Committee (IASC), catapulted from relative obscurity in the early 1990s to become universally recognized world standards today. Use of International Financial Reporting Standards (IFRS) is now required or permitted in over 100 countries, including the member nations of the European Union. Even in the United States, where support for domestic adoption of IFRS has been mixed, progress toward harmonization[1] has gained ground following a series of regulatory shifts, including the 2002 Norwalk Agreement to achieve convergence between US and international financial reporting standards, and the 2007 Securities and Exchange Commission's (SEC) decision to allow foreign companies to use IFRS in SEC filings without reconciliation to US standards.[2] Although less prominent than the rise of IFRS, the formalization of international auditing standards has, likewise, gained momentum in recent years (see Humphrey & Loft, 2009; Humphrey, Loft, & Woods, 2009; Loft & Humphrey, 2006).

[1] The term harmonization refers to standardization of laws, rules, and regulations governing commercial activities across national borders. Accounting harmonization refers to the standardization of financial reporting standards (i.e. the rules governing corporate financial reporting), auditing standards (i.e. the rules governing the conduct of audits) and/or other accounting-related rules and regulations such as licensing and qualification requirements or ethics rules.

[2] *Memorandum of Understanding between the Financial Accounting Standards Board and the International Accounting Standards Board*, Norwalk, Connecticut, September 19, 2002 (www.fasb.org/memorandum.pdf, accessed February 12, 2010); Securities and Exchange Commission Press Release 2007-235, November 15, 2007 (www.sec.gov/news/press/2007/2007-235htm, accessed February 12, 2010).

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The surprisingly rapid pace of accounting harmonization in recent decades has inspired a stream of interdisciplinary accounting research aimed at explaining the rise of international financial reporting and auditing standards (for example see: Bhimani, 2008; Botzem & Quack, 2009; Camfferman & Zeff, 2007; Chau & Taylor, 2008; Chiapello & Medjad, 2009; Humphrey & Loft, 2009; Humphrey et al., 2009; Loft & Humphrey, 2006). Interest in the forces driving accounting harmonization also extends beyond the accounting literature to the broader field of social sciences, where sociologists and political scientists have turned to the study of accounting harmonization in order to understand emerging forms of global economic governance (see: Armijo, 2001; Botzem, 2008; Eaton, 2005; Martinez-Diaz, 2005; Mattli & Büthe, 2003, 2005; Nölke & Perry, 2007; Perry & Nölke, 2005, 2006; Porter, 2005; Posner, 2009; Simons, 2001).

This study contributes to this literature by examining one episode in the history of international accounting harmonization. The research focuses on an event that the IASB's first Chairman, David Tweedie, frequently cites as a major turning point in the history of international accounting, namely the East Asian financial crisis of 1997–1998 (Street, 2002; Tweedie, 2002, 2008). In the aftermath of the East Asian crisis, finance ministers and central bank governors from the Group of 7 (G-7) nations[3] set in place a so-called "new international financial architecture" to address the problem of systemic instability within the international financial system that had been exposed by the crisis. The centerpiece of their plan to reform the international financial infrastructure was the creation of a new international organization, the Financial Stability Forum (FSF), and the endorsement of a set of 12 financial standards and codes to govern the crisis ridden international financial system by bringing greater transparency to the marketplace. Significantly, the FSF selected international financial reporting standards and international auditing standards as two of the 12 financial standards that would form the foundation for global financial governance. Subsequent support for domestic accounting reforms within the developing world from the Financial Stability Forum, the World Bank and the International Monetary Fund (IMF) contributed to the development and diffusion of international accounting standards in several ways, both practical and ideological.

The history of the rise of international accounting standards in the wake of the Asian crisis is interpreted from a theoretical perspective that blends institutional analysis and political economy, an approach that I call macro-institutional analysis.[4] The lens of political economy allows us to examine the relationship between the process of international institution building within the accounting field and the transformation in late 20th century capitalism that Giovanni Arrighi (1994, 2007) and others refer to as financialization. The aim is to better understand how institutional developments within the accounting field, in this case the rise of international accounting standards, have both shaped and been shaped by the ascendance of financial capital to a dominant position within the world capitalist system.

The following section discusses the research methodology. Section three describes the international financial architecture that was set in place in the wake of the East Asian crisis and the role that international accounting standards played within this emerging system of global financial governance. To answer the question of why accounting figured so prominently in the new international financial architecture, the paper situates the history of the response to the East Asian crisis and the G-7's endorsement of international accounting standards in the context of several features of the international political economy, including the structural crisis of capitalism in the 1970s, the consequent rise of finance capital and dependence of the US and other advanced economies on the growth of the financial sector, the geopolitical influence of the United States in the 1990s as the organizing center of international capitalism, and US finance ministers' support for institutional "reform" within emerging economies modeled on Anglo-American modes of financial governance in order to facilitate the growth and expansion of Western capital markets. The final sections of the paper discuss the implications of G-7s response to the East Asian financial crisis for the diffusion of international accounting standards, the international auditing industry, and prospects for global financial stability.

Analytical approach and methodology

In contrast to international accounting research (Nobes & Parker, 1988) that emphasizes the embeddedness of accounting in national cultures and national institutional forms, this interpretation of the G-7's response to the East Asian crisis and its implications for the development and diffusion of international accounting standards adopts a world-systems perspective (Arrighi, 1994, 2007; Wallerstein, 2004). Power (2009) maintains that the rapidity of accounting internationalization is less surprising if we recognize that accounting has never been a distinctively national affair; long before codification of accounting norms by standard setting bodies began in the mid-20th century, the basic elements of financial accounting had already been widely disseminated as part of what he calls a "world system of accounting" which developed over centuries rather than decades, and which accounts for the non-trivial degree of similarity found across various national accounting systems. Accordingly, Power (2009, p. 325) argues that we need to "rethink the very conception of the 'internationalization' of financial accounting" and "redefine the starting point" for international accounting research. Rather than taking national accounting systems as our primary unit of analysis and viewing the rise of international accounting standards in terms of a movement from national to international accounting norms and the opposition between forces of international standardization and nationally embedded institutional and cultural constraints,

[3] The Group of 7 (G-7) includes France, Germany, Italy, Japan, United Kingdom, United States and Canada.

[4] Although the terminology is my own, the blending of institutional analysis and political economy is not a new concept; it is prominent in the work of economic sociologists, especially within the French regulation school (Aglietta, 1976; Boyer, 1990, 2007). In a prior work (Arnold, 2009b), I make a case for a broader conceptualization of institutional research in accounting that includes a macro political and economic perspective.