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Accounting for varieties of capitalism: The case against a single set of global accounting standards[☆]

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ABSTRACT

This paper argues that the optimal design of accounting standards may depend on the institutional characteristics of the political and economic system. There are several varieties of capitalism, and it is not obvious which of these varieties is best. Moreover, the existence of different varieties of capitalism arguably promotes economic progress. This being the case the paper urges a cautious approach to the imposition of a single set of global accounting standards for all companies. The forced adoption of single form of accounting runs the risk of severely restricting the different forms of capitalism that can develop. It also privileges one particular way of doing business over alternative forms that currently exist or, more importantly, may exist in the future. In effect the forced adoption of a single form of accounting can be viewed as a form of restrictive practice that prevents alternative and superior ways of doing business from taking shape. International accounting standards optimised for stock market based capitalism are not necessarily optimal for other forms of capitalism and, since stock market capitalism has lost credibility as a way of doing business, the world may be better served by encouraging alternative forms of capitalism to develop with accounting standards tailored to their needs.

> *"As we know, there are known knowns. There are things we know we know. We also know there are known unknowns. That is to say we know there are some things we do not know. But there are also unknown unknowns, the ones we don't know."*
> Donald Rumsfeld—Feb. 12, 2002, US Department of Defense news briefing.

We live in interesting times. The UK, in particular, has suffered a major setback as a result of a worldwide recession caused by excessive credit expansion. These events have revealed enormous gaps in our understanding of how financial markets and financial governance systems work. Viewed through the philosophical prism of Rumsfeld we can safely conclude that the number of known unknowns has increased dramatically. Also the number of known knowns has decreased, in the sense that things we thought were known are now known to be unknown. Of course it is unknown whether the number of unknown unknowns has also increased. All we can say with certainty is that we now know the world is more uncertain than we previously knew.

These momentous events have given rise to searching questions about the pace and fragility of stock market based globalisation as an economic and political process. Whereas just a couple of years ago the intellectual and political proponents

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of stock market based globalisation seemed to be defeating all who stood in their way, the intellectual and political opponents of the rush to stock market based globalisation now have an opportunity to be heard. Moreover even some of the proponents of stock market based globalisation as a long term aim, are beginning to ask more intelligent questions about the most appropriate pace with which this aim should be achieved. In particular the wisdom of replacing national institutions and regulatory safeguards built up over centuries with largely unrestricted free global markets in the presence of highly fragile global governance structures is beginning to run into serious opposition.

One major issue requiring attention in relation to these events is the role of financial reporting in general and financial accounting standards in particular. The recent credit crunch has undermined confidence in the competence of accounting standard setters worldwide. How can it be that the financial reports of banks and other financial institutions failed to alert investors to the massive risk exposures they faced, often on the scale of billions of dollars? Are the accounting standards of the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), and other major standard setters good enough? Are they fit for purpose?

World leaders have called for improved international accounting standards. On the 15th of November 2008, following a meeting of the G20 Heads of State, leaders of the World Bank, the International Monetary Fund, the United Nations, and the Financial Stability Forum, the participants published a *Declaration of the Summit on Financial Markets and the World Economy*. This declaration outlined an action plan for the reform of international financial institutions and markets. This action plan contained measures for strengthening transparency and accountability.

The G20 plan calls for the *“key global accounting standards bodies”* to work intensively toward the objective of creating a single set of high-quality global accounting standards (see Appendix 1). Implicit in this statement is the view that current international accounting standards are not high quality. In the light of the recent collapse of the global financial system it is difficult to disagree with this view.

However, the call by the G20 for the key accounting bodies to work toward a *single* high-quality global accounting standard is, in my view, highly questionable. When major financial scandals or collapses occur politicians often respond in haste. Sometimes the cures they propose turn out to have undesirable and unanticipated consequences e.g. Sarbanes–Oxley. Sometimes the proposed cure turns out to be a curse. Thus the purpose of this lecture is to explain why I believe that the call of the G20 for a single accounting standard is unwise. Why, that is, I think it would be a curse.

My arguments are conditioned by a conviction that accounting policy, like all areas of social and economic policy, should be shaped as much as by acknowledging what we do not know as by what we do know. A call to frame a single set of accounting standards, based on an assumption that we know all we will ever need to know in order to frame such standards, seems to me to fail to comprehend the nature of the problem.

1. The wisdom of creating a global monopoly accounting standard setter

The right to set the accounting standard for the entire world would represent a very significant monopoly power. It is somewhat ironic that the political supporters of unrestrained and competitive markets appear to think that free trade requires a monopoly over the setting of accounting standards. The purpose of this paper is to argue that there are fundamental reasons for doubting the wisdom of current attempts to establish a single set of global accounting standards. However, before discussing the fundamental arguments against a single set of global standards it is important for me to point out that my arguments do not involve or imply any judgements on my part about the motivations or competence of the IASB or the FASB.

With regard to motivations I do not doubt the generally good intentions and trustworthiness of these two bodies. Also I would agree that both of these bodies have done many good things for the quality of financial reporting across the world. With regard to competence one can point to concerns about the track record of FASB and IASB. In particular, the recent financial collapse has occurred under the watch of both the FASB and the IASB and this has inevitably given rise to questions about their competence.

However, even if recent events had raised no doubts about the ability of existing regulators to set standards, there are in my view more lasting and more fundamental reasons to doubt the wisdom of granting any accounting standard setting body a monopoly power to set a single set of global standards. Even if FASB and IASB were found to be entirely blameless for the current fiasco, which they may be,[1] there are fundamental reasons for resisting the call for a single set of global standards.

In this paper I present three mutually reinforcing arguments against having a single set of global standards. I start by pointing to the existence of significant disagreements between accounting experts on the scope and objectives of financial reporting. I then go on to discuss the economic literature concerned with how economies respond to risk and uncertainty. This discussion highlights how markets may fail to achieve optimal outcomes under conditions of risk and uncertainty. The role of firms as a response to market failure is highlighted, and the possibility of there being different institutional designs, across which the role and importance of stock markets varies, is explained. Finally, I discuss the literature on *Varieties of Capitalism*, and explore reasons why the variety of accounting models needs to be large enough to accommodate more than one variety of capitalism. The final section discusses the implications of my arguments for the future of international accounting standards.

[1] This is a known unknown.