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Towards a Unifying Model of Systems of Law, Corporate Financing, Accounting and Corporate Governance

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Abstract

It has been noticed by several authors that there seems to be a relationship between a country's type of legal system and its style of financial reporting. Generally, the causality is presumed to be from legal system to accounting system. However, one model of accounting differences has no need for this hypothesis as it rests on two independent variables: colonial influence and equity markets. Indeed, it is suggested that the type of accounting is an influence on the regulatory system of accounting rather than *vice versa*. This helps to explain why the Netherlands has Roman law but approximately Anglo-Saxon accounting. It also allows for the extensive use of US rules or international rules by many large continental European companies. This paper expands on these themes, and extends the model to include corporate governance. It is suggested that the latter also follows more from certain aspects of equity markets than from legal systems or accounting systems.

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Introduction

This paper examines the relationships between four systems: legal, corporate financing, financial reporting and corporate governance. The objective is to make preliminary suggestions towards a unifying model in the shape of a model containing testable propositions.

Nobes (1998) investigated the linkages between the first three of the above systems. This is summarised and elaborated below, and then suggestions are made about linkages with the fourth system: corporate governance.

Terminology

Discussions in the areas of concern to this paper are sometimes confusing because of a lack of clarity in the terminology used. For the purposes of this paper, certain terms need to be defined before proceeding.

The expression "legal system" is used to mean the broad nature of law within a particular jurisdiction. The frequently used distinction between Roman codified law and English common law (e.g. David and Brierley, 1985; van Caenegem, 1988) is an example of the level of abstraction intended here.

"Systems of corporate financing" are ways in which classes of company are financed within a jurisdiction. For example, in some countries, there is a class of public companies which are largely funded by equity issues to millions of investors. Several

systems of financing may exist simultaneously in a country, but one may dominate economic activity.

The term “system of financial reporting” refers to a set of financial reporting practices held in common by the financial reports of a set of companies. The term (sometimes abbreviated here and elsewhere to “accounting system”) covers both measurement and disclosure practices, but is not intended to cover the regulatory system for financial reporting nor such issues as audit. Nobes (1998) draws on previous descriptions and classifications to propose two main classes of accounting. Table 1 illustrates some features of these. Different types of company in a country can use different systems of financial reporting (Roberts, 1995). Further, a single company might use more than one system at the same time in order to address different users or uses of information.

A “corporate governance system” is taken to comprise the elements whereby companies are controlled and managed. This includes such issues as board structure, how dividend policy is set, whom the auditors report to and who sets management remuneration. It does not include the profile of owners and lenders, which is seen as an aspect of financing. Different classes of companies within a jurisdiction may have different systems of corporate governance.

Reasons for international differences in accounting

Elsewhere, Nobes (1998) notes that previous writers have suggested a large number of reasons for international differences in financial reporting. It is proposed that most of these factors are either too vague to be useful or are covered by other factors or

Table 1 Examples of features of the two accounting classes		
Feature	*Class A*	*Class B*
Provisions for depreciation and pensions	Accounting practice differs from tax rules	Accounting practice follows tax rules
Long-term contracts	Percentage of completion method	Completed contract method
Unsettled currency gains	Taken to income	Deferred or not recognised
Legal reserves	Not found	Required
Profit and loss format	Expenses recorded by function (e.g. cost of sales)	Expenses recorded by nature (e.g. total wages)
Cash flow statements	Required	Not required, found only sporadically
Earnings per share disclosure	Required by listed companies	Not required, found only sporadically

are results rather than causes. However two factors stand out as explanations for financing reporting differences across the world: colonial influence and corporate financing.

A majority of countries in the world exhibit accounting systems imposed by or copied from other influential countries. Thus, colonial or cultural influence overwhelm all other factors, sometimes leading to apparently inappropriate financial reporting. For example, an African country which was once a British colony may have no stock exchange but a British-style system of financial reporting which seems most suitable for a country with many listed companies, private shareholders, qualified auditors, etc.

In countries which do not fit this description, financial reporting is particularly influenced by corporate financing systems. It is suggested that financing systems can be divided into four types for this purpose. Nobes (1998) proposes a development of Zysman's (1983) classification, as in Table 2. It is suggested that the equity/credit split explains different measurement practices, whereas the outsider/insider split explains different disclosure practices. Class A accounting (see Table 1) is caused by an amalgam of equity and outsider features (i.e. a category IV financing system in Table 2). In countries with a category IV system, the accounting rule-makers tend to be pre-occupied with this system, so that Class A accounting is spread even to small private companies which are not financed in a Category IV way.

In countries which have traditionally relied on financing systems I to III, Class A accounting will not be the general system in use. However, as a whole country or particular companies move towards system IV, then Class A accounting will follow. Nobes (1998) gives examples, and some are explained below.

Legal systems

Previous writers (e.g. Nobes and Parker, 1988, ch.1) have noted the correlation between common law countries and Class A accounting, and between codified law countries and Class B accounting. Causality has been assumed to be from law to accounting (e.g. Doupnik and Salter, 1995).

One radical feature of the model in Nobes (1998) is that legal systems are not seen as a major and direct explanatory variable for financial reporting systems. Rather, the nature of the regulatory system for financial reporting will follow from the type of

Table 2 Financing systems

	Strong Credit	*Strong Equity*
Insiders dominant	I	III
Outsiders dominant	II	IV

financial reporting system, although this in turn will be linked indirectly to the legal system. The argument here is that there are too many major exceptions to the legal causality model. These can be illustrated now.

First, the Netherlands is a Roman law country but with a Class A system of financial reporting,[1] which seems connected with its large equity market (Nobes, 1998, Appendix). The Netherlands would thus have to be seen as an exception to legal causality. Following the logic of Nobes (1998), we would expect to find a private sector standard setter and permissive[2] legal regulation, despite Roman law and a Civil Code. This seems a reasonable description of the Netherlands (Zeff *et al.*, 1992; Buijink and Eken, 1999).

An alternative explanation for Dutch Class A reporting despite Roman law is that the Netherlands is a small country with extensive influence from overseas, particularly from Britain in the setting up of its accountancy body in 1895 and in the Anglo-Dutch multinationals (Royal Dutch Shell and Unilever) which exert enormous influence (Zeff *et al.*, 1992). This explanation would not run counter to the arguments here, but it would

place the Netherlands in the "cultural influence" part of the model rather than as a refutation of "law causes accounting".

Secondly, Italy is a Roman law country but from the late 1970s to 1994[3] had a quite separate regulatory regime for the consolidated financial statements of listed companies. Such financial statements were not required by the Civil Code but were supervised by the stock exchange regulator, CONSOB.[4] For such reporting, special accounting standards (*principi contabili*) which exhibited several Class A features and were written by a private sector committee dominated by auditors working in the Italian offices of international accountancy firms. These financial statements, unlike most others in Italy, were also required to be audited by external independent experts (*società di revisione*).

A third and more recent problem for legal causality concerns the changes that have occurred in France and Germany, both having codified commercial law. From the early 1990s, increasing numbers of French and German groups have used US rules or International Accounting Standards when preparing their consolidated financial statements. The French position at the end of 1996 is shown in Table 3; the German position from 1993 to 1997 is shown in Table 4. In 1998, laws were passed exempting the consolidated statements of certain listed companies from domestic laws if internationally recognised standards are followed instead, under certain conditions.[5] This led to an increased use of Class A accounting, as Table 5 shows for Germany. Both countries have also set up standard setting bodies.[6]

In summary, all these examples illustrate that Class A accounting is sometimes allowed (or even required) to replace Class B accounting in Roman law countries.

Table 3 French companies publishing 1996 IAS/US data

US GAAP			IAS	
'Compatible' national set of accounts		*Supplementary set of accounts (20-F or full annual report)*	*'Compatible' national set of accounts*	
Fully	*With exceptions*		*Fully*	*With exceptions*
• Bull • Chargeurs • Dassault Systèmes • Elf • Legrand • Rhône-Poulenc • SEB	• Air Liquide • Carrefour • Danone • PSA • Technip	• AB Productions • Alcatel Alsthom • Axa-UAP • Bouygues Offshore • Business Objects • Coflexip • Dassault Systèmes • Elf • Flamel Tech-nologies • Genset • Ilog • LVMH • Péchiney • Usinor-Sacilor • SCOR • Total	• Bongrain • Canal Plus • DMC • Essilor • Moulinex • Saint Louis • SEB • Technip • Thomson • Usinor-Sacilor • Valéo	• Aérospatiale • Béghin-Say • Cap Gémini • Lafarge Coppée • LVMH • Renault • Saint-Gobain

Source: S. Zambon and W. Dick (1997)

Table 4 Some examples of use of IAS and US rules for consolidated statements by German companies before 1998

US GAAP		IAS	
Supplementary set	*20-F Reconciliation*	*Compatible national set of accounts*	*Supplementary set*
Daimler-Benz (1996-1997)	Daimler-Benz (1993-1995) Deutsche Telekom (e.g. 1997)	Bayer (1993-1997) Schering (1993 - 1997) Hoechst (1995- 1997) Adidas (1995 - 1997)	Deutsche Bank (1995 - 97)

Table 5 German use of IAS for 1998

US GAAP	IAS
Daimler-Chrysler	Adidas-Salomon
Degussa*	Allianz*
Deutsche Telekom**	Bayer
Hoechst**	B. Hypo. Bank*
SAP**	Commerzbank*
Veba**	Deutsche Bank
[BASF]	Dresdner Bank*
[Siemens]	Henkel
	Hoechst
	Lufthansa*
	Schering
	[MAN]
	[Metro]
	[Preussag]
	[RWE]

* = new for 1998
** = reconciliation
[ ] = announced plans

Source: Adapted from *IASC Insight*, March 1999

Furthermore, a suitable regulatory system for such accounting develops despite the prevailing nature of the country's legal system.

A linkage in a quite different area is proposed by La Porta *et al*. (1997) who suggest that the nature of the legal system may affect the development of financing systems in a country. For example, common law systems may predispose a country towards the creation of equity-outsider financing. According to the previous section, this would then lead to generalised use of Class A accounting and private sector standard setting.

Pagano (1993) suggests that these arguments connecting legal systems to financing systems are "not completely persuasive" (p.1102). Instead, he proposes that a company's choice to go public involves a trade-off between the advantages of diversification and the costs of flotation and loss of control. In a country with few listed companies, there are capital market imperfections and few opportunities for risk sharing. Such a country's stock market may get trapped at a low level of activity. This may help to explain why Italian and German equity markets do not keep pace with their economies, but it does not explain how the international difference arose in the first place. For that, the legal system argument seems the best available so far, although other elements of culture might play a role but remain to be identified.

Corporate governance

Just as a country can have more than one type of company, accounting system and regulatory system for accounting, so it can have more than one type of corporate governance system. A clear example of this is the requirement in Germany and the Netherlands for certain companies[7] to have two-tier board structures, with the top board (the supervisory board) required to take account of the interests of the work force as well as the owners.

Such an element of corporate governance seems not to be caused by the legal system, because most other codified law countries do not have two-tier boards. Nor can it easily be tied to the accounting system or to the category of financing system, as there seems to be nothing relevant in common between the Netherlands and Germany which is not also to be found in France,[8] Italy or Spain. Similarly, in the UK, the growth of audit

committees and the increased importance of non-executive directors[9] seems not to be linked to a change in legal system, accounting system or financing system.

The concentration of ownership may be relevant here. If ownership is concentrated in the hands of a few owner-managers, there seems to be no need for elaborate corporate governance procedures. If ownership is widely spread, the separation of ownership from management introduces problems which might be addressed by such procedures. The problem here is that, for example, German ownership of listed companies is more concentrated than British ownership (e.g. Franks and Mayer, 1997), but it is the former country which has supervisory boards designed to control the management, set their salaries and receive auditors' reports.

Furthermore, concentration of ownership has greatly increased in the UK over the last three decades (Stapledon, 1996), and this has coincided with an *increase* in the strength of corporate governance procedures designed to control management, such as the rise of non-executive directors and of audit and remuneration committees and the Cadbury (1992) Code and subsequent extensions of it.

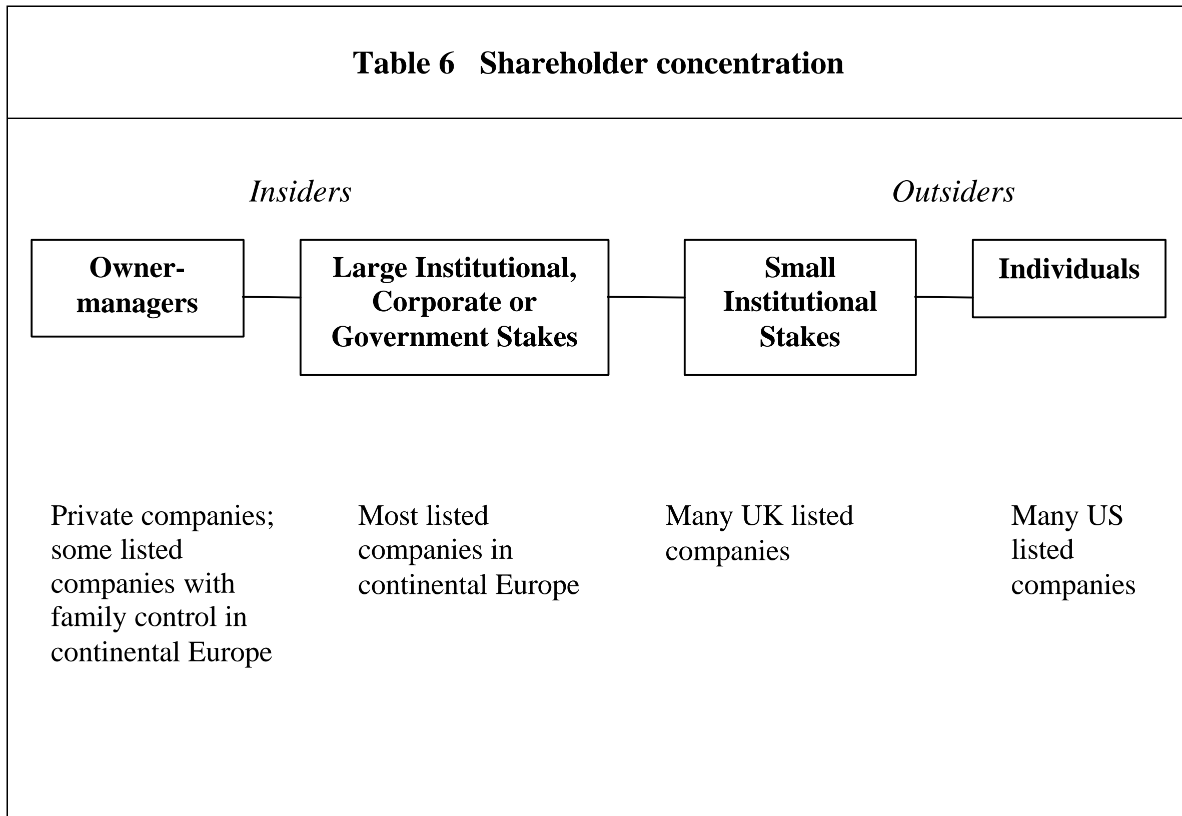
The explanation may contain two elements. First, there are cultural and political factors here. The Germans and the Dutch are more interested in workers' rights than the British or the Americans.[10] Works councils in these countries have extensive rights of information and consultation. The legal requirement for supervisory boards is part of co-determination (*Mitbestimmung*) legislation which is designed to give rights to workers rather than to non-manager shareholders. Furthermore, both the German and the Dutch legislation applies to companies with above a certain size of workforce[11] whether they are public or private. It became compulsory in Germany in 1951 for the coal, iron and steel

industries and in 1976 for other industries. In the Netherlands, it became compulsory in 1971 (Zeff *et al*., 1992, p.11; Dijskma and Hoogendoorn, 1993, p.21) in the context of a prevailing wish to control management and give rights to workers. Similarly, the British interest in corporate governance occurred in the 1990s, coinciding with a major swing of political and social mood after the Thatcher years of unbridled capitalism.

A more "economic" explanatory factor returns to the issue of concentration of ownership[12] and rests upon an elaboration of the insider/outsider categorisation of shareholders identified in Table 2. Two types of insiders can be identified: owner-managers and large institutional, corporate or governmental stakeholders who may be represented by non-executive directors. Table 6 illustrates this, with concentration decreasing to the right. Private companies are generally dominated by owner-managers, and even some listed companies may be actively controlled by groups of descendants of a founder. Many other continental European or Japanese listed companies are controlled by small numbers of 'core' shareholders with substantial share stakes (e.g. Cable, 1985; Franks and Mayer, 1997; Renneboog, 1997). These core shareholders will have formal ways (e.g. as non-executive or supervisory directors) or informal ways of exercising influence and extracting financial information.

Outsiders could also be split into two groups: institutions with small stakes and private individuals. Many UK listed companies have a number of institutional shareholders with small stakes (e.g. 5%, see Stapledon, 1996). In 1992, such shareholders were the largest group, owning 22% of the shares of UK companies (Goergen and Renneboog, 1998). The US is the country with the most obvious dominance of private individuals.

Table 6 Shareholder concentration



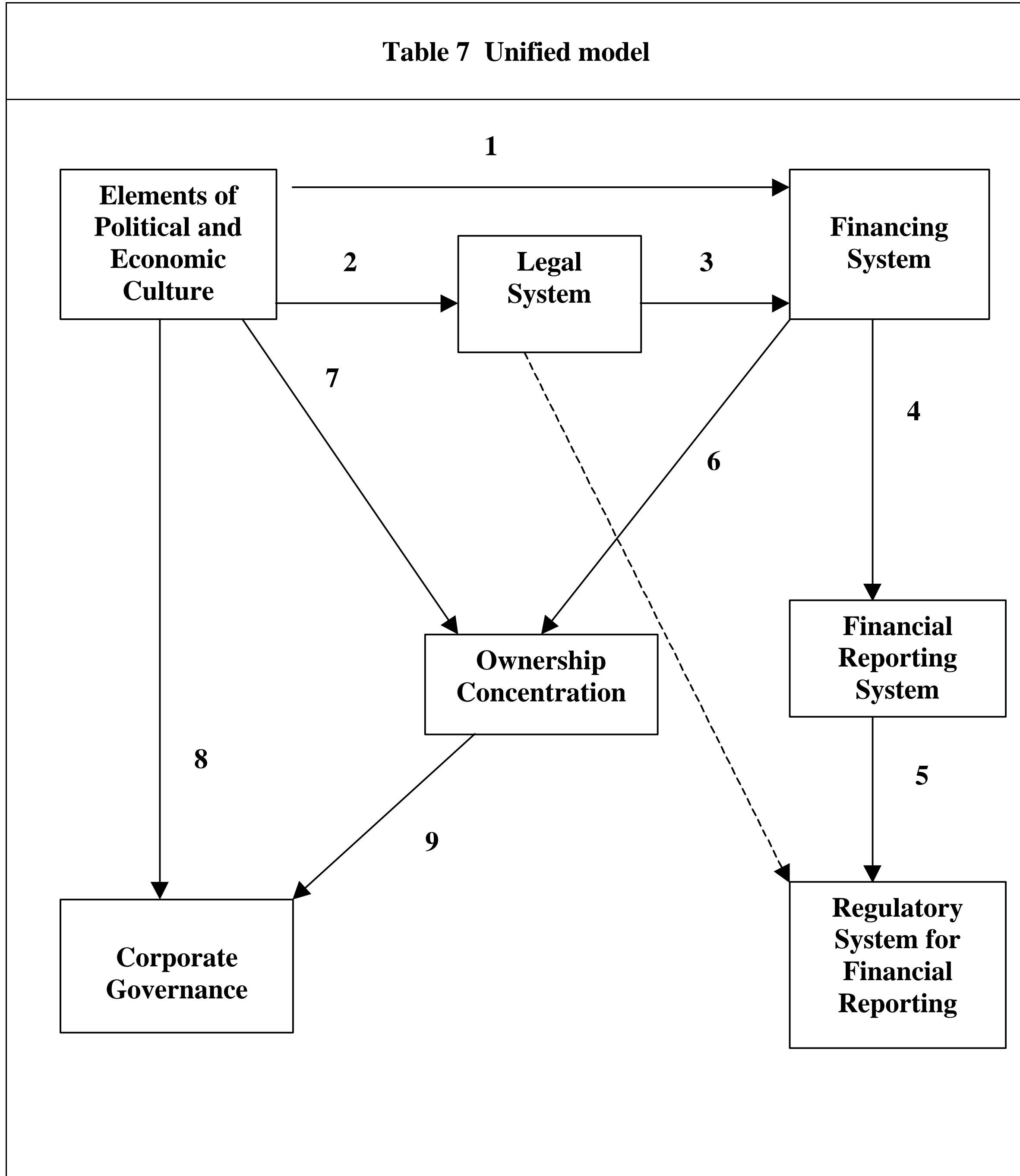
The proposed model is that elaborate corporate governance systems are most likely to be found in the middle two boxes of Table 6. This is because, at one extreme, corporate governance is not a problem for owner-managers. At the other extreme, it is a problem for individual shareholders but they are not powerful enough to impose control on management. In between, the large institutional stakeholders are powerful enough to appoint non-executive directors (institutionalised as supervisory boards in some countries), and the small institutional stakeholders may be jointly powerful enough to impose their will concerning audit committees, the existence of non-executive directors, the separation of the roles of chairman and chief executive, etc. Unlike most individual shareholders, some institutions have expertise and sufficiently large holdings to be taken seriously by management.

The prediction is, then, that corporate governance systems will be weakest in countries and for companies at the two extremes of ownership concentration. Also, as concentration increases in a country for large companies which start from the right of Table 6, so corporate governance issues get a raised profile. This seems to be the UK position in the 1990s.

Summary and conclusions

This paper makes some preliminary suggestions for a unifying model involving systems of law, financing, financial reporting and corporate governance. For many countries, some or all of these systems are imported as a result of colonial or cultural influence. Table 7 summarises the model for other countries. The proposed linkages have been discussed above and are shown as numbered arrows as follows:

1. Pagano (1993) provides good reasons for small and large equity markets to remain in their respective positions. How they get to their positions in the first place is not well established. Various economic and political reasons may be involved, as well as law (see 3).
2. The legal system can be seen as being determined by culture or as part of culture. Clear explanations of the direction and mechanism of influence seem lacking.
3. La Porta *et al.* (1997) provide arguments and evidence for a connection between legal system and financing system.



4. Nobes (1998) suggests that, except for culturally dominated countries, the main influence on class of accounting is type of financing system.

5. It is proposed that the regulatory system for accounting is a *result* of the class of accounting not its cause.
6. The degree of ownership concentration will depend partly on the system of corporate financing. Unconcentrated ownership can only exist in equity/outsider systems.
7. Ownership concentration may also be influenced by other economic factors yet to be specified.
8. To the extent that ownership concentration (see 9) does not explain different regimes of corporate governance, they may be partly a question of political mood.
9. The concentration of ownership may be an explanation of the corporate governance procedures adopted.

The following propositions form part of this model:

P_1: Common law countries tend to have strong equity markets.

P_2: For culturally dominated countries, the financial reporting system will be imported.

P_3: For other countries, Class A accounting (see Table 1) will be found when there is equity-outsider financing.

P_4: A non-codified regulatory system for financial reporting will be adopted to regulate Class A accounting even in codified law countries.

P_5: Ownership concentration can only be very low in equity/outsider financing systems. Corporate governance systems will be weak for countries or companies with very high or very low ownership concentration.

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FOOTNOTES