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The political economy of International Accounting Standards

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ABSTRACT

On 1 January 2005, all stock exchange listed companies in the European Union (EU) began using International Financial Reporting Standards (IFRS) written by the International Accounting Standards Board (IASB). This article argues that the IASB's introduction of fair value accounting reflects and reinforces changed relations of production in which the financial sector increasingly dominates the productive sector, nationally institutionalized economic systems are undermined, and new forms of economic appropriation are validated. As a private body, the IASB has been able to rapidly introduce the fair value paradigm with little public debate outside specialized financial circles. In contrast to more functionalist views, this article argues that accounting standards are inherently political. Accounting numbers provide some of the key economic anchors around which social relations are structured. Accounting techniques cannot be reduced to questions of efficiency since they set out to quantify and compare things which, by their very nature, are neither quantifiable nor directly comparable.

KEYWORDS

Accounting; International Accounting Standards Board; private authority; capital; financialization; varieties of capitalism

1. INTRODUCTION

On 1 January 2005, all stock exchange listed companies in the European Union (EU) began using International Financial Reporting Standards (IFRS)¹ written by the International Accounting Standards Board (IASB). The adoption of IFRS in the EU marks a critical turning point in two regards.

Whereas accounting standards in the EU have previously been set at a national level by a combination of public and private actors, the process will

now be managed internationally by a London-based organisation whose parent foundation is a private company incorporated in the US state of Delaware. To what extent are we therefore witnessing a transfer of authority from national to global and from public to private?

There are also important substantive changes taking place in the standards themselves—it is not simply a question of harmonisation and ironing-out a few minor discrepancies between the old national standards. Intense controversy surrounds the new standards, as any reader of the financial media could confirm. More is to come: as Sir David Tweedie, head of the IASB, put it in an interview with the *Financial Times* ‘There will be blood all over the streets’ (FT, 2004b).

The question is: whose blood? Accounting is a system for measuring economic activity and therefore, in an economic world characterized by division and specialisation of labour, it is an important and necessary social practice. Resolution of social conflict over resources is not simply recorded by accounting after the event; rather, accounting numbers themselves form the basis for such resolutions. Accounting impacts the lives of everyone in society, even (or perhaps especially) those who know very little about the subject and have never set eyes on a financial statement. Looking only at the substance of accounting standards (as often done by accounting scholars) or only at their mode of governance (the typical political science perspective) is inadequate. In this article we aim to do both. First we explain how newly instituted accounting techniques for defining and valuing business assets, chief among them fair value accounting (FVA), are integral to the ongoing reorientation of the international political economy. Second we argue that although the IASB is not the root cause of this reorientation, it has nevertheless served to codify the political economic changes through the introduction of new accounting standards. The IASB has been able to do this rapidly and largely unchallenged because of the particular form of transnational private authority which it represents.

Our analysis of accounting standards and their setting is different from that of practitioners and mainstream accounting scholars who assess standards in terms of their efficiency, and whether they reduce principal-agent conflict and information asymmetries. After critically reviewing these efficiency arguments we offer an alternative comprising three complementary perspectives from the field of political economy. We support these perspectives with empirics from three specific areas of accounting impacted by IFRS. Questioning the portrayal of FVA in principal-agent terms, we instead argue that the new standards represent a shift in power from production to finance. From a Varieties of Capitalism perspective, we show how harmonized IASB accounting standards favour the Anglo-Saxon over the Rhenish model. From the perspective of capital theory, we demonstrate how the standards institutionalise new forms of assets which herald an era of intensified economic restructuring.

Our argument is mainly relevant for three literatures: (1) In context of the current discussion about comparative corporate governance and the varieties of capitalism (Erturk *et al.*, 2004; Gourevitch and Shinn, 2005; Hall and Soskice, 2001; O'Sullivan, 2003), our article offers a first assessment of current changes in international accounting regulation. Transparent accounting is a pre-requisite for effective corporate governance, but the implications of its international harmonisation for different systems of capitalism have hardly been considered until now, although some observers argue that the accountancy profession is a major driving force of recent reforms in corporate governance regulation (Dewing and Russell, 2004: 310–1). (2) From a more general political economy perspective, accounting also plays a crucial role within current discussions about the changing nature of capitalism, in particular about the shift from industrial to finance capitalism or from corporate liberalism to neo-liberalism (Overbeek, 2005; Van Apeldoorn, 2004). Notably, the rise of institutional investors (Harms, 1998; Langley, 2004) has led to an increasing focus on relations between the financial and productive sectors. A substantial shift in accounting methodologies can tilt the balance between the two, as we will demonstrate later. (3) International accounting regulation is one of the most fascinating cases of private authority in international affairs (Biersteker and Hall, 2002; Cutler *et al.*, 1999; Sinclair, 1994), given that the rulings of a private body are being made obligatory for more than 7,000 listed companies in the EU alone. Although accounting has been mentioned frequently in the literature on the increasing role of private actors in global governance (Braithwaite and Drahos, 2000: 121–2; Germain, 2004: 15; Sassen, 1999: 413–4; Strange, 1996: 135–46; Woods, 2002: 31;) it is rarely studied in much detail and few political economists analyse the substance of what is being regulated.

2. CURRENT CHANGES IN THE SUBSTANCE OF ACCOUNTING REGULATION

We argue that the most significant change which International Financial Reporting Standards (IFRS) bring to accounting is in the role and valuation of assets. This change presents itself in two forms: Fair value accounting (FVA) and the balance sheet approach. In this section we offer an introduction to these concepts. For readers with no prior specific accounting knowledge, our appendix briefly defines some basic accounting terms and relates them to the political-economic issues with which this paper is concerned.

As financial magnitudes, asset values are the key quantitative anchors around which capitalism is organized. The way in which assets are valued and defined is thus a central parameter in socio-economic relations. Accounting is not the sole authority for valuing assets but, by institutionalising and codifying methods for doing so, it is an extremely influential reference that both reflects and reinforces broader social changes—phenomena

that we examine more closely in Section 3 of this article. Whereas accounting traditionally valued business assets at their historic cost, IFRS now applies fair value accounting (FVA) techniques to an increasing range of assets. Set against historic-cost accounting, FVA represents a significant shift in thinking because it removes the direct link between what a firm paid for an asset and the value the firm attributes to that asset in its statutory financial statements. The IASB defines fair value as '... the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction' (IASB 1999—IAS19, Section 7: definitions). Fair-values are thus closely related to market-values. However, some caution should be exercised in equating fair value directly with market value since not all assets are traded on active markets and so sometimes a model is used to reach a 'synthetic' market value. This practise has given rise to much debate among accounting scholars about how to calculate a fair-value (see for example Barth and Landsman, 1995; Gray, 2003). Likewise, from the practitioner's side, global accounting firms have highlighted how the term 'fair value' is misused by accounting regulators to cover a wide range of valuation models, of which a *direct* market value is only one (Ernst & Young, 2005).

The measurement of any asset involves discounting the future into a present value. Someone will only pay for an asset if they expect it to yield future income, whether in money or in kind. As Pixley (2004: 141) puts it, 'Value is future-oriented. If accountants stuck firmly to making statements about the past, they could not value fixed capital'. Since the future is inherently unknowable, any precise value placed on an asset is ultimately an estimation of the future, rather than a simple fact. This is true of both historic cost and fair value accounting, with the main difference between them being the timing of the estimation, and who does it. Under historic cost accounting, the estimation is made in the past by the buyer and seller, and validated by a transaction. Under fair value accounting the estimation is made today by the market, or by an auditor modelling the market, and is not necessarily validated by a transaction. Uncertainty is unavoidable in both types of accounting.² As Pixley asserts, 'uncertainty is never settled by bookkeeping, only allayed or repressed' (ibid, 2004: 138).

Nevertheless, the IASB and the US Financial Accounting Standards Board (FASB), which are committed to a long-term convergence project (IASB, 2002), clearly believe that the FVA approach to such inherent uncertainty is, in many cases, superior to historic cost. Both regulators are keen to extend FVA to more areas of accounting, as evidenced by the FASB's publication of its exposure draft 'Fair Value Measurements' (FASB, 2004), which the IASB has also embraced (Ernst & Young, 2005), proposing a framework for measuring fair value that would apply broadly to financial and non-financial assets and liabilities. The document lays out a 'fair value

hierarchy' (FASB, 2004: paragraphs 14–24) which gets around the lack of active markets for some assets by allowing the modelling of fair value on the basis of expected future income streams—in other words simulating what a rational market participant would do.

The use of FVA techniques for asset valuation is all the more important given that the IASB also promotes the so-called balance sheet approach, whereby corporate performance is increasingly judged from the perspective of asset values on the balance sheet as opposed to cash-flows on the income statement (see appendix for definitions). As such, assets and liabilities rather than operating income become the reference point for calculating financial results (Barker, 2003). Taken to its limit, the balance sheet approach is conceptually equivalent to the proposition that profit can be expressed in terms of changes in wealth. The IASB refers to this extreme version of the balance sheet approach as 'comprehensive income' and, at the time of writing, had a special project led by Dr Barker investigating how to apply comprehensive income to accounting (IASB, 2004b). One of the weaknesses of the balance sheet approach is that, when combined with FVA, it leads to an increased volatility of profits caused not by core business activities but instead by re-measurements of asset values (Bernstein, 2002). This weakness is recognized by standard setters who propose a new kind of income statement, whereby profit is expressed as a *range* rather than a single figure, and enough supporting data is disclosed for users to subsequently make their own calculations according to their particular preferences (Barker, 2003: 21, but also Damant, 2003b: 12).

It should be noted that both FVA and the balance sheet approach are part of an accounting trend with roots beyond the IASB. Nevertheless, the IASB represents a grouping of (mostly Anglo-Saxon and English speaking) accounting specialists who strongly support both changes, and who have had considerable success getting them incorporated into new accounting standards. Of the two changes FVA is the more substantial. IASB standards bring FVA to many important areas of accounting including intangible assets (IFRS3), the recognition of financial assets and liabilities (IAS32), the measurement of financial assets and liabilities (IAS39), agricultural commodities (IAS41), and pensions (IAS19). The first three of these are analysed in Section 3. The balance sheet approach plays a supporting role to FVA since it increases the extent to which profits are driven by changes in asset values. So far, however, the IASB has not issued any explicit rulings on comprehensive income or the balance sheet approach (FT, 2005b), but rather has incorporated the concept implicitly into FVA standards which require asset value adjustments to show up in the profit and loss result. For this reason the analysis which follows is focussed on FVA and the concomitant shift away from traditional historic-cost accounting.

3. THE MEANING OF FVA: THEORETICAL PERSPECTIVES

3.1 FVA: The Efficiency Perspective

Mainstream analyses of accounting standards, written both by practitioners and accounting scholars (but with notable exceptions in critical accounting—see Section 3.4), generally assume a functionalist perspective. Mirroring the functionalist notion of a rational-bureaucratic technocracy emerging as a benevolent social driving force (Mitrany, 1975), the IASB is described as having ‘emerged . . . to establish high quality International Financial Reporting Standards and to engineer [international] convergence’ (Zeff, 2002: 43).

In particular, the availability of timely and reliable information about firms’ finances is seen as a functional requirement of an economic system which is supposed to efficiently allocate social resources through capital markets. To operate efficiently, capital markets need to predict a firm’s future income streams based on the resources which it controls. Efficiency proponents of FVA argue that traditional historic-cost based accounts are inadequate for this purpose (Barlev and Haddad, 2003; Damant, 2003a). Rather than giving an accurate picture of the resources that a firm controls, historic-cost accounts simply tell management’s story about what they have done with investor’s money, the so-called ‘stewardship’ approach (see, for example, Berry, 1999). Such accounts are said to contain irrelevant data because they are based on the initial values of assets and liabilities which are often very different from their current economic values (Damant, 2003a).

The IASB itself also tends to present IFRS and FVA in terms of increasing market efficiencies. In explaining his organisation’s application of FVA, the vice-chairman of the IASB makes his case plainly: ‘[it is] not our objective to get away from economic reality . . . There is nothing more real than the value of an asset today’ (FT, 2005a). Historic-cost accounting practises are seen as distorting this ‘economic reality’ because they enable profit-smoothing via the under-reporting of asset values, which in turn leads to a misallocation of resources (Ball, 2004). FVA techniques, on the other hand, are said to give capital market investors the most direct and objective data upon which to base their resource allocation decisions. This corresponds with the stated aim of the IASB’s constitution, which does not mention the stewardship function anywhere and instead gives prominence to the predictive uses of financial statements that ‘help participants in the world’s capital markets and other users make economic decisions’ (IASB, 2004a). Wherever FVA is applied, proponents assume its transparency will imply fewer surprises for investors and so less uncertainty and lower risk. Since mainstream finance theories assert that lower risk translates into lower returns being demanded by investors, the transparency of FVA is

expected to reduce the cost of capital for society at large. FVA can thus be sold by its proponents as a cornerstone for societal progress: '... even a small improvement in efficiency of the major capital markets will lead to an enormous increase in wealth... the benefit to even the poorest members of society and the poorest countries will be very significant indeed' (Damant, 2003a: 12).

However, even among those who see accounting standards largely in terms of technical efficiency, not all share such a rosy view of FVA. Bernstein (2002) says that the choice between historic cost and FVA amounts to a choice between economic reality and comparability. While FVA accounts might better reflect current economic reality and might theoretically have more predictive power, he claims that the number of complex and subjective assessments required to produce an FVA financial statement means that the results are not comparable between different time periods or between different firms. Barth and Landsman (1995) highlight practical problems with FVA, explaining that in an ideal-type world of perfect and complete markets a fair value balance sheet would reflect all relevant information but, under more realistic assumptions, fair values are poorly defined.

To sum-up: Those who question FVA from within the mainstream efficiency perspective of accounting claim that the paradigm introduces as many arbitrary judgements into financial statements as it purports to remove from them. So far they appear to be losing the argument, although this may change now that the big accounting firms are becoming more openly critical of the way the IASB is proceeding with FVA (see for example Ernst & Young, 2005). In contrast, those supporting FVA do so on the basis that markets have become more sophisticated in their ability to process (and price) detailed financial information. It is argued that shareholders no longer need managers to interpret economic reality for them; much better to get the raw data and do it themselves. Management should focus on strategy while shareholders should be left to evaluate that strategy. Proponents claim that an FVA balance sheet will focus shareholders' attention on whether managers are getting the best possible returns on the assets they control, causing a substantial change in the latter's perception of their duties to the former (Barlev and Haddad, 2003). As such, FVA accounting standards are expected to increase management efficiency and reduce the principal-agent conflict.

3.2 Where is the Principal? Power to Fund Managers and the Financial Sector

It is our contention that the efficiency-based arguments presented in the preceding section make a fundamental conceptual error at the outset: FVA supporters portray the paradigm in principal-agent terms, claiming that

it reduces principal-agent conflict and increases overall efficiency. In this section we demonstrate why such an analysis is mistaken: First we present FVA as an agent-agent struggle played out between different economic sectors; second we use the example of a specific FVA standard to analyse this struggle in terms of finance and production, and show that it has less clear-cut implications for efficiency.

In summarizing their analysis of FVA's effects on the management of the firm, Barlev and Haddad (2003) make the following claim:

We may expect a change in the perception of financial statements by shareholders. In preparing historic-cost based financial statements, managers have a dominant power over the process. They are able to manage income and to 'window-dress' the statement of financial position. Hence, the manager's voice is clearly heard and is highly reflected. Shareholders must, therefore, be tuned to the manager's voice. The FVA paradigm reduces the manager's voice in favour of the market's voice [which] takes its power from . . . fair values, which are independent of the manager's influence. (Barlev and Haddad, 2003: 384)

In short, FVA shifts power from managers to markets, which benefits shareholders. In this analysis, shareholders are the principals, managers the agents, and the market is a mechanism for obtaining the most relevant asset values. However, the ultimate owners of shares do not—for the most part—actively participate in trading them and allocating their capital. Instead, that task falls to investment funds, pension funds, insurance companies and the proprietary trading desks of large international banks. Thus, we should replace the term 'shareholder' in the earlier citation with 'trader/fund manager'. Similarly, market-based asset prices do not represent some sort of abstract social equilibrium, but rather they represent the actions of marginal buyers and sellers, driven by the views of dominant market analysts and pundits who do not necessarily make the long-term calculations which reflect broader societal interests. Thus, we replace the term 'market' with the term 'financial analyst'. For clarity we also replace 'manager' with the more precise term 'enterprise manager'.

We now get a different interpretation of Barlev and Haddad's observation: Under FVA, financial analysts gain power and traders/fund managers pay more attention to them; enterprise managers lose power. All three are agents of one kind or another. Most of the real principals in the financial system—i.e. investors, savers, pensioners and future pensioners (workers)—are not in the picture. The only missing category of principal, wealthy private blockholders of shares, already have access to detailed inside information by virtue of their close relations with management so it is doubtful that they gain from FVA in the way the efficiency perspectives would have it.

With the agents that gain power being located in the financial sector, a fuller understanding of FVA needs to consider how that sector operates and how it relates to the rest of the economy, i.e. the productive sector (which we take here to include all non-financial services). It has become common to claim that finance has been disintermediated. On one important level this is true: in recent decades corporations have come to rely far less on bank loans (i.e. savings intermediated by banks) to fund their investment. They now go directly to the capital markets and sell corporate bonds or issue new shares. In this process, as Sinclair (2005) has shown, the credit rating agencies have become an exemplar of private authority. However, while this has reduced the need for some traditional banking activities, it is perhaps too soon to talk of *fully* disintermediated finance: The majority of the financial system's capital base still comes from relatively fragmented wealth which is not controlled directly but rather is controlled by intermediaries, the most important being the funds and the largest international banks. In other words, while investment *risk* has been disintermediated (i.e. risk is passed on directly to the principal), *control* has not.

The dispersal of risk away from the core financial intermediaries, combined with the retention of financial control by them, is a central feature of the process broadly referred to by political economists as financialisation. Building on our reinterpretation of Barlev and Haddad's analysis earlier, we now use the controversial accounting standard IAS 39 to demonstrate that certain aspects of FVA are integral to the ongoing process of financialisation.

An important empirical characteristic of financialisation is the steadily expanding volume of financial assets which has appeared on the balance sheets of non-financial corporations in recent decades (see Crotty, 2002; Krippner, 2005). IAS 39, and the earlier US standard upon which it is based, relate directly to this phenomenon because they prescribe how to measure financial assets in accounting statements. These standards require that financial assets be listed on a company's balance sheet at their fair values (either market value or, where an asset is not actively traded, a model of market value). Furthermore, any changes in those values are carried directly to the income statement, therefore impacting the company's profit or loss result (IASB, 2003).³ Historical analyses of non-financial corporations in rich-economies show that, on average, they now make as much as 40% of their net income from financial transactions compared to just 10% in the 1950s and 1960s (Crotty, 2002; Duménil and Lévy, 2004; Epstein and Power, 2002; Krippner, 2005). In this regard, IAS 39 should be understood as both reflecting and reinforcing the subordination of production to finance, so that the profits of the productive sector become increasingly related to movements in financial markets (as opposed to product markets). This in turn has led to an overall transfer of profitability between sectors at the macroeconomic level: The creation and trading of a whole

new range of financial assets in recent decades has been accompanied by a sharp reversal in fortunes of finance and production to the extent that the profit-share of the financial sector (as a ratio of GDP) is now larger than that of the productive sector, despite the financial sector being significantly smaller by most other measures (see, for example, Krippner, 2005 on the US and Dumenil and Levy, 2001 on France).

A second characteristic of financialisation, also directly related to FVA, is the restructuring of corporate activity to meet targets set by the capital markets, i.e. by the analysts, banks and funds. Froud *et al.* (2000) explain how this aspect of financialisation has been fuelled by the rise of shareholder value, which originated as an add-on to historic cost accounts, introduced in the 1980s by management consultants, with the aim of incorporating changes in asset values and other forms of future income into measures of corporate performance. Because the logic of today's FVA paradigm corresponds precisely with these aims, FVA's introduction effectively institutionalises this second facet of financialisation in the form of accounting standards. In as much as they are a mirror of shareholder value, FVA accounting standards thus serve to intensify the transformation of corporate strategy from '*retain and reinvest to downsize and distribute*' (Lazonick and O'Sullivan, 2000: 17; emphasis added).

In summary, to say that FVA increases efficiency requires not only that one defines efficiency purely in pecuniary terms (as opposed, for example, to industrial terms), but also that one measures such pecuniary efficiency exclusively from the perspective of the financial sector.

3.3 National Differences: FVA and the Varieties of Capitalism

Although the continuing rise of the financial sector has been a phenomenon of all advanced capitalist societies in recent decades, it affects national economic systems to varying degrees, and with very different consequences. This argument becomes clear, if we examine the implications of FVA from the perspective of the Varieties of Capitalism debate (Albert, 1991; Hall and Soskice, 2001). The most widely used and comprehensive version of the Varieties of Capitalism-model (Hall and Soskice, 2001) is based on two ideal types: Coordinated Market Economies (CMEs) and Liberal Market Economies (LMEs), which are, respectively, illustrated with the cases of Germany and the USA.

The defining characteristics of the CME (or 'Rhenish') model are the consensual (for the most part) relationship between labour and capital, the supporting role of the state, and the availability of patient capital provided either by major banks (*Hausbanken*) or from internally generated funds. These characteristics are seen as conducive to a relatively long-term perspective with regard to economic decision making in the private sector. Stable ownership and control structures provide firms, including

the small and medium-size *Mittelstand* companies, with considerable protection against hostile take-overs. All of these factors support the long-term investment in human resource development that is crucial for CME specialisation in high skill and quality products based on incremental innovation.

The second ideal-type, the Liberal Market Economy (or 'Anglo-Saxon') capitalist model, is characterized by more adversarial management-labour relations, comparatively short-term employment, the predominance of financial markets for capital provision, an active market for corporate control, and an increased emphasis on short-term price movements on stock markets. This model arguably yields comparative advantages in sectors with a premium on particularly fast moving and/or capital intensive sectors such as biotechnology and high value-added services. As Section 3.2 makes clear, the shift to FVA serves to reinforce the already powerful role of finance in the Anglo-Saxon variety of capitalism—both in terms of the agency of financial analysts/fund managers versus enterprise managers, and also more structurally at a sectoral level as finance versus production. However, given the already powerful role of finance in the Anglo-Saxon type of capitalism, the consequences for the Anglo-Saxon model in this respect are more limited; the introduction of the FVA paradigm is compatible with, and complementary to, existing political-economic arrangements.

In contrast, within the Rhenish capitalist model, the rise of FVA has more disruptive consequences. It makes the familiar (Rhenish) practice of hiding revenues in the balance sheet significantly harder—and thereby limits the build-up of hidden internal reserves for long-term strategies. In this regard there is a clear contrast between IFRS and the rather conservative and prudent accounting approach under, for example, the German Handelsgesetzbuch—which is characterized by low book values of assets, overstated liabilities and 'hidden reserves' (Ball, 2004: 103). This conservative approach evolved under the influence of the Hausbanken, who were primarily concerned with ensuring the security of their long-term loans to enterprises and so took a relatively cautious view of the future, acknowledging its inherent uncertainty.⁴ However, it is not only the Hausbanken who are less interested in short-term financial performance and more interested in enduring solvency and stability. The same perspective applies to other sources of investment capital in the Rhenish model, especially paid-in owners' equity which is an important source of funding for the *Mittelstand*. In addition, hidden reserves are expedient for enterprise managers since they can be used to smooth-out good and bad years—at least for a certain period of time—thereby avoiding conflicts with shareholders, and hence also with workers.⁵

In the Rhenish model, the introduction of FVA-based accounting standards takes away the 'primary accounting tool available to reduce earnings volatility' (Ball, 2004: 125). Whereas enterprise managers previously

had considerable discretion over when to recognise unrealized gains and losses, the fair value approach calls for changes in the capitalized value of *future* income to be shown on the balance sheet immediately. Financial analysts can now exert pressure on enterprise managers to put these resources to more productive, and often rather short-term, uses. While the move to FVA in both capitalist models is seen to strengthen the position of shareholders *vis-à-vis* managers, in the Rhenish model FVA also impacts a broader socio-economic arrangement between workers, employers and other so-called 'stakeholders' which was built on the basis of more prudent accounting. Thus, the well-known 'pressures of short-termism that plague American and British companies—pressure from shareholders to maximize dividends by concentrating on quarterly results and short-range return on investment' (Sally, 1995: 69) are likely to arrive alongside FVA, bringing with them a more conflictive relationship between corporations and representatives of labour.

The potentially destabilizing consequences of the rise of FVA on the Rhenish variety of capitalism are well-illustrated by IASB accounting standard IAS 32, and the strong opposition its pending adoption has raised from the German 'Mittelstand'. The term 'Mittelstand' refers to the small- and medium-sized, mostly family owned companies that form the backbone of German industrial production. Such companies are typical of the consensual and long-term perspective of the Rhenish variety of capitalism, based on close consultation with 'Hausbanken' and workers councils. At present, EU regulations require only publicly-listed companies to use IASB standards, which makes most 'Mittelstand' companies exempt. However, there is a clear intent on the part of the IASB to extend IFRS to non-listed companies and thus avoid inconsistency within accounting practises of individual EU countries (IASB, 2006). Furthermore, many 'Mittelstand' companies would like to use IFRS not only to enable their international customers to understand them better, but also to access international capital markets (e.g. private equity capital). Finally, the drive towards an extension of the application of IFRS is intensified by the forthcoming implementation of the Basle II capital adequacy accord in 2007 that stipulate an improved validation of credit risks, preferably on the basis of the internationally accepted IASB standards.

For 'Mittelstand' companies, by far the most controversial standard is IAS 32, which stipulates how to account for equity capital. The current version of IAS 32, as revised in 2003, classifies the paid-in capital from members or partners in a Mittelstand company as a financial liability—and not as equity—because the capital is, in principle at least, repayable. In addition, IAS 32 demands that this 'liability' is accounted for at fair value, which in this case is the current market value of the company, based on future earning expectations by the market. The net effect of IAS 32 will not only be to strip Mittelstand companies of their equity capital, but

also to substantially increase their liabilities because the fair value of the company is in most cases much higher than the value of paid in capital. The expected result is that these companies will find it very difficult to mobilize new credits, particularly under the risk-sensitive Basle II agreement.

Reclassifying the money that has been invested by the owner families as long-term debts and assessing the value of these debts based on FVA would seriously undermine the capital base of many of the more than 900,000 'Mittelstand' companies. In the context of the Basle II agreement this would dramatically raise their borrowing costs, effectively driving many to close or sell themselves to larger companies. It is therefore no surprise that, in recent years, the drafting of IAS 32 has caused massive protest from German business, leading to critical IASB comment letters from German associations such as the German Cooperative and Raiffeisen Confederation (DGRV, 2005) or the German Accounting Standards Committee (DRSC, 2005). In addition, large family-owned companies such as Bertelsmann, Freudenberg, Heraeus, Haniel, Oetker and Holtzbrinck are also similarly affected by this regulation and have thus formed an *ad-hoc* group to oppose such an implementation of IAS 32. In this we can see a clear clash between domestic social constituencies and transnational private governance, so far without success for the former (FAZ, 2005), and where the latter represents the imposition of a unified financial investor perspective with little apparent regard for the particularities of the institutional structures of differing varieties of capitalism. Changes in accounting practices thus have the very real potential to threaten the basis of the Rhinish capitalist model since its elements are highly interdependent and not easily transferred or exchanged.

3.4 Capital Pricing, Income Division and Economic Restructuring

In the preceding sections we argued, in contrast to the rather apolitical efficiency perspective (Section 3.1), that the shift towards FVA institutionalises significant changes in the balance of forces between different social constituencies. In this section we extend our argument by demonstrating how FVA, through the pricing and validation of new capital assets, can restructure relations of appropriation among corporations, and also between these corporations and their respective labour forces. To do this we draw on a long-standing controversy in the field of economics to critically examine the logic of IFRS 3, an FVA accounting standard which prescribes how to measure intangible assets acquired in a corporate takeover.

We start by explaining why the quantity of capital which an economy employs in production is ultimately an arbitrary magnitude, and how this reveals the role of accounting in maintaining the illusion of capital as scientifically quantifiable—an illusion which is mutually reinforced by neo-classical economics. We then combine this analysis with an institutional

economics perspective on accumulation, to demonstrate that an accounting standard such as IFRS3, which creates entirely new and inherently unobservable assets from little more than economic rents, serves to disguise appropriation as production and hence lock-in exploitative production relations in the international political economy.

Neoclassical economics attempts to explain how a market economy operates in the following way: (1) Economic output is defined as a function of the quantities of input factors used in production, the latter usually being categorized as capital and labour. Each factor of production is assumed to have a marginal productivity. This gives rise to the *production function*. (2) The invisible hand of the market optimises an entire economy by maximising this production function subject to the constrained availability of capital and labour as expressed by their prices (the interest and wage rates), which in turn are determined by supply and demand in the capital and labour markets. In doing this, the market economy determines the optimal quantities of capital and labour to use, and the division of income between them. For its part, accounting is supposed to provide an empirical measure, at the level of the firm, of the quantity of capital employed in production. As such, the social division of income between capital and labour can be justified by reference to the 'normal' rate of return on assets.

However, the neoclassical logic makes two important, and questionable, assumptions. The first is that capital is a quantifiable magnitude; the second is that individual inputs of capital and labour have their own distinct (marginal) productivities. Without the first assumption, the notion of a maximisation process—upon which the methodology of neoclassical economics and modern accounting are both based—becomes untenable. The second assumption depends on the first; without a quantity, a factor of production cannot have a *marginal* productivity. Challenging these two assumptions was the central focus of the so-called Cambridge Controversies,⁶ an intense theoretical debate to which neoclassical economics has yet to provide a robust response (Cohen and Harcourt, 2003). One of the few accounting scholars to have empirically illustrated the Cambridge Controversies summarises their impact thus: 'in so far as accounting relies on marginalism for its theoretical foundations then those foundations are fallacious' (Tinker, 1980: 147). In this article we only cover what is important for our analysis of FVA; there are many fuller accounts of the Controversies and their implications for political economy (for a review of such literature see Cohen and Harcourt, 2003).

To quantify capital, both accounting (for example Berry, 1999: 333) and economics (for example Varian, 1996: 192) use money as the unit of measurement. They say that the monetary quantity of any individual capital asset is the value of expected future income streams arising from ownership of that asset. Future income is discounted to present value using an

interest rate. This is also the common practise in business and finance. The critical argument of the Cambridge Controversies was that such a quantity of capital cannot be optimized, as part of the production function, subject to its price because in this case the very definition of quantity already incorporates price—i.e. the interest rate. Here, neoclassical logic is circular because the expected income streams which underpin the money value of a capital asset, and so give it a ‘quantity’, depend not only on estimates of total income in the future but also depend on an assumed social division of that income. In other words, rather than *explaining* the social division of income, the ‘quantity’ of capital *depends* on the social division of income. Realising that the price and quantity of capital were effectively the same thing, Sraffa demonstrated how ‘the same assortment of capital goods represents *different* quantities of capital’ (Sraffa, 1960 as paraphrased in Nitzan and Bichler, 2000: 72) and in doing so revealed the quantity of capital to be indeterminate.

From a functionalist standpoint, the purpose of accounting—one might presume—is to keep an accurate record of who contributes what to production and therefore ensure that distribution is fair. In as much as it attempts to meet this purpose, modern accounting relies on the principal of marginal productivity (why else measure assets?). However, this principal can be challenged on at least two counts: First, if capital indeed has an indeterminate quantity, then the marginal productivity of capital (changes in output divided by changes in the quantity of capital used) is conceptually void. Second, in anything other than the most stylized and abstract examples of socially isolated production, it is not possible to empirically observe the precise relation between individual inputs and outputs, and hence it is impossible to verify the marginal output of any single factor of production. As an influential institutional economist put it nearly a century ago, production is not a mechanical process but rather a societal one whose ‘inputs’ extend as far back into human history as one chooses to look (Veblen, 1908a: 540).

These neoclassical failings leave a problem: If marginal productivity either does not exist, or at least is impossible to measure, then what is left to explain the different income streams received by the owners of assets, and their workers? According to Veblen the answer lies in the control of production, by ‘means of engrossing the community’s industrial efficiency’ (ibid: 526). The owner of a machine does not receive income because of the innate productivity of his machine per se (which can anyway not be observed), but rather because control of that machine—in a given industrial phase—effectively controls society’s ability to put its own accumulated knowledge into motion. Controlling the machine amounts to a bottleneck in production, not a contribution to production. This control allows the appropriation of economic rents which can be capitalized as an asset, the ownership of which then forms the basis of capitalist accumulation. The asset relates

primarily to a power relation, not a physical machine. As Nitzan puts it 'accumulation is not an offshoot of production, but rather an *interaction between productivity and power*' (Nitzan, 1998: 174). This *power* is the power to appropriate and it is not unique to the present historical period. In feudal times it was expressed coercively; under capitalism it is expressed as an asset presented as having productivity, validated by accounting, and accepted by most of society as such.

What has this got to do with FVA? Quite a lot because in the current phase of capitalism there is an increasing volume of rents which cannot be traced to recognisable assets. Before IFRS 3, these rents were capitalized by stock markets in share prices, but not validated by accounting as assets. The resulting gap between the stock market value of a company and the accounting value of its assets is not openly referred to as appropriation but instead labelled *goodwill*. This so-called goodwill gap has grown sharply in recent decades (Lev and Zarowin, 1999; Zambon, 2002) in line with structural changes in the international political economy such as the financialisation referred to in Section 3.2. In a departure from historic cost accounting, FVA in the form of the IASB's standard IFRS 3 now demands that goodwill acquired in a takeover become a permanent accounting asset⁷ whose inclusion on the balance sheet is supported by expectations of future cash flows (IASB, 2004c).

IFRS 3's new form of goodwill accounting is justified by many on the basis that technological change has created a new intangible economy and that goodwill represents intangible assets which accounting has not yet managed to measure separately. Indeed a specially commissioned EU study on intangible assets defines them broadly as 'non-physical sources of future economic benefits' (European Commission, 2003: 18). Non-productive factors such as monopoly, market knowledge and trade secrets therefore *actually become assets*—these three examples are taken directly from the same EU study. This is extremely important because, in the context of a political-economy dominated by market logic and the ideas of neoclassical economics, the notion of an asset is socially very influential. In accounting terms, the capitalisation of goodwill converts super-normal profits into a 'normal' rate of return on assets, since the firm's asset base is—at a stroke—expanded. Reducing the apparent rate of return on assets negatively impacts the bargaining position of labour, regardless of the source of the original 'goodwill'. Furthermore, because goodwill is a residual, the assets created by IFRS 3 could be intellectual capital symptomatic of the so-called 'knowledge economy' (Canibano *et al.*, 1999), but they could equally be capitalized profits caused by a successful squeeze on wages! In our reading, accounting has not yet developed a reliable way to tell the difference. Politically therefore, the capitalisation of goodwill institutionalises appropriation; appropriation is made to look like capital-intensive production.

Table 1 Categories of social constituencies affected by FVA-related changes

Perspective	Winner	Loser
Mainstream Accounting	Shareholders, society at large	Management
Finance versus Production	Financial sector	Productive sector, especially enterprise managers
Varieties of Capitalism	Anglo-Saxon	Rhenish
Capital Pricing Approach	'Knowledge Economy' (knowledge capital)	Industrial capital Waged labour

3.5 Overview: Perspectives on Fair Value Accounting

Taken together, each of the three different political economy perspectives that we have outlined earlier gives a different but complementary interpretation of the shift to FVA—and they all contrast with the perspective of mainstream accounting (Table 1).

In the preceding sections we have explained how current changes in accounting standards both reflect and reinforce the power balance between different socio-economic constituencies. From a political economy-perspective this immediately raises questions about how these new standards were able to get such authority, and so quickly. Moreover, why have those social constituencies which lose from the political-economic reconfiguration of which these standards are a part, not prevented them? Our answer to these questions highlights the role of transnational private authority as the chosen mode of governance for international accounting standard setting. In order to substantiate this point, Section 4 puts the regulation of accounting standards by the IASB into the perspective of debates about different public and private modes of governance. Subsequently, for each of the perspectives outlined earlier, Section 5 demonstrates how this private mode of governance privileges certain constituencies above others.

4. THE TRANSNATIONAL PRIVATE GOVERNANCE OF ACCOUNTING STANDARDS

The regulation of accounting has attracted considerable attention by (global) governance scholars (cf. Braithwaite and Drahos, 2000: 121; Germain, 2004: 15; Sassen, 1999: 413; Strange, 1996: 135–46; Woods, 2002: 31). The attraction of the topic is obvious—in hardly any other case has such wide-ranging authority been delegated to a private body. Since January 2005 some 7,000 European listed companies have been subject to the IFRS of the private International Accounting Standards Board whereas statutory accounting standards in the EU were previously regulated at national level. Furthermore, the regulation of accounting was largely a public task,

although the accountancy profession has always played an active part in developing the details of regulation. In Germany, for example, accounting rules were contained within the *Handelsgesetzbuch* (HGB), i.e. company law, from the eighteenth century onwards (see Gulin *et al.*, 2004).

Cross-border economic transactions soon made the need for international harmonisation obvious. While Napoleon's Code de Commerce of 1809 arguably was the basis of the first phase of harmonisation, this process was given new impetus in the late twentieth century. Within the European Union two directives on accounting regulation were adopted in 1978 and 1983, while the International Accounting Standards Committee was disseminating 'best practice' on a broader—but only voluntary—basis. Nevertheless, the EU decision to make IFRS binding for all publicly listed European firms from 2005 was the first major international standardisation. This decision marks a significant 'shift in governance' (van Kersbergen and van Waarden, 2004) towards the private and transnational level, although we are still some distance from what can be termed 'purely private regulation'. International Accounting Standards may be set by a private organisation and monitored by private firms (i.e. the Big Four⁸ accountants), but within the EU they must still be endorsed by public authority, in this case the European Commission and the Accounting Regulatory Committee. Nevertheless, the EU bases its endorsement decisions on regular advice from the private-sector European Financial Reporting Advisory Group (EFRAG) which is itself an umbrella network of organisations representing European employers, banks, accountancy professions, insurers, stock exchanges and financial analysts.

The transfer of regulatory competence from the national to the transnational sphere is also not yet complete. While many countries currently are applying or moving to adopt IFRS, the US remains the most substantial gap in the coverage of internationally standardized accounting standards. However, the IASB and FASB are involved in an ongoing convergence project ('Norwalk Agreement') that strives for a harmonisation of accounting regulation on a nearly global level (see IASB, 2002).

Although the private mode of governance is frequently discussed as a rather technical question of institutional design, it is certainly not neutral in political-economic terms. Here we depart from the governance mainstream, by emphasizing that shifts in the substance of regulation (towards FVA) may not properly be understood without taking shifts in the mode of regulation (towards transnational private governance) into account, and vice versa. But we are also aware that our explanation of current shifts in the substance of regulation is yet incomplete, as it does not incorporate broader contextual factors such as shifting patterns of trade and production. Similarly, the change in the mode of regulation—i.e. why the European Union has adapted the IASB standards—has yet to be accounted for, taking the task of explanation a step further. Nevertheless, by putting the issue of

private regulation in the context of the different theoretical perspectives outlined earlier, we hope to contribute to a more comprehensive explanation of current shifts in both the substance and the mode of regulation.

5. THE ROLE OF TRANSNATIONAL PRIVATE AUTHORITY

5.1 The Institutional Efficiency of Transnational Private Authority

Why have the productive sector and its enterprise managers not successfully contested the shift to FVA? The paradigm is an instrument of increased control of production by finance so one would logically expect some resistance from productive enterprise managers. Indeed there have been a number of critical statements about the IASB's introduction of FVA (see for example FT, 2005b,c), but so far these have not lead to the mobilisation of a powerful opposition.

Our focus on the transnational private governance of accounting regulation indicates three complementary answers to this question, all departing from the market efficiency argument which is central to mainstream analysis in the academic disciplines of economics and accounting (see Section 3.1). First, managers are very much in favour of transnational, as opposed to national, regulation of accounting standards. In order to have better access to global capital markets many enterprise managers anyway have to accept the accounting regulations of other countries besides their own. Accordingly there are obvious savings in compliance costs under a set of global, or at least regional, standards such as those offered by the IASB. Second, private authority is preferred in this perspective because of its assumed speed and flexibility, in particular with regard to the accounting treatment of fast-changing fields of business such as financial instruments and the 'New Economy' of intangible assets. In contrast, public intergovernmental regulation by an international accountancy regime or even an 'International Accountancy Organization', perhaps under the auspices of the United Nations, would be considered too slow and cumbersome. Lastly, public regulation might also bring in 'political' considerations that are not based on a narrowly conceived efficiency perspective. Thus, there are a number of self-serving reasons for enterprise managers to accept accounting regulation by transnational private authority. However, in accepting the authority of the IASB they also have to accept what is perceived to be the most efficient accounting regulation (i.e. fair value accounting), as defined by experts drawn from the current mainstream of economics and accounting. Based on the efficiency perspective, any attempt to deviate from this mainstream consensus can be derided as being 'political' or as one authority on accounting standards puts it '... self-interested considerations or pleadings by preparers and others that may be detrimental to the interests of investors and other users [of IFRS]' (Zeff, 2002: 43).

5.2 Transnational Private Authority and the Rise of the Financial Sector

From a less functionalist and also less benign perspective, the shift of accounting regulation to the private IASB has been caused by the sheer dominance of a highly organized financial sector which plays an increasingly prominent role in setting the agenda for managing the European (and world) economy. There are several avenues by which the economic power of this sector translates directly into influence on the substance and mode of accounting regulation. Firstly, it can simply use its lobbying prowess, both for transferring the task of EU accountancy regulation to the IASB, and then for the directing the substantive content of regulation towards the FVA paradigm. Secondly, while the politics of IASB adoption by the EU still await a more comprehensive study (see also Section 5.3), network analysis of IASB and EFRAG committee membership reveals that financial sector actors are by far the best connected and most represented in the standard-setting network (Perry and Nölke, 2005).

Membership of IASB committees is formally awarded on the basis of a members' ability to offer independent expert knowledge. However, following Gramsci's notion of the organic intellectual (Gramsci, 1971), we view experts as political actors whose preferences set the 'technical' agenda and define the range of possible outcomes in a decision making process. Expert knowledge is itself always political because it is always acquired in a particular social context, and reflects the political-economic structures and social relations which generated and which reproduce that context. Each expert uses his or her own theoretical approach to produce technical solutions, which is why they are seen as experts. As Robert Cox puts it, 'theory is always for someone and for some purpose' (Cox, 1981: 128). In other words, technical solutions are never purely technical; they always have a political purpose even if those propagating the solutions are not fully aware of it. Therefore, while the experts on IASB committees may be independent in as much as they do not consciously make decisions to serve their material interests, the social context in which such expert knowledge has been acquired and practised is critical in determining *which* technical solution of the many possible ones is produced. In the cases of IASB and EFRAG committee membership, Perry and Nölke (2005) find that this social context is predominantly a financial one: In the governance network which links 131 companies and organisations to IASB and EFRAG committees, there are almost twice as many ties with the financial sector as there are with the productive sector.

5.3 Transnational Private Authority and the Disembedding of Institutionalized Economies

From the Varieties of Capitalism perspective, the shift in accounting regulation should be seen as part of the ongoing process of structural change

(or adaptation) of Rhenish capitalism. Among the divergent analyses of the current restructuring of Rhenish capitalism, it is widely agreed that the decision of Daimler-Benz to be quoted on the New York Stock Exchange is of major symbolic importance (Ball, 2004; Dewing and Russell, 2004). The move by Daimler-Benz signalled not only a change from bank to stock exchange financing, but also the increasing possibility that US-Generally Accepted Accounting Practice (US GAAP) would be adopted as *de-facto* global accounting standards. At the same time it highlighted the need for a substantial harmonisation of accounting standards since, under US GAAP, Daimler Benz was deemed to have made substantial losses in contrast to the profits it had claimed under German HGB standards. The prospect of ceding control of the accounting regulation of large multinational companies to the US standard setter was a significant factor in the EU's decision to adopt IASB accounting regulations from 2005 (Dewing and Russell, 2004: 293–4). By closely connecting the IASB to the EU, and institutionalizing the consultation mechanism through EFRAG, it was hoped that European actors could influence the substantive development of the new IFRS. Certain categories of actors have apparently been more successful in this regard than others. Productive sector enterprise managers, particularly those from continental Europe have apparently been unable to prevent the introduction of FVA. German companies in particular are clearly dissatisfied with their national organisation for accounting, the 'Deutsche Rechnungslegung Standards Committee' (DRSC), as indicated by a massive reorganisation in March 2003. Questions of institutional design may play a role here, but there is also the structural factor of nationally organized interest intermediation within Rhenish capitalism. Although not straightforwardly macro-corporatist, business actors in the Rhenish model, are traditionally accustomed to articulating and negotiating their interests on a national level with their national government and other interest groups. In the context of transnational private regulation this can be a severe disadvantage compared to financial actors and coordination service firms (see Cutler *et al.*, 1999: 10) from the Anglo-Saxon mould, which are well-adapted to interest intermediation in the transnational sphere. Somewhat ironically, the EU's move to assert itself in the battle for global accounting standards has led to a large scale dismantling of dominant accounting regulations within most of the member states, in favour of practices that can be conceived as being part of a US hegemony (Dewing and Russell, 2004: 311–3).

5.4 Transnational Private Authority and the Isolation of Accounting Standard Setting from Society

The Varieties of Capitalism literature highlights the varying degrees of access of different social constituencies to transnational economic governance. This analysis can be taken a step further by situating the IASB in the

context of the relationship between capital and labour. As we explained in Section 3.4 earlier, by capitalising economic rents as assets, the FVA paradigm could institutionalise new divisions of income in society, to the disadvantage of labour. Admittedly, it is doubtful that capital pricing controversies feature prominently on the radar screens of the average trade union, but nevertheless by shifting the regulation of accounting standards away from public deliberation in parliaments (i.e. away from bodies of law such as the German *Handelsgesetzbuch*) to transnational private 'expert' bodies, economic discourse becomes yet more isolated from broader debate. Correspondingly, the implications of the shift to FVA for the relationship between capital and labour go completely unnoticed and do not become the object of societal contestation.

A good indicator for the current societal isolation of the setting of accounting standards is the low participation rate of organisations outside the business sector within the IASB comment letter process. A survey of the comment letter process on all IFRS exposure drafts published on the IASB website as of August 2004 demonstrates that, of the 900 organisations participating in the process, none can be identified as a trade union or an international association of trade unions (Perry and Nölke, 2005), nor do any such organisations have representatives on the committees of the IASB or EFRAG. Although not each comment letter can and will be heeded by the IASB, the complete absence of trade unions from the central deliberation process over international accounting standards is still astonishing. This is despite the fact that, during the period surveyed, the IASB issued exposure drafts relating to labour-sensitive issues such as share-based payments and employee benefits (*ibid*). Similarly, no such organisations have representatives on the committees of the IASB or EFRAG, thereby further institutionalizing the dominance of the business interests in the accounting arena.

5.5 Overview: Perspectives on Transnational Private Authority and the Rise of Fair Value Accounting

This section of the article has taken each of the four perspectives which we used to analyse the substance of accounting, and applied them to the governance of accounting (Table 2).

In contrast with the more institutionalist literature on transnational private authority we claim that there is limited utility in analysing the mode of regulation without paying due attention to its effects on the substance of such regulation. In the case of accounting standards, an important consequence of transnational private authority is to privilege a financial perspective on measuring economic activity, while also restricting discussion of accounting standards to the realm of technical efficiency.

Table 2 Relationship between transnational private authority and substance of accounting regulation

Perspective	Role of transnational private authority
Mainstream Accounting	Efficiency advantages of global and private regulation
Finance versus Production Varieties of Capitalism	Voice to financial actors, via role of experts Weak representation of nationally institutionalized economic interests
Capital Pricing Approach	Further isolation of accounting/economic discourse from society

6. CONCLUSION

Our analysis has shown that, rather than merely adjusting the way corporate assets are measured, today's incarnation of Fair Value Accounting (FVA) also brings new and contentious classes of asset to the forefront of the international political economy. Section 3 demonstrated how this reflects and reinforces changed relations of production in which the financial sector increasingly dominates the productive sector, nationally institutionalized economic systems are undermined, and new forms of economic appropriation are validated. In Sections 4 and 5 we then linked substance to governance to make the case that, through a transnational private body, the mode of governance has contributed to the recent rise of the FVA paradigm.

Accounting is not a purely technical matter; accounting numbers provide some of the key economic anchors around which social relations are structured. As we have shown, accounting standards cannot be reduced to questions of efficiency since they set out to quantify and compare things which, by their very nature, are neither quantifiable nor directly comparable. Because of this accounting standards are political, regardless of whether they are recognized as such, and play a central role in shaping the future path of our market-oriented societies.

However, it should be noted that this future path is inherently uncertain and the new accounting discourse might not lead to the outcome expected by its proponents. FVA brings many potential risks to accounting, most notably the way in which the paradigm compresses an expected vision of the future into present values, which can subsequently become mistaken for economic reality. Here the corporate failure of US energy giant Enron provides an instructive example. Even though the Enron case was primarily related to auditing rather than accounting standards, a substantial part of the fraud resulted from compressing the future into the present in much the same way as FVA now attempts. This should alert us to the dangers of privileging such an accounting technique above more broadly based social measures which are less 'efficient' only in so far as they are not quantifiable.

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NOTES

- 1 The IASB has recently started using the term International Financial Reporting Standards (IFRS) instead of International Accounting Standards (IAS). To avoid confusion, when referring collectively to all IASB standards currently in force, we use the single term *IFRS* in this paper. This includes previously issued IAS which are still in force.
- 2 We owe this point to one of three anonymous referees of an earlier version of this article.
- 3 Notwithstanding two temporary 'carve outs' (exemptions) from IAS 39 won by the European banking sector (Grant, 2005). Neither of these exemptions change the finance-productive sector relations with which this part of our analysis is concerned.
- 4 We owe this point to one of three anonymous referees of an earlier version of this article.
- 5 For a more comprehensive historical debate of the advocacy of accounting philosophies by different socio-economic groups in Germany see Richard (2005).
- 6 The term 'Cambridge Controversies' refers to a long debate between economists in Cambridge, England and Cambridge, Massachusetts from the mid-1950s to the mid-1970s (see Cohen and Harcourt, 2003). Although the dates might imply that the debate was resolved, the recent article by Cohen and Harcourt concludes otherwise.
- 7 To maintain consistency between accounts it is also expected that equivalent accounting treatment will have to be applied to goodwill generated internally by a corporation (Bromwich, 2004; FT, 2006).
- 8 The Big Four global accountancy firms are PriceWaterHouseCoopers (PWC), Ernst & Young, Deloitte & Touche, and KPMG.

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APPENDIX

Accounting is conventionally seen as aiming to measure two things: wealth and profit. Each year a firm produces two core financial statements: the balance sheet and the income statement. The first of these is supposed to measure wealth, the second is supposed to measure profit.

Balance sheet: $\text{Wealth} = \text{Assets} - \text{Liabilities}$

Income statement: $\text{Profit} = \text{Revenue} - \text{Expenditure}$

It is important to remember that—conceptually—wealth is a stock and so the balance sheet is written for a particular date: it is a *spot* measure; a snapshot in time. In contrast, income is a flow therefore the income statement is for a particular year: it is a *period* measure. Nevertheless, the balance sheet and income statement are logically related because wealth on a particular date is equal to wealth at an earlier date plus profit made between the two dates. For example:

$$\begin{aligned}\text{Wealth at the end of 2004} &= \text{Wealth at the end of 2003} + \text{Profit during 2004} \\ \text{Wealth}_1 &= \text{Wealth}_0 + \text{Profit}_1\end{aligned}\quad (1)$$

Equation (1) can be rearranged as:

$$\text{Profit}_1 = \text{Wealth}_1 - \text{Wealth}_0\quad (2)$$

This logic implies two different approaches to measuring profit. The first is driven by the income statement, and corresponds to traditional historic cost accounting; the second is driven by the balance sheet and corresponds to the Fair Value Accounting (FVA) approach.

Historic cost accounting:

$\text{Profit} = \text{Revenue} - \text{Expenditure}$ (income statement)

Fair value accounting: $\text{Profit} = \text{Wealth}_1 - \text{Wealth}_0$ (balance sheet)