

**The State and/of Accounting Regulation**

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### **Abstract**

Our research question can be simply stated: to what extent, and how, should the State be involved in the regulation of financial accounting and reporting? We begin with a historical and conceptual analysis of “State” and “accounting”. We continue with an exploration of “legitimacy” both in principle and as applied to accounting regulation in both Anglo-Saxon (common law) and Continental (Roman law) traditions, with specific examples and illustrations.

We consider some recent literature and political polemic relating to the role of, and inter-relationships between, the IASB (a private sector organisation to its very core), investor/creditor/fiscal/legal/prudential regulation stakeholders, and “due process”.

Our essential conclusion is that self-interested interference is endemic, is actively facilitated by “due process”, and that, crucially, a necessary (but not sufficient) condition of effectively dealing with this problem is to ensure that “the State”, whilst maintaining an essential overall monitoring role on the fundamental effectiveness of the process, is allowed, whether in the guise of elected representatives or otherwise, zero influence in the details and operational content of financial accounting and reporting regulations for market-based resource-allocation-focussed information.

**Key words:** State, accounting regulation, legitimacy, FASB, IASB

## The State and/of Accounting Regulation

*If I had to choose between betraying my country and betraying my friend, I hope I should have the guts to betray my country*

E.M. Forster (1951): Two Cheers for Democracy: What I believe.

*An argument can be made that social science has been too geographical and not sufficiently historical, in the sense that geographical assumptions have trapped consideration of social and political-economic processes in geographical structures and containers that defy historical change.*

J. Agnew (1995): The hidden geographies of social science and the myth of the 'geographic turn'

### 1. Introduction

This paper directly focuses on the theme of this conference. We explore the problematic relationship between "the State" and "accounting regulation". We attempt a "first principles" approach, necessitating a historically-based investigation of the notion of State, which reveals deep-seated dichotomy and disagreement (section 2), of accountancy, which again reveals major differences (section 3), and of legitimacy (section 4).

We then illustrate the application of these concepts in two contrastive scenarios, the U.S.A. and France (sections 5 and 6), before pulling all the ideas and issues together in sections 7 and 8.

We show throughout the vital importance of a historically-informed time and place specificity and awareness. Our conclusions are not optimistic, as major inconsistencies, incompatibilities and logical impossibilities are being widely ignored. We hope that our attempts at rigorous analysis will help to show the way towards practical improvement.

## 2. The notion of State

The notion of State is surprisingly difficult to comprehend and explain. Perhaps more precisely, there are different, and highly incompatible, notions of State, each easily understood by its adherents but incomprehensible to others. Our outline is based first on Cassese (1986), whose title can be taken as a neat nine-word summary of the position.

Essentially, a State is an artificial legal person, distinct from both society and government. Of necessity, the State operates through natural persons, who hold office within a specified organ of the State. The office (Cassese, 1986: p.122)

is distinguished from the holder of the office, what belongs to the office from what belongs to the holder of the office, and so forth. These distinctions favour the development of the theory of the public organ (which presupposes a trilateral relationship between the legal person, the organ and the office holder) as opposed to the theory of representation (which presupposes a bilateral relationship between representative and represented). To ensure that the activity of the organ is referred to the state, recourse is made to the theory of imputation, whereby actions performed by organs of the state are imputed to the state, and the same with their effects. If a ministry, an organ of the state, enters a contract, it is binding on the state, not the organ, and still less the official.

Cassese further quotes Kelsen (1949: 191), as follows (p.122)

To impute a human action to the state, as to an invisible person, is to relate a human action as the action of a state organ to the unity of the order which stipulates this action. The state as a person is nothing but the personification of this unity. An 'organ of the State' is tantamount to an 'organ of the law'.

Considering the State as a legal person, more precisely as a corporation that possesses a legal *persona* of its own, Van Creveld (1999: 1) points out that it differs from other corporations for three aspects. First the State authorises all other corporations but is itself authorised/recognised only by other corporations of the same kind, second certain of its functions, known as attributes of sovereignty, are exclusively reserved to it and third those functions are exercised over a defined territory where its jurisdiction is exclusive and all-embracing.

The State, then, is a legal construct or it is nothing. It perhaps reached its high point in France and Spain in the sixteenth century, when these two countries became legally and politically unified, and in Germany and Italy, neither unified until the second half of the nineteenth century, some three hundred years later. Complex legal doctrines emerged, controlled, of course, by lawyers. Note that the countries mentioned all have Roman law based legal systems.

In the UK, and therefore in its former colonies (such as the United States (sic) of America), none of this happened, essentially simply because there was no need for it. As Cassese puts it (1986: 123)

Here “self-regulation by society” (Badie and Birnbaum, 1979: 222-226) holds sway. There is a strong tradition of self-government; for many centuries there was no administrative law, because public bodies were subject to common law. In Great Britain, it has been said, the state is an illegitimate historical concept.

Cassese also states in his footnote 7

To grasp how incomprehensible the theory of the state is for English thinkers, see MacIver (1927 (sic): 452) – “a grove of trees is not a tree, nor a colony of animals itself an animal. It is no less absurd to think of a society of persons as a person”<sup>1</sup>.

Our heading quotation from Forster is redolent of this attitude. It follows from the above that the “notion of State”, in meaning, implication, and (lack of) significance, is specific both in time and space. In a historical (time) perspective the concept of State is relatively recent. In fact, during pre-history and most of the history even if there were communities of people living under a set of common rules, the notion of State, in the sense here considered, was unknown. For a wide period of the history of human beings there were pre-state political communities of different kinds, such as tribes without rulers, tribes with rulers (chiefdoms), city-states, and empires (Van Creveld (1999: 2-52)). Indeed, structures close to some of these can still be found today.

The main limit of this pre-state era, characterised by the absence of the State as a legal *persona*, is the incapability of developing a precise distinction between government and ownership and the consequent confusion between public and private ambit. If during feudalism, government was shared among many different rulers connected to each other by fealty links, the modern state project intended to substitute these situations of overlapping jurisdictions through the creation of a centralised State.

The theory of sovereignty, asserting the supremacy of the government of the State over people, things and all kinds of authorities within a territory, underpinned the institution of centralised State which was “sovereign”, commanding without being commanded, and “absolute”, as not accountable to others but itself (Anderson, 1996, Axmann, 1996). The Treaty of Westphalia at the end of the Thirty Years’ War (1648) represented a fundamental moment in this sense, as it recognised State autonomy from external influences in religious issues, determining a shift in power equilibrium between State authority (territorially based) and confessional groups (religious based), in favour of the former (Axmann, 2004: 260). During this period the sovereignty is exercised over people and resources within a specific territory with recognised boundaries (territorial State).

In the 19<sup>th</sup> century, the ‘nation’ was the unitary element in which sovereignty had to be located (nation-state). It was the period of the strict nexus between State and society, characterised by a political nationalism aiming to create a national-societal identity. This political nationalism was united to a nationalisation of culture which became ‘territorialised’/‘nationalised’. This situation generated a cultural homogenization within each different nation-state that will be at the origin of the cultural diversity at the moment of universalization of the nation-state model (Axmann, 1996).

During the 20<sup>th</sup> century, we see a global diffusion of this idea of the nation-state, with the legitimization of the sovereign nation-state as a key aspect of the world system. The sovereign

'nation-state' represented the "ultimate power" allowed to impose order within a defined territory, to defend both territory and people and with an authoritative role of representation abroad (Axmann, 2004: 262). To generalise, with some more details, as underlined by Parekh, a modern state should possess these six features:

First, it should be territorially distinct, possess a single source of sovereignty, and enjoy legally unlimited authority within its boundary. Second, it should rest on a single set of constitutional principles and exhibit a singular and unambiguous identity ... Third ... [it] represents a homogeneous legal space within which its members move about freely, carrying with them a more or less identical basket of rights and obligations. Fourth ... all citizens are directly and identically related to the state, not differentially or through their membership of intermediate communities. Fifth, members of the state are deemed to constitute a single and united people ... Sixth and finally, if the state is federally constituted, its component units should all enjoy the same rights and powers (Parekh, 2002: 41–42).

This list perhaps presents a rather theoretical picture, and it is not difficult to postulate possible uncertainties of application. Particular examples in this sense are the State where the source of power comes from religion, for example the Government of Tibet. A particularly apposite issue for our purposes, as later further developed, concerns the European Union. Certainly this is not "a State" in the Parekh sense, but equally clearly it seeks to empower itself with significant elements pointing towards these features. This is an example of the way in which, in recent years the 'nation-state' concept has met structural transformation towards an international dimension, whose fundamental processes are internationalization of problems, societies and political decision making (Goldmann, 2001: 178 ss.). As underlined by influential authors, the structural effects on the State of internationalization are mainly referable to a 'denationalization of the state' (Jessop, 1997: 573, Jessop, 2002: 195, Brenner, 1999: 52-53, Sassen, 1996) and 'destatization of the political system' (Jessop, 1997: 574, 2002: 199).

The 'denationalization of the state' is linked to the territorial and functional reorganisation of (old or new) State capacities on supra-national, national, sub-national and trans-local levels, with upward/downward/outward delegation of State powers. Upward delegations relate to

supra-regional or international bodies, downward delegations relate to national/urban/local levels, while outward delegations relate to relatively autonomous cross-national alliances among regional States characterised by complementary interests (Axmann, 2004:269). It is consistent with, and illustrative of, this increasing flexibility and fluidity over recent times that the European Union can be analysed applying many of the general issues raised here.

The 'destatization of the political system' is a stronger effect, linked to a strategic reorganisation that involves a change from government to governance (Axmann, 2004:269).

More specifically, using Jessop's words:

While denationalization concerns the territorial dispersion of the national state's activities . . . destatization involves redrawing the public-private divide, reallocating tasks, and rearticulating the relationship between organizations and tasks across this divide on whatever territorial scale(s) the state in question acts. (Jessop, 2002: 199)

The significance of these issues, considered in a historical framework, supports the importance of a proper historical consideration as recommended by Agnew in our second heading quotation. Specific reflections about these effects relating to accounting regulation will be later expressed in the paper.

As already recalled the notion of State is not only time specific, but also space specific. The specification of space follows from the simple historical fact that communities have developed over time in a relatively fixed and specific physical area. Contact within a community was likely to be close, and contact and influence from other communities outside was likely to be infrequent or effectively non-existent. Each distinct community, therefore, developed its own culture, way of life, and mode of community organisation. Without major outside influence, such developments would, over time, 'go their own way', leading to sometimes significantly different 'accepted norms' on, *inter alia*, the role of, and notion of, the State.

These differences are still very significant today, as Cassese illustrates. The increasing cross-nation contact and influence, and the need for cooperation and some degree of harmonisation, have thrown such differences into high relief, but have often not significantly lessened their impact or their importance. It is not meaningful to refer to the notion of State without clearly defining the spatial context within which the discussion is taking place.

Today there is a multiplicity of artificial legal persons *within* the nation-State, and an increasing number of artificial legal persons *above* the nation-State. Further, the notion that the imputation of (ultimately absolute), and legally derived and legally enforceable, power to “the nation State” is irrational, unnecessary, demonstrably open to massive abuse and (Cassese p.123) “illegitimate”, is increasingly widespread.

Since, like any artificial human (social) construct, the “notion of state” is dependent on perceptions of legitimacy, usefulness and acceptability by populations at large, Cassese’s title is rationalised. The implications of the widely divergent views discussed above regarding the centrality of, or the irrelevance and even illegitimacy of, the notion of State in the context of accounting regulation are considerable as will emerge below (section 4).

After pointing out that the State is a time/space specific notion, it is important to underline that on one hand interaction among States has been amplified under the impact of global processes and on the other an increasing fragmentation has been realised as a consequence of trends towards decentralisation (Reis, 2004, Rosenau (1984: 257)). All these dynamics are altering the nature of State sovereignty, as well as the significance of territory and the meaning of political and economic space, transforming States and their role (Ferguson, Y. H. and Mansbach, R. W. (2009: 17)).

On this subject, Sassen (2006) underlines that if during the last centuries there was a growth of the national public realm, a U-turn has been realised in the last few decades, with a

growth of private forms of authority in areas previously exclusive to the State and public domain (p.192). Implications about impacts of this change regarding accounting regulations will be analysed in section 7.

### **3. Accounting**

It is axiomatic that the need for accounting regulation arises from the necessity for business entities (in the widest sense of both the words business and entities) to report to the community at large. It can be seen as an important subset of the more modern concepts of corporate governance. A corporation uses and controls a large variety of scarce resources which therefore become unavailable for alternative uses (or deliberate preservation) by the community, and in this sense the corporation and its operatives (especially managers) are *accountable* to the community. It should not for a moment be assumed that the accountability should, or could, be restricted to that which is measurable in money terms. Table 1 first column gives an interesting set of significantly different definitions.

Some of these definitions are surprisingly narrow, indeed in some respects, e.g. Parkinson's restriction to the "interests of shareholders", unacceptably so. More is involved than a functionalist focus on optimising returns to suppliers of finance. In summary, corporate governance may be taken as that which is necessary for an economic entity to be satisfactorily accountable to the community within which it is embedded, and which provides or sacrifices the resources used by the entity. The vagueness of this statement is very deliberate.

Accounting is perhaps rather easier to delimit, but not necessarily easier to precisely define. Table 1 second column gives three suggested definitions. All are from the US, but it should be particularly noticed that none make any suggestion, whether explicit or implicit, that accounting is or should be focussed on investors.

**Table 1: Definitions of corporate governance and accounting**

Some UK-based definitions of corporate governance	Some definitions of accounting
<p>...the process of supervision and control intended to ensure that the company's management acts in accordance with the interests of shareholders (Parkinson, 1994).</p> <p>...the governance role is not concerned with the running of the business of the company <i>per se</i>, but with giving overall direction to the enterprise, with overseeing and controlling the executive actions of management and with satisfying legitimate expectations of accountability and regulation by interests beyond the corporate boundaries (Tricker, 1984).</p> <p>...the governance of an enterprise is the sum of those activities that make up the internal regulation of the business in compliance with the obligations placed on the firm by legislation, ownership and control. It incorporates the trusteeship of assets, their management and their deployment (Cannon, 1994).</p> <p>...the relationship between shareholders and their companies and the way in which stakeholders act to encourage best practice (e.g., by voting at AGMs and by regular meetings with companies' senior management). Increasingly, this includes shareholder 'activism' which involves a campaign by a shareholder or a group of shareholders to achieve change in companies (The Corporate Governance Handbook, 1996).</p> <p>...the structures, process, cultures and systems that engender the successful operation of the organization (Keasey and Wright, 1993).</p> <p>...the system by which companies are directed and controlled (The Cadbury Report, 1992).</p> <p>The purpose of the Code is to promote high standards of corporate governance in the belief that good governance should contribute to better long-term performance by helping a board discharge its duties in the best interests of shareholders (Financial Reporting Council (December 2009).</p> <p>Source: Adapted and extended by the authors from Solomons (2007: 13)</p>	<p>Accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof.</p> <p>'Review and Resume', <i>Accounting Terminology Bulletin No. 1</i> (New York: American Institute of Certified Public Accountants, 1953), paragraph 5.</p> <p>Accounting is the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of the information.</p> <p>American Accounting Association, <i>A Statement of Basic Accounting Theory</i> (Evanston, IL: American Accounting Association, 1966), p.1</p> <p>Accounting is a service activity. Its function is to provide quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions, in making resolved choices among alternative courses of action.</p> <p>Accounting Principles Board, Statement No. 4, 'Basic Concepts and Accounting Principles Underlying Financial Statements or Business Enterprises' (New York: American Institute of Certified Public Accountants, 1970), paragraph 40.</p> <p>Source: Alexander and Nobes (2007: 4)</p>

In view of the claims made in the literature for very significant progress towards harmonisation in financial reporting, it is instructive to compare Table 1 column 2 with the statement of the objectives of the major harmonising force, the International Accounting Standards Board (IASB), as it itself defines them. See Table 2.

**Table 2: Objectives of the IASB**

<p>The objectives of the IASB are:</p> <ul style="list-style-type: none"><li>(a) to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the various capital markets of the world and other users of the information to make economic decisions;</li><li>(b) to promote the use and rigorous application of those standards;</li><li>(c) in fulfilling the objectives associated with (a) and (b), to take account of, as appropriate, the special needs of small and medium-sized entities and emerging economies; and</li><li>(d) to bring about convergence of national accounting standards and IFRSs to high quality solutions.</li></ul>
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**Source: IASB Handbook. Preface to IFRS, paragraph 6.**

In Table 2 the priority given to investors (participants in capital markets) is clear. So to summarise, accounting (Table 1 second column) is narrower than corporate governance (Table 1 first column) and IASB accounting (Table 2) is narrower than accounting (Table 1 second column).

The above exposition is reflective of general international trends, themselves consistent with and emanating from the Anglo-Saxon tradition. But another very different tradition exists, based in Continental Code Law Europe, namely that accounting is a legally-based activity, not an economics-based activity. Accounting has been described as “the algebra of law” (Garnier, 1947; Baert and Yanno, 2009). Since economic rights and obligations are generally enforceable in law, and civil law issues are frequently economic in nature, the difference may appear largely cosmetic. But attitudinally it can be very significant. The implications of “economic substance over legal form”, or the converse, for accounting and reporting practice, especially if both are strictly and unimaginatively applied, can be

enormous as regards the contents of financial statements. At the local (national) level, tensions and inconsistencies against “international” thinking and practice can be very strong.

A further vital issue with potential significant effect on the regulatory process concerns the different users and uses of financial reports – i.e. the differences, and different needs, of stakeholders. Some commonly suggested purposes are listed in Table 3. It should be noted that the different purposes may lie at very different points on the economic/law spectrum. Also, the importance of any particular purpose, both in absolute and relative terms, is very much time and space specific. Different purposes imply different information content.

**Table 3: Some purposes/uses of financial reporting**

- |   |
|---|
| <ul style="list-style-type: none"><li>- Providers of equity finance</li><li>- Providers of debt finance</li><li>- Bankers and other flexible lenders</li><li>- Tax calculations</li><li>- Determination of legally available distributable dividends</li><li>- Preservation of the patrimony of the enterprise</li><li>- Prudential regulation</li><li>- Competition policy</li></ul> |
|---|

**Source: authors**

#### **4. Regulation and legitimacy**

The long history of accounting regulation shows that financial reporting could be regulated in a number of ways, including:

- legislation, such as Companies Acts and Commercial Codes;
- other rules issued by departments of government (such as a Ministry of Finance) or by committees operating under their control;
- rules from governmental regulators of stock exchanges;
- rules of stock exchanges;
- accounting guidelines or standards issued by committees of the accountancy profession;

- accounting guidelines or standards issued by independent private-sector bodies acting in the public interest.

The expression 'accounting standard' is used here to mean a document containing a series of instructions on a particular topic of financial reporting where the standard is written in the private (non-governmental) sector and is intended to be obeyed in full before an entity or an auditor can claim compliance with the system of rules of which the standards form part.

Here again, traditions differ widely in different countries and contexts. In each historical moment, whatever the source or sources of financial regulations are, it is essential that they are regarded as *legitimate* by both preparers applying the regulations, and stakeholders using this resulting information.

Legitimacy is an elusive concept to define with any precision. The ultimate test is a pragmatic one. Do the necessary parties in practice accept that the regulations have legitimacy, and are valid and should be followed?

Suchman (1995) proposes what he describes as:

an inclusive, broad-based definition of legitimacy that incorporates both the evaluative and the cognitive dimensions and that explicitly acknowledges the role of the social audience in legitimation dynamics.

Legitimacy is a generalised perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions.

Legitimacy is generalised in that it represents an umbrella evaluation that, to some extent, transcends specific adverse acts or occurrences; thus, legitimacy is resilient to particular events, yet it is dependent on a history of events. An organisation may occasionally depart from societal norms yet retain legitimacy because the departures are dismissed as unique. Legitimacy is a *perception or assumption* in that it represents a reaction of observers to the organization as they see it; thus, legitimacy is possessed objectively, yet created subjectively. An organization may diverge dramatically from societal norms yet retain legitimacy because the divergence goes unnoticed. Legitimacy is *socially constructed* in that it reflects a congruence between the behaviours of the legitimated entity and the shared (or assumedly

shared) beliefs of some social group; thus, legitimacy is dependent on a collective audience, yet independent of particular observers. An organization may deviate from individuals' values yet retain legitimacy because the deviation draws no public disapproval. In short, when one says that a certain pattern of behaviour possesses legitimacy, one asserts that some group of observers, as a whole, accepts or supports what those observers perceive to be the behavioural pattern, as a whole – despite reservations that any single observer might have about any single behaviour, and despite reservations that any or all observers might have, were they to observe more (emphasis original).

Two points are worth noting. The first is that, whilst legitimacy within a community may indeed be created by general rather than universal acceptance, the individual who rejects legitimacy may still act according to this rejection. Secondly, and perhaps more fundamentally, Suchman refers to the actions of an entity, not the existence of an entity. Whilst there are obvious relationships between the two, since we are dealing with perceptions, not facts, the legitimacy of either could be granted without the other.

Suchman continues to distinguish three “broad types” of legitimacy, as follows:

- Pragmatic legitimacy is created by the self-interested calculations of the audience or stakeholder concerned. To put the point crudely: if I benefit, I accept it;
- Moral legitimacy “reflects a positive normative evaluation of the organisation and its activities”. Things are ‘done right’ within the parameters of the socially constructed value system of the community (or the individual);
- Cognitive legitimacy implies positive acceptance of legitimacy of an organisation because it is seen as natural, necessary or inevitable based on some taken-for-granted or generally accepted cultural account. In simple terms: I understand it and it seems sensible within my world view, so I accept it.

Any and all of these considerations may be relevant in the context of accounting regulation.

A further distinction is particularly apposite in the context of democratic regulation of an area involving detailed specific knowledge. This may be characterised as technical versus political legitimacy (e.g. in Colasse and Pochet, 2009a, 2009b). Technical legitimacy has as

a necessary condition that the source of regulations is perceived as having the technical knowledge and expertise to produce 'good' regulations. Political legitimacy requires that the source of regulations is seen in some sense as adequately accountable (whatever precisely that may mean) to the community in which it operates. These two desirable attitudes may well have significantly conflicting implications.

In the following two sections we explore practice and rhetoric in two contrastive contexts, the USA and France.

## **5. Evidence from accounting regulation in the USA**

For listed companies, and within federal as opposed to State law only for listed companies, the responsibility for accounting regulation lies with the Securities and Exchange Commission (SEC). This is a government body, created in 1934, and the appointment of its members is an overtly political process. The SEC is responsible to, and controlled by, Congress. Since 1973 it has delegated the practical preparation of regulations to the Financial Accounting Standards Board, which is a private sector body. The power relationships between these three bodies (Congress, SEC, FASB) are complex, but a key point (Alexander and Archer, 2000) is that the SEC can over-rule (or *in extremis* could disband) the FASB at any time. Nevertheless the US is widely seen, with some day-to-day operational justification, as a private-sector regulatory system.

If regulation is indeed to be private sector based<sup>2</sup>, the need for genuine institutional legitimacy cannot be ignored. Accounting regulations have economic consequences by imposing costs on some while benefiting others. Conflicts arise because affected parties have incompatible preferences for accounting rules (Hussein and Ketz, 1980). Standard-setting bodies attempt to regulate these conflicts by issuing accounting regulations (Hussein and Ketz, 1980). However, due to varying preferences it is generally impossible to select accounting standards that achieve consent of all affected parties (Demski, 1973). Accordingly, rule-making requires 'political' choices making standard-setting a political

process (Hussein and Ketz, 1980). Gerboth (1973: 481) therefore concludes “In a society committed to democratic legitimisation of authority, only politically responsive institutions have the right to command others to obey their rules.” Accordingly, a standard-setting body needs to possess legitimacy, meaning its standard-setting authority and its standard-setting process itself are accepted by its constituencies. Johnson and Solomons (1984) provided an in-depth analysis of institutional legitimacy applied to the FASB, arguing that the viability of a private sector regulator (such as the FASB) “depends on its ability to sustain itself against criticism of both its rule-making procedures and the rules it promulgates” (p.171).

Johnson and Solomons suggest three conditions for “regulatory defensibility” (pp.172-4), as follows:

**CONDITION 1 (Sufficient Authority):** An accounting standard-setting process possesses sufficient authority if it has both a clear mandate of authority... and competence to carry out the assigned function.

**CONDITION 2 (Substantive Due Process):** An accounting standard-setting process meets the substantive due process criterion if it adequately justifies each exercise of its authority and provides an adequate rationale for each ruling.

**CONDITION 3 (Procedural Due Process):** An accounting standard-setting process meets the procedural due process criterion if it permits all interested parties a reasonable and timely opportunity to be heard and provides a reasonable opportunity to influence the rule-making process.

These conditions are held to be both necessary and sufficient. Applying them, Johnson and Solomons (1984: 179) conclude that “there is support for the assertion that the FASB possesses sufficient institutional legitimacy to establish its accounting standard-setting authority and prevent its abuse.” Note that, once again, this conclusion is both historically and spatially specific.

An important issue related to the regulatory process (resulting from conditions 2 and 3 above) is the role and (un?) desirability of lobbying. This touches not only the issue that a rule-making body may be dominated by a particular party and its standards therefore biased towards the needs of a specific interest group. It also links into the broader issue, which in a

sense is where Johnson and Solomons started, of legitimacy and democratic control of the regulatory process. Schmidt (2002: 181), perhaps faces in both directions on the control implications. He states as follows:

A significant aspect in the US is the threat that the FASB's rules could be rejected by the Securities and Exchange Commission (SEC). Leaving the final authoritative support for standards to a public or governmental authority can indeed serve as a considerable safeguard against special interest groups, provided, of course, that this authority clearly protects the needs of all affected individuals and is not also susceptible to such political influence.

But he then adds a footnote suggesting that "the SEC has to be judged critically in this regard". There is ample evidence to support such criticism (see, for example, Zeff 1997), but the problem surely applies just as strongly to the European Union (see the endorsement problems of IAS 39, e.g. in Alexander (2006: 70/71 with the famous letter from President Chirac as an appendix), and further updates below.

A recent example of political influence relates to the issue of fair values and financial instruments. Indeed it provides an example of the blatant intellectual dishonesty which can permeate this whole area. As part of the process of being approved as the new chairman of the SEC, Mary Schapiro told a US Senate hearing in January 2009 that "she could not endorse a standard-setter that was not independent" (Walton, 2009a). Only four weeks later, Walton (2009b) wrote the following.

Another month, another standard-setting crisis. Last month it was the (US) Financial Accounting Standards Board that found itself having to issue urgent amendments to its literature with the merest fig leaf of due process, following political pressure.

It is useful to explore "due process" in the US context rather further. For many years US GAAP had a very complicated hierarchy (SFAS 69, replaced by SFAS 162). This consisted of five levels, categories (a) to (d) and "other accounting literature". As a broad generalisation, Category (a) embraced Standards and other FASB statements exposed to

comment, redrafting and redevelopment, i.e. to a claimed “due process”, and the lower categories did not. Explicitly, Category (a) was superior to, and if necessary over-rode, Category (b), and so on down the line (hence the “hierarchy”).

All this has now been swept away by a new “FASB Accounting Standards Codification”, created by the issue of SFAS 168, and effective from 1 July 2009, which creates a much simpler two-level hierarchy: “codified” and “non-authoritative”. Since “codified” includes items from several of the earlier “categories”, and also “all guidance contained in the Codification carries an equal level of authority” (SFAS 168 para 6) it follows that non-due-process items, such as SEC Staff Accounting Bulletins (para 7) have equal status with widely exposed and discussed new Standards. So “due process” is surely dead in the US context.

It is not easy to map this situation onto the various sub-concepts of legitimacy discussed earlier. Technical competence should be high, as therefore should technical legitimacy. The rule-based arbitrariness of much detail, often emerging from back-office officials, seems uncondusive to both pragmatic and moral legitimacy. Cognitive legitimacy would imply acceptance that this regulatory system has a natural inevitability. This seems doubtful, unless one takes the view that US citizens see day-to-day instructions by officials – usually unelected, but with legal and political backing – as natural and inevitable. This of course may be so, but if that is the case then political legitimacy is very much lacking, as accountability to the community is absent.

Overall, it seems difficult to avoid the conclusion that legitimacy, within this particular historical and spatial context, to the extent its existence is perceived, is created through some more-or-less resigned inevitability.

## 6. Evidence from accounting regulation in France

France represents an interesting, and highly contrastive to the US, case study to consider. It is probably the most “anti-IASB” of the European countries at the present time. Although most mainland European countries share the same civil law philosophy, differences of detail can be significant, France and Spain sharing an “accounting plan” approach, for example, but Germany and Italy having no such tradition.

We avoid here a description of institutions and organisations. There are a number of sources available giving a survey of French accounting history and tradition. English language examples include Walton, in successive editions of Alexander and Archer to 2003, successive editions of Nobes and Parker, and Walton, Haller and Raffournier (2003). For a recent institutional approach (in both literal and social/philosophical senses of “institutional”) see Colasse and Pochet (2009a, 2009b).

However we base our exposition on a recent French source, namely Baert and Yanno (2009). This document is both up-to-date, and apparently influential in the French context. This report of over 160 pages was prepared for the finance and economy commission of the Assemblée Nationale (the lower and more powerful house of parliament) by Dominique Baert and Gael Yanno, both of them members of that assembly. It explicitly aims to increase political awareness, and to encourage political involvement and intervention. It therefore has the additional advantage of being directly and overtly involved in the political process which, as discussed later, seems more part of the problem than of the solution<sup>3</sup>.

This document develops the position that French accounting is significantly legalistic (“l’algèbre du droit”), detailed in its rules, bureaucratic, not pro economic thinking, and not pro Anglo-Saxon. Having said that, two caveats must be noted. The first is that the legalistic approach to the net assets is twice referred to as a fiction. The implications are unclear, as the significance of this “fiction” for French thinking continues to be

emphasised. In fact, the statement, widely accepted, that, for example, credit-bail (leasing) creates an asset not belonging legally to the enterprise, is simply wrong. As was recognised by Raybaud-Turrillo, (1997), a credit-bail creates the right to use the (tangible) asset, and that right is legally enforceable, i.e. belonging legally to the enterprise (as an intangible asset), in the fullest sense of legally.

The second point, which is central to our entire philosophy, is the explicit recognition that there is no “natural” economic reality at all, that there are many “true and fair views”, and that a presentation which may absolutely genuinely represent a true and fair view for an investor, may simply be misleading, or useless, for different users and purposes.

It is interesting to note the closing words of the quotation: “but nobody can say that the other users of the accounts will find their requirements there”, because of course the IASB does say precisely this in the Framework paragraph 10, claiming that

As investors are providers of risk capital to the entity, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy.

This surely blatant *non sequitur* is watered down in the proposals for revising the Framework. The May 2008 Exposure Draft: Conceptual Framework for Financial Reporting, Chapter 1 paragraph OB 2 states:

The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to present and potential equity investors, lenders and other creditors in making decisions in their capacity as capital providers. Information that is decision-useful to capital providers *may* also be useful to other users of financial reporting who are not capital providers (emphasis added).

The implications of this different perception are far-reaching, as we discuss in Section *ultimo*.

It is outside both our focus and practical length limitations to explore internal French developments in detail. Two points can be briefly mentioned. The first is that, as Baert

and Yanno explicitly accept, France has voluntarily introduced large elements of IFRS requirement, virtually word for word, into the *plan comptable général*, i.e. into its national GAAP, despite the fact that its objectives are very different from the IASB's "general purpose financial statements". This is discussed and illustrated at length in Alexander and Segura (2010). The second is that the French internal regulatory system has recently been significantly restructured (for the second time in ten years), a process described and discussed in Colasse and Pochet (2009 a, b). All three papers refer back to Colasse and Standish (1998)<sup>4</sup>.

These developments share a commonality: they represent significant moves towards the Anglo-Saxon tradition, of regulation content and regulation creation respectively. Paradoxes are legion. It was the "second CNC", more French in construction than the third, which pushed IASB thinking and requirement into so many corners of the PCG. It is the Statist French who have reduced State influence in the "new and third CNC"<sup>5</sup>. And it is the French who appear to have significantly ignored the, surely predictable, difficulties of forcing square Anglo-Saxon pegs into round French holes.

In terms of perceptions of the legitimacy of all this, from a French perspective, the acceptance of this system over the years seems likely to be related to cognitive legitimacy, i.e. the control by the State is simply inevitable within the French constitution and tradition. This might be taken also as a political legitimacy, but this is not logical, as the French "dirigiste" system is based on the dominance of a self-perpetuating cadre, not on democratic control. Indeed it forms the basis for the original construction of the European Commission under the Treaty of Rome. McDonald (2000: 107) states bluntly that "the European Commission was never intended to fit models of democratic accountability as we might now understand them". She quotes a comment from an official from an un-named Member State joining the EU in 1995 (therefore not the UK) (2000: 118): "The Commission is childish, male-dominated, very southern and very French".

## 7. Some critical perspectives on Critical Perspectives

A rather different slant on the arguments we are building up is provided in Chiapello and Medjad (2009). Its scope, its rigorous coverage, and its use of emotive rhetoric are well encapsulated in its Abstract, which we quote in its entirety.

The EU-member States have long intended to harmonise their respective accounting rules in order to facilitate the comparison between European companies. This process was brutally accelerated by a 2002 regulation announcing that as of 2005, listed companies would be required to comply with the accounting standards enacted by the IASB (International Accounting Standards Board), a private body which, until then, had no public mandate.

After having tried to harmonise internally the respective standards of its members, the EU has thus decided to resort to private subcontracting, an even more puzzling decision when one realises that at the time, the EU had simply no statutory control means on the IASB. Building on this striking episode of privatisation of the regulatory process, we first examine the structure and governance of the IASB, and the process leading to the transplantation of its norms into EU law. In a second part, we argue that while diverse, the reasons behind such relinquishment of public authority lie primarily within the EU itself. In a third part, we show that in the area of accounting, such transfer of competences went well beyond known forms of delegation to private sector. In a final part, we discuss the subsequent – and so far successful attempt of the EU to reassert its authority as well as its agenda in this area.

The French authorship of this paper seems to be broadly consistent with the French authorship of Baert and Yanno (2009) and also of Colasse and Pochet (2009 a, b). A similarity of philosophy is detectable. Perhaps of more fundamental importance, it is surely obvious that the paper takes a particular, and rather extreme, position as regards the alternative views on the concept of State, and the concept of legitimacy, discussed earlier in this paper.

A contrasting view, which some will undoubtedly view as equally extreme, is provided by Solomons (1978).

Solomons quotes Hawkins (1975: 9-11), and then continues, as follows:

“The [FASB’s] objectives must be responsive to many more considerations than accounting theory or our notions of economically useful data.... Corporate reporting standards should result in data that are useful for economic decisions *provided that the standard is consistent with the national macro economic objectives and the economic programs designed to reach these goals.*” And, as if that were not enough, he added that “because the [FASB] has the power to influence economic behaviour it has an obligation to support the government’s economic plans”. [emphasis as in Solomons].

In that last passage, the word “because” is noteworthy, implying as it does that the power to influence economic behaviour always carries with it an obligation to support the government’s plans. Even if the matter under discussion were, say, pricing policy or wage policy or some aspect of environmental protection, the assertion would be open to argument. In relation to accounting, where the end product is a system of measurement, the position which Hawkins urges on the FASB could, I believe, threaten the integrity of financial reporting and deprive it of whatever credibility it now has.

Solomons concludes his paper:

Whatever limitations representational accuracy may have in pointing us toward right accounting answers, it will at least sometimes enable us to detect a wrong answer. For instance, FASB Statement no. 2, which requires all R&D expenditures to be expensed as incurred, is bad cartography because to represent the value of the continuing benefits of past research expenditures as zero will usually not be in accord with the facts of the situation, however, expedient the treatment may be. Off-balance-sheet financing requires that certain unattractive features of the landscape be left off the map, so that again the map is defective. The criterion by which rules are to be judged is not the effect which they may or may not have on business behaviour. It is the accuracy with which they reflect the facts of the situation.

### **Conclusion**

It is not at all palatable for accountants to be confronted by a choice between appearing to be indifferent to national objectives or endangering the integrity of their measurement techniques. But if the long-run well-being of our discipline is what matters, the right choice should be easy to make. It is our job, as accountants, to make the best maps we can. It is for others, or for accountants acting in some other capacity, to use those maps to steer the economy in the right direction. If the distinction between these two tasks is lost sight of, we shall greatly diminish our capacity to serve society, and in the long run everybody loses.

If the “State” is going to appraise, or seek to determine, the content of laws, rules and regulations, then it needs criteria against which measurement can be made. We now present three example situations.

The first is well-known, from the “IAS Regulation” (European Parliament and Council, 2002). This is the statement that the EU may adopt an IAS only if:

- It is not contrary to the principles of the EU Fourth and Seventh Directives.
- It is conducive to the European public good.
- It meets the criteria of understandability, relevance, reliability and comparability required of financial information needed for making economic decisions.

Of these three criteria, the implications of the first and third are vague, internally contradictory, and highly debatable. The second is either completely meaningless, or is an opportunity for some body (or somebody) to provide a definition in its own selfish interests.

The second example is Article 52 of the Charter of Fundamental Rights of the European Union (2000/C 364/01), which provides a statement of limitations on the individual rights and freedoms supposedly given to European citizens. Sub-paragraph 1 reads as follows:

Any limitation on the exercise of the rights and freedoms recognised by this Charter must be provided for by law and respect the essence of those rights and freedoms. Subject to the principle of proportionality, limitations may be made only if they are necessary and genuinely meet objectives of general interest recognised by the Union or the need to protect the rights and freedoms of others.

Under the Treaty of Lisbon, this Charter is now legally binding on all EU citizens as if it was part of a Treaty itself.

The message is crystal clear. Having spent 51 Articles stating the rights and freedom of European citizens, Article 52 says that they can be taken away if to do so meets “objectives of general interest recognised by the Union”. Who defines the general interest of the European Union?

The third example is older. Documents exist recording discussions and decisions of the Venezia “Council of 10” which accept that actions in restraint of freedom (explicitly including assassination) are justified for “reasons of state”.

The Reason of State rationale was employed to support the behaviour of governments whose security or existence was threatened, thereby triggering the adoption of transparent or secret politics of necessity, which employed any “tool”, irrespective of any justice, ethics or Christian morality principles, but which was necessary for the protection, presentation and strengthening of the State. It is argued in this study that Machiavellian tenets permeated the early sixteenth century society in Europe and justified and legitimised the premeditated secret decisions taken by the [Council of Ten] to kill or harm the enemies of the Venetian State. (Sargiacomo, Servalli and Carnegie 2010).

The three criteria are animals of a similar nature:

- “for the European public good”
- “objectives of general interest recognised by the Union”
- “reasons of State”.

The issue in all three cases is

- what do these phrases mean?
- what are the criteria for determining whether they are applicable?
- who decides on the application of those criteria in any particular situation?

Should we rename the European Commission the “Council of 27”? Presumably the European Court of Justice can determine when the needs of the (European) State can remove fundamental “rights and freedoms”.

The ECJ is of course an important institution within that State itself. Here is an extract from the London Daily Telegraph, 7th December 2009, page B4.

It is the European Court (ECJ) that decides what is “proportional” or “necessary”, and it cannot be trusted. The ECJ behaves like the Star Chamber of Charles I, as I learned following three cases where it rubber-stamped the abuse of state power against whistleblowers Bernard Connolly and Marta Andreasen, and German journalist Hans-Martin Tillack.

Mr Tillack was arrested by Belgian police and held incommunicado for 10 hours on the basis of a fabricated allegation by two EU officials. Police went

through his notes and computers, identifying his network of informants inside the EU apparatus. Mr Tillack took the case to the ECJ. It ruled in favour of the system. It always does.

This is our new Supreme Court under Lisbon, its jurisdiction vastly expanded from narrow commercial law (Pillar I) to the breadth of Union law (Pillars, I, II, and III) ... Lisbon gives the EU “legal personality” to enter treaties as a state and contains an escalator clause that lets it aggregate further power without need for ratification by national parliaments – it draws charisma (Papal usage) from itself.

French and Dutch voters rejected this leap from a treaty organisation to a unitary state when given a chance in 2005. The revamped version was slipped through by parliaments – except in Ireland, where voters said no, until coerced by events into acquiescence. In Britain, Labour did this knowing with absolute certainty that citizens would have voted no.

The EU has crossed a subtle line. It is no longer legitimate.

Here is one final example of EU double-speak, from para 2 of the Radwan report to the European Parliament (A6-0032/2008).

The European Parliament ..... Notes that the IASCF is a private self-regulatory body which has been given the role of lawmaker for the EU by Regulation (EC) No 1606/2002; underlines that the IASCF/IASB lack transparency, legitimacy, accountability and are not under the control of any democratically elected parliament or government, without the EU institutions having established the accompanying procedures and practices of consultation and democratic decision-making that are usual in its own legislative procedures...

The latter part is simply an insult to the intelligence. Is this sort of thing supposed to be justified because it is “meets objectives of general interest recognised by the European Union”?

It is worth exploring the issue of public interest rather further. The standardisation process is a change that re-shapes socio-economies, where private bodies play a fundamental role. If by one hand the standardisation with its specific aims, as has been underlined,

[...] is a matter of someone wanting to fix the way things exist, not from a viewpoint of the almighty but from someone who lives in the specific background context in which this particular standardization is preferred (Biondi & Suzuki, 2007: 592),

on the other this aspect tends to be disregarded in the name of involved technicalities and of an always asserted and recalled ‘public interest’.

As an evidence of this carelessness we can consider the case of the adoption of IFRS in March 2002, when, despite strong influences on socio-economies, the European Parliament proposed to adopt these standards, almost without a serious questioning, obtaining a vote result of 492 in favour, 5 against and 29 abstentions (Biondi & Suzuki, 2007). The fact that this adoption was then automatically imposed on all EU member countries, with no input whatsoever (whether democratic or bureaucratic) at the national level, is an illustration of the tendency for nation-states to suffer from “upward delegation” of powers and responsibilities to supra-national bodies, as discussed in section 2. Arguably the need for legitimacy and the other issues of “a state” are delegated upwards at the same time.

It seems that the EU political actor has declined its political role at least in debating the adoption of such an important socio-economic accounting framework and a similar conclusion can be asserted for national political actors too, i.e. States. In fact, if large groups of stakeholders (outside the capital market) are individually unable in making their voice heard and with too different kinds of specific interest to ally in order to object to proposals coming from IASB, the States which could claim the political legitimacy to represent all stakeholders are fundamentally out of the process.

So, the assertion to act in public interest (see objective of IASB, Table 2) is an ambiguous expression that induces to ask what is the meaning of the public interest? On the subject

it is probable that the answers would depend to a large extent on the ideological perspectives of the respondents (Baker, 2005: 690).

And note this answer given to Hallström during an interview by a IASC expert:

You shouldn't put too much weight on different interest groups, you should be careful with this concept! It's like the medical profession – within accounting we are seeking the truth, not over different interests. We seek the truth for a more efficient capital market. That is what the IASC is doing and not trying to be democratic. The best experts should be there. There are about 50 powerful men and women in the world. And what really is the contribution of developing countries? We know what is best and we can help the rest of the world with our standards. So we shouldn't let developing countries interfere with the

technical work. (IASB expert during an interview: Hallström, 2004: 126).

The fact that the “public interest” tends to be ideologically reshaped and reoriented by respondents seems to be clear.

If supranational (e.g. EU) and national political actors (States) have delegated their power in accounting regulation towards private bodies (such as for example IASB), this shift was not a mere delegation to technical bodies, with proper expertises, but a real “shift in governance” (Van Kersbergen K. & Van Waarden F. (2004: 152)). On the subject it is important to investigate the positions represented inside these private bodies in order to understand the drivers of this reshaping of “public interest”.

Evidence coming from a study conducted by Perry and Noëlke (2005) allows some observations in this sense. Specifically the authors have analysed both IASB Exposure Draft (ED) comment process (from 1 April 2002 to 5 August 2004) and voting-membership of the IASB-EFRAG committees and working groups.

The results of the ED comment process analysis show that the actors that submitted the most comment letters were EFRAG and Association pour la participation des entreprises françaises à l'harmonisation comptable internationale (ACTEO), with a strong presence of Big Four accounting firms, Professional Accounting Associations and Standard Setters. Among the actors present with more than ten comment letters there are few non financial corporations, while only IOSCO is a governmental body.

The mapping of IASB-EFRAG working groups and committees done by these authors, with a network analysis methodology, leads to some interesting results about the democratic legitimacy of the “shift in governance” from public to private authorities in the accounting field. In fact, the Perry and Noëlke findings show that inside the IASB-EFRAG network there

is a domination of Big Four accounting firms, an unbalanced influence of the financial-sector actors and no participation of broad social interest groups (such as for example labour union).

## **8. Towards implications and conclusions**

We have covered a wide range of issues, and attempted to lay the groundwork for applying some of the basic propositions from the early part of the paper to the difficult and contentious issues, propositions and juxtapositions of the later parts. Essentially, there are two issues we wish to address. The first relates to the spread of IFRS, or IFRS content, into areas where its relevance and suitability is debatable (or worse). The second relates to the role of the State in determining the content, both attitudinal, and in detail, of accounting regulation. The theoretical underpinnings of these two issues are conceptually distinct, but a connection exists in that State involvement may, or may not, be conducive to more appropriate achievement of the purposes of financial reporting (whatever they are). The role of the State is the ultimate focus of this paper, but the objectives of reporting, and the implications for regulatory content in general and IFRS in particular, are a necessary input, so we address this issue first.

We have already made the point that financial reporting has a wide range of users. The implications of the diverse uses are often significantly incompatible, as a quick glance at Table 4 should confirm. Providers of equity finance need a realistic picture of economic performance and therefore potential. A banker, and a banking regulator, need a prudent outcome. Tax calculations require a clear, objective outcome. Dividend determination requires a prudent, objective and legally precise outcome. And so on. Different reporting numbers, and different regulations, are implied. As we show in section 6 the IASB is showing early signs of beginning to acknowledge this.

One interesting and highly topical example is given in European Commission (2000), a precursor to the eventual “IAS Regulation” itself (European Parliament and Council, 2002). The 2000 document states in its footnote 11 as follows.

The Commission proposal does not address supervisory issues and the specific information required by supervisory authorities. The implementation of the proposal should not lead to a lessening of the prudential requirements for regulated entities.

In other words, the Commission believes (believed) that IAS are implicitly unsuitable for, and explicitly are not recommended to be used for, prudential regulation by supervisory authorities.

Unfortunately footnote 11 from the 2000 EU document has disappeared, and is not even hinted at, in the definitive 1606/2002 regulation. It seems to have been totally ignored ever since, with well-known disastrous results. For the banking industry to blame the IASB, or fair value reporting, for revealing the effects of its own incompetent management and incompetent regulatory activity is at best opportunistic, and arguably dishonest.

The crucial emphasis on users and purposes is well recognised by Chiapello and Medjad (2009: 459), referring to

the accounting standards situation with its stack of private bodies that are neither financed nor therefore [*sic*] controlled, by the EU.

As a result of this situation, certain public requirements are at risk of not being taken into account. Although accounting serves to inform investors, it is also used to set the limits for distributable profits, to elaborate public budgets and of course, for tax purposes. In these three areas, the determinant factors should be the State’s needs, but such concerns are not covered by the work of the IASB.

We can agree that in these three areas the determinant factor should be the needs of the State (or of those specific users lying behind the fiction of the concept of State). But the obverse is also equally true: the “needs of the State” must not be allowed to interfere with

the provision of economically meaningful investor focussed transparent information. And this latter is precisely what, centrally and crucially, *is* “covered by the work of the IASB”.

The potential confusion of purpose and method is well illustrated by the ongoing saga of the banking crisis. Here is an extract from World Accounting Report, August 2009 (Walton, 2009c:7)

The European Council of Finance Ministers (ECOFIN) considered a report from its working group on procyclicality in July. They called for the recognition of expected losses and the creation of counter-cyclical buffers. They also claimed that fair value accounting should be reviewed in the light of its procyclical effects.

The ECOFIN meeting in July issued a set of conclusions on procyclicality. They said that the ‘absence of counter-cyclical buffers and the lack of flexibility of accounting rules in allowing through the cycle provisioning have been important factors in the amplification of the financial crisis’. The announcement underlined the ‘urgency and importance’ of addressing these issues.

It suggested that the introduction of forward-looking provisioning to deduct expected losses from profits in the good times would limit procyclicality. It would also contribute to a better assessment of real profits in good times, adjust managerial incentives in relation to remuneration, and make investors more aware of the underlying risks. It would also enhance the consistency between accounting and prudential rules.

We simply make three points. Firstly “forward-looking provisioning” means telling lies about economic performance in good times, in order to be able to tell lies about economic performance in bad times. This is State-sponsored income-smoothing and the creation of secret reserves, which the Fourth Directive, as long ago as 1978, set out to prevent. Secondly, enhancing “the consistency between accounting and prudential rules” is exactly what we should NOT be trying to do. This would likely reduce the effectiveness of financial reporting for both purposes.

Thirdly however, and consistent with the combined implications of our first two points, the State-sponsored economic misleadingness (i.e. lying), which is proposed could in principle

be justifiable and desirable, for “reasons of State”. This leads us back to our fundamental focus.

We stated our research question as: to what extent, and how, should the State be involved in the regulation of financial accounting and reporting?

The State seems to be, in essence, a legal fiction, behind which those in positions of authority can shelter from accountability and responsibility.<sup>6</sup> It may be central to the effective functioning of a legal system for maintaining the coherence of a particular community, or it may be actively antithetical to it. Its role, as a human construct, is time and space specific as therefore is its acceptability or otherwise. A necessary condition for such acceptability is legitimacy.

Legitimacy is a perception. It implies social acceptability of the existence, powers and actions of an entity. It is necessarily, as Suchman says, created subjectively. It has to be earned. It may usefully be analysed under the pragmatic/moral/cognitive split, and the technical/political dichotomy, as discussed in section 4. But social acceptability can only be analysed up to a certain point. Perceptions do not have to be logical.

We have potentially three forces, outside individual national systems, to consider: the IASB, the FASB, and the European Union. But the FASB can be dismissed immediately, in that any legitimacy it has outside the USA can only be pragmatic. The EU seems to lack both political and technical legitimacy, the former because of its fundamental lack of accountability and democracy and the latter because of the inherent expertise required in understanding and regulating the accounting function. The IASB can logically claim no political legitimacy at all. Its claims must rest on technical legitimacy, leading, it must hope,

to cognitive legitimacy (“natural or inevitable”) and perhaps eventually to moral legitimacy in the sense that things are perceived as “done right”.

Table 4 – Authors’ perceptions of legitimacy

<b>ACTORS</b>	<b>PRAGMATIC LEGITIMACY</b>	<b>MORAL LEGITIMACY</b>	<b>COGNITIVE LEGITIMACY</b>	<b>TECHNICAL/POLITICAL LEGITIMACY</b>
FASB	YES	NO	NO	TECHNICAL
EU	NO	NO	NO	NONE
IASB	YES (?)	NO ?	NO (?)	TECHNICAL (?)

**Source: authors**

By these considerations, the IASB is currently significantly unsuccessful. It has failed to resolve a number of serious issues over a number of years – consider the still continuing gestation period of revisions to, e.g. IAS 18, 37, and the even longer-term leasing project – producing instead an annual “improvements project” containing minor, but for preparers and users extremely time-consuming, changes, presumably in order to appear to be doing at least something. We summarise our perceptions in Table 4.

In a sense however, the above comment is rather unfair because the IASB has devoted enormous time and effort to dealing with external interference. Given, for the moment, the premise that, with Solomons, the “criterion by which rules are to be judged is not the effect which they may or may not have on business behaviour. It is the accuracy with which they reflect the facts<sup>7</sup> of the situation”, such external interference is destructive in the extreme. It may emanate from affected parties, who try to lobby directly. But it may emanate from political organisations of one kind or another. This latter can itself be divided into two groups: the political organisation may have been “captured” by the affected parties, who, having failed with technical arguments to the regulator, persuade the political organisation to

interfere on other grounds: or the political organisation may be operating for its (or its members) own personal political ends.

Examples of such political interference are commonplace, and we have referred to several earlier in the paper. They are made easier by “due process”, which actively encourages interference.

The most obvious regulatory capture today is by the banking system, which seems to be able to speak and operate through national parliaments, e.g. in France and Italy, and through the European Union, still in denial over its questionable legitimacy.

We have no space to describe in detail the extraordinary changes in IAS 39 requirements in recent years. Our point can be simply made by quoting brief extracts from World Accounting Report of November 2008 (Walton, 2008: 2-3):

In an astonishing *volte-face*, the IASB has had to bow to political pressure and abandon both a key tenet of IAS 39 and its own due process. From 1 July IFRS reporters are able to reclassify ‘held for trading’ financial instruments to ‘held to maturity’ and avoid further fair-value measurement.

If asked before this meeting, most people would have said that the fastest you could amend an IFRS would be something like a year, but with two years more likely. The IASB set a new record by amending IAS 39 inside 10 days, although quite a lot of other things got broken in the process.

On 4 October, a meeting of European G8 finance ministers issued a document dealing with the credit crisis and saying that they would ‘ensure that European financial institutions were not disadvantaged *vis-à-vis* their international competitors in terms of accounting rules and their interpretation’.

The ministers said banks should be able to reclassify out of fair value through profit and loss, and if the IASB did not deal with it by the end of October, they would ask the European Commission to issue its own rules. Their position was endorsed on 7 October by the EU Council of Ministers (Ecofin).

How far has the IASB been damaged by the European political pressure? It is of course too early to say. Its independence and credibility have been called into question, and the banking lobby has once again demonstrated its political clout.

Pozen (2009) reports that Deutsche Bank avoided more than €800 million in losses. Ricciardi and Del Viva (2010) report that for Italian banks, €1.152 million of losses were not recognised as a direct result.

Fortunately we can avoid accusations of national stereotyping by referring to a statement by French accountants. World Accounting Report for May 2009 states as follows (Walton, 2009d: 14-15):

Two associations of accountants who work in business have issued a statement insisting on the focus of IFRS on information for shareholders, and underlining that banks remain a minority amongst companies using IFRS. They say prudential supervision clearly failed in the crisis and should address its own issues.

The associations, the *Association des professionnels et directeurs de comptabilité et gestion* (APDC) and the *Association française des dirigeants finances gestion* (DFCG), were in part responding to a suggestion from French bankers published in March that the Financial Stability Forum (FSF) should take over supervision of the IASB. They were also underlining that in all the recent debate about standards, sight had been lost of the potential impact of changes in IFRS on non-banking companies, who are by far the majority of those applying IFRS.

The joint statement notes that the FSF's primary responsibility is to improve the functioning of the international markets and reduce systematic risk, whereas users of financial statements want transparent and viable information which reflects the performance and financial situation of the issuers.

They acknowledge that the bank supervisors think that some form of risk buffer is necessary. But they suggest that this is necessary for prudential reasons and it is the prudential regulators that should take the steps necessary. They suggest that it would help if the IASB clarified that IAS 39 allowed the creation of provisions based on judgement and historical experience, once negative signs emerge. They do not think diverting accounting standards from their objective of providing good information for investors is desirable.

They emphasise that in their view different economic models require different measurement bases. They would like the IASB to identify clearly those situations where fair value is appropriate and identify acceptable measurement bases for other situations.

These proposals accord closely with the logic of our own arguments. If the Solomons premise quoted above is accepted, then accounting regulations should, indeed must, be left to the accountants. No cartographer would omit a minefield because the government, or a local land-owner, wanted to encourage tourism. No accountant should omit a liability, a fall in expected receivables, or a loss for the year, because the government, or a local banker, wanted to encourage risky investment.

But there is a major proviso. We earlier quoted with approval the Chiapello and Medjad reference to accounting being “also used to set the limits for distributable profits, to elaborate public budgets and... for tax purposes”. For these purposes the Solomons premise should not be accepted.

Our applied analysis can be linked directly to our historical and conceptual expositions in sections 2 and 4. The notions of State and of legitimacy, both separately and within their linkages, can only be conceived and interpreted via contextual relationships which are informed and understood by a rigorous historical and spatial awareness. "The State", in those limited times and places where it has meaning in the first place, is losing authority both downwards (e.g. to local regions, and to quangos and other lower-level non-accountable groups of bureaucrats) and upwards (e.g. to supranational bodies and other high level non-accountable groups of bureaucrats). In the accounting sphere, the fundamental incompatibilities of different user needs are being laid bare by the forces of pseudo-harmonisation, as are the different perceptions regarding the legitimacy of regulators and regulations. Perhaps an awareness of historical specificity has never been so important an input into trying to make sense of apparently ever-increasing complexity.

Our essential practical conclusion is that the IASB should be left alone to do its reporting job. Its standards should not be used, as they frequently are, for purposes for which they are not designed.

This lesson shows little sign of being learnt quickly, in either respect. The financial statements of individual companies, and of SMEs whether forming small groups or otherwise, are largely, in many countries entirely, used only for these three purposes. So the introduction of IFRS, or IFRS philosophy, for the financial statements of such entities is not rationalised. Yet 26 of the 27 EU countries, with the support of, often at the direct order of, their governments are doing precisely that.<sup>8</sup> The recently issued “IFRS for SMEs” Standard, though optional in application as far as IASB is concerned, is being considered by many European governments for compulsory introduction within specified size criteria (including, perhaps surprisingly, the UK), despite its adherence to the measurement criteria of full IFRS. This, again, seems likely to lead to increasing usage of investor-focussed information for State/public purposes. This in turn will only encourage, and arguably provide justification for, destructive interference with the proper work of the IASB.

Overall, we are not optimistic about the situation, or future developments. The IASB must stop selling itself as a panacea for all purposes. The State, at every level and in every guise, must not be allowed to interfere with proper transparent financial cartography.

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## Endnotes

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<sup>1</sup> The reference is MacIver (1926), indicated by Cassese as MacIver (1927).

<sup>2</sup> The next few paragraphs lean on an unpublished paper: (reference suppressed for anonymity).

<sup>3</sup> The following extracts from early parts of the Baert and Yanno report both give the clear flavour, and raise several issues worthy of comment.

France has a highly centralised conception of accounting. Based on legal principles, accounting constitutes an autonomous branch of law, and the State considers itself as the only body entitled to create accounting rules, even if other users may participate in its creation. This conception, consistent with the State's traditional interventionism in the economy and the necessity to create a platform on which to build fiscal rules, has historically allowed the tax authorities (and to some extent, the National Statistical Office [INSEE] to have a major influence in the creation of accounting requirements.

In contrast, in Anglo-Saxon countries, the accounting regulators operate with a separation of legal and financial matters, and with a genuine independence in the achievement of their mission.

French accounting standards are based on an explicit civil law approach to the business resources, which can be envisaged as the totality of rights and obligations ("patrimony") attaching to a person. Accounting is therefore traditionally, the numerical representation of this legally-defined "patrimony", founded on the ownership rights of a person and on the changes in these during an operating period. In a celebrated phrase, "accounting is the algebra of law" and the French accounting system generally takes the legal characteristics of a situation as the basis of determining the accounting treatment.

Opposite to the legal fiction [sic] of a "patrimony" representing a single integrated set of (net) assets, the IFRS standards seek to reveal the underlying economic substance, that is to say that the accounting should reflect the economic rights, obligations, and benefits which are available to an entity. The nature of assets, defined via control over their future benefits, is profoundly changed, and departs from the right of personal ownership. It follows that certain assets defined in legal vehicles as separate from the enterprise can be reintegrated into the balance sheet, or that assets under a hire purchase agreement (and thus not legally belonging to the enterprise) should be included in the assets.

However, while lifting the veil of the legal patrimonial fiction, the IFRS economic approach to accounting appears somewhat biased by its orientation towards investors. Indeed, a single natural economic reality does not exist. As in quantum physics, the characteristics of an object vary depending on the point of view, and there are as many "true and fair views" relevant to an enterprise as there are users of the accounts. The IFRS standards only give one particular economic reality, that which satisfies the information needs of individual investors, but nobody can say that the other users of the accounts will find their requirements there.

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<sup>4</sup> Colasse and Pochet summarise this latter issue as follows:

The current reform of the French accounting standard-setter – that began with the reorganisation of the CNC and which should result in the creation of an accounting standards authority (ANC) – is inscribed in the margins of the historic path of ‘French-style’ standardisation and can be considered as a departure from its partnerial tradition. Indeed, within the new and third CNC, the elaboration of standards is the responsibility of a body, the college, composed of a majority of specialists, whereas in the first and second CNC the elaboration of standards was carried out within the framework of a discussion between the representatives of the various stakeholders. The reform is intended to give added technical legitimacy to the national standard-setter, but doubtless at the price of a deficit of political legitimacy.

<sup>5</sup> This paradox seems to have been recognised. When this third structure was formally activated in February 2010, a career civil servant, Jérôme Haas, was appointed as its president, whereas the last three presidents of the predecessor body were accountants. This may be an attempt to increase political legitimacy, but seems much more likely to be an attempt to increase political control – not at all the same thing!

<sup>6</sup> Nietzsche, in *Also sprach Zarathustra* (Nietzsche, 2010, Canto XI), describes the State as “the new idol”. His disdain is more Anglo-Saxon than Germanic – perhaps a reaction against 19<sup>th</sup> Century Germany.

A state is called the coldest of all cold monsters. Coldly lieth it also: and this lie creepeth from its mouth: “I am the state, am the people” ... (T)he state lieth in all languages of good and evil, and whatever it says it lieth; and whatever it hath it hath stolen. ... (F)or the superfluous ones was the state devised... (w)here the state ceaseth – there only commenceth the man who is not superfluous.

Perhaps the accountant, necessarily independent of, and outside of, the state, is the (wo)man who is not superfluous?

<sup>7</sup> We do not for one second deny that these “facts” are socially constructed

<sup>8</sup> The 27<sup>th</sup> is Malta, which introduced full IAS in 1995, and has now reversed the decision. See Alexander and Micallef (2010). For support of our statement, which could be provided at length, see Chiapello and Medjad footnote 40, and note e.g. the Baert and Yanno paper used in section 6. Note also that membership of IFAC carries an obligation on professional accounting bodies to use their “best endeavours” to achieve precisely this extension of IASB requirements (IFAC, 2006).