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# THE POLITICAL ECONOMY OF THE ACCOUNTING FIRM

**By**

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A thesis submitted in partial fulfilment of the requirement for the degree of Doctor of Philosophy

University of Warwick, Warwick Business School
March 2010

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ABSTRACT

The aim of this thesis is the development of a political economy of large accounting and auditing firms. The importance of this lies in the rapid growth of these firms and the lack of appropriate theories. Economists have applied the theory of the firm to accounting and have approached auditing from agency and litigation costs perspectives, while sociologists have studied the culture of accounting firms and approached auditing using concepts such as ‘legitimation’ and ‘jurisdiction’. These approaches do not recognise that to do justice to the subject matter, we must study accounting firms in the broader context of *accounting* and its many conceptual and practical problems. These include the conceptual framework, auditor independence, the audit expectations gap, creative accounting, and fraud. To study the accounting firm within the context of accounting the thesis develops a political economy approach that emphasises conflict between investors, managers, workers, and the state. This approach proves helpful because it encompasses all accounting and auditing problems within a framework that recognises agency and links together the profits of accounting firms with their legitimation.

The method adopted is the development of a theory of the profits of accounting firms and a model of factors driving auditor independence. Following Bryer, the thesis develops the theory from Marx’s *Capital* by combining his analyses of ‘bookkeeping’ and ‘commercial capital’. The theory highlights that as capitalist enterprises accounting firms compete with all other capitalist firms for a share of surplus value, as well as competing with other accounting firms. However, the political economy approach also highlights the essential contradiction in accounting: that measuring and disclosing profits can exacerbate the ‘labour danger’. The provocative character of accounting means that disguise of profits is part of its nature, but that this must co-exist with the contradictory need for accurate, objective measurement of profits. The model therefore suggests that the role accounting firms play in disguise is the key to understanding their behaviour. It predicts that as the level of profits and labour militancy rises, so do investors’ demand for disguise. However, because investors need disguise, auditors cannot have full independence, and the thesis concludes that this explains why auditing is within the private sector. Its general conclusion is that rather than being a principle, auditor independence is a variable driven by investors’ needs and the capitalist tactics of accounting firms.

The thesis derives and tests two behavioural predictions. First, that accounting firms will exhibit the same types of behaviour as other capitalist firms. Second, the auditor does not act independently. The thesis tests these predictions with evidence of accounting firms’ mergers and profit margins (1986 to 1995), the changes introduced in the US to increase auditor independence (2001 to 2003), and the change to limited liability partnership status (2004 to 2007) in the UK. The high levels of profits disclosed by the LLP accounting firms and the close relationship between mergers and profit margins support the hypothesis that accounting firms adopt capitalist tactics. The wide-ranging debates (1995 to 2005) and changes to auditor independence rules introduced by SEC and Sarbanes-Oxley support the hypothesis that claims of auditor independence are untrue, and that the level of audit independence is a variable. The thesis proposes further development of the theory through historical research and formalising the model.

ACKNOWLEDGEMENTS

Thanks to Rob Bryer for all his help and guidance.

## CHAPTER ONE

## Accounting firms, accounting problems, and the political economy of accounting

### Introduction

The thesis explores whether the organisation and function of accounting firms exacerbate many of the evident problems of accounting. These problems take a wide variety of forms, extending from confusions and disagreements over the conceptual framework and theory of accounting (Bryer, 1999a; IASB, 2006) to lack of auditor independence (Independence Standard Board, 1997; Securities Exchange Commission, 2003). They include the expectations gap (Gray and Manson, 2008, p.46), disagreements regarding overhead allocation (Armstrong, 2002; Bryer, 2006a), disagreements regarding specific accounting issues such as goodwill (Bryer, 1995), the causes of conservatism (Bryer, 2008a, 2008b), creative accounting (Smith, 1992; Berenson, 2003), and fraud (Treadway Commission, 1987). In addition, the introduction of international financial reporting standards (IFRSs) has stirred up many new controversies, especially regarding fair value (Ball, 2005).[1]

To explore the relationships between these problems and the work of accounting firms, this study employs a critical political economy approach (Bryer, 1993a, 1993b, 1994a, 1995, 1999a, 2006a; Tinker, 1980; Armstrong, 1987a). It uses it to identify the fundamental causes of accounting problems and to theorise the role of accounting firms

[1] As a former practitioner I have witnessed these accounting problems both in accounting firms (auditing) and corporations (management accounting). This thesis attempts to go beyond a practitioner's view to gain a deeper understanding of accounting problems.

in exacerbating them. It concludes that capitalist accounting firms are incapable of carrying out independent audits.

This chapter defines “political economy”, “accounting”, and the “accounting firm”. It explores the strengths and weaknesses of political economy, develops a methodological approach termed the ontology of connectivity,[2] and examines the general relationship between political economy and accounting. It then outlines the overall structure of the thesis.

## Defining political economy

Dobb argues that the decisive moment in the development of economic thought was the triumph of neoclassical utility theory over political economy, the “Jevonian revolution” (1973, p.168). A consequence of the dominance of modern economics over political economy is the tendency to define political economy as the application of modern economics to political questions, or as the relationship between economics and politics. This definition reduces political economy to a multi-disciplinary activity rather than a distinctive meta-theory. For example, Frey argued that political economy “studies the interdependence between the economy and polity of a country” (1978, preface), characterized by broadness of approach, empirical orientation and simplicity. He catalogued a number of different variants of political economy: Cambridge capital

[2] This draws on readings in labour theory of value such as those by Banaji (1979), Elson (1979), Horowitz (1968), Marx (1954) and Mepham and Reuben (1979) (see chapter four). Bryer’s (1994a, 1999a, 2007) suggestion of a link between value and accounting provides the academic inspiration for this study which develops Bryer’s thinking to incorporate large accounting firms.

theory; radical economics; social science systems theory and systems dynamics; systems analysis and policy science; public choice; applied economic policy; the unorthodox, e.g., Galbraith (Frey, 1978, p.38). The multi-disciplinary definition of political economy is clearly not synonymous with a single model, aim or methodology, and political economy becomes difficult to define.

Other scholars have applied what they called a political economy approach to "underdevelopment" and "globalisation", such as Staniland (1985), O'Brien and Williams (2005), and they do provide some limited insight into the definition, scope and distinctive nature of political economy. Staniland considers the definition of political economy as "the relationship between politics and economics" (1985, p.1), but shows that a wide range of approaches and interpretations can be used in studying this relationship. Rather than choose between the various approaches, Staniland proposes a general model, broad enough to encompass all the different variants. He argues that political economy is an agenda, not a theory, and one with a strong normative element. Within this agenda, a number of approaches attempt to explain the relationship between politics and economics. These approaches, he argues, evolve through time. Staniland (1985, p.2) describes an intellectual dialectic, producing theories of political economy, which has passed through four broad stages (Orthodox liberalism, regarding the individual as fundamental; the "Social" criticism of liberalism; "economism": the argument that politics is secondary and economics primary; and "politicism": the argument that politics is primary and economics secondary).

The notion of an intellectual dialectic, a reciprocity between concrete structures and the theories which interpret those structures, is a useful one (see Tinker *et al*, 1982 in relation to value theory), but it is a broad vision, reflecting Stanilands' global development perspective. The subject of this thesis is Anglo-Saxon accounting systems, those characteristic of the USA, UK, and Australia (Ball, Kothari and Robin, 2000; Ball, 2005), and therefore Staniland's broad, open-ended approach is not appropriate. Wickramasinghe and Hopper's (2005) response to the problem was to suggest a "cultural political economy". O'Brien and William's (2005, p.12) approach to the study of globalisation contrasts political economy with "liberal" economics, allowing it to stand independently as a "critical" alternative framework. The thesis develops this approach to the definition of political economy.

Leading founders of political economy were Smith, Ricardo and Marx, and recourse to these grand masters provides a working definition. I leave Smith to one side because influential theorists argue that Smith's *Wealth of Nations* (1980, originally 1776) was not theoretically sophisticated, more a popular work rather than an academic piece (e.g., Dobb, 1973).[3] Leading scholars accept that the work of Ricardo and Marx provides the theoretical core of political economy, particularly the concepts of value, distribution, and class (e.g., Dobb, 1973; Meek, 1973; Foley, 2000). They highlight important differences between Marx and Ricardo, particularly in the use of dialectic and different types of value theory (Meek, 1973; Rosenthal, 1993; Foley, 2000), but generally conclude that the

[3] An example of Smith's popular approach is Landes (1988), who following Smith adopts a narrative historical perspective.

concepts and methods common to both provides the basis for the most authoritative definition of political economy.

Ricardo argued that:

> "The produce of the earth, all that is derived from its surface by the united application of labour, machinery and capital, is divided among three classes of the community" (1971, preface, originally published in 1817).

Ricardo's three classes were capital, land and labour, but generalising this approach we can define political economy as a world-view in which powerful economic groups, such as shareholders, managers, financial intermediaries, accountants, etc., organise production and distribution. Ricardo's focus on 'the produce of the earth', all of production and distribution, means that we cannot study these groups in isolation. They are closely interconnected, each a part of a greater social whole or system. Relations between the "classes" of this system, often conflicting but sometimes cooperative, and their relative power and ability to control economic benefits and wealth, is therefore the stuff of political economy. As a world-view, political economy clearly contrasts sharply with neo-classical economics' focus on individuals making decisions to maximize utility.

Marx's political economy explicitly defines the relevant groups as "classes" by their role in the cyclical economic processes of production, distribution, exchange and consumption, and we can link his approach to defining political economy with accounting. Bryer (1994a, 1999a) has found Marx's (1954, 1956, 1959) model of the "circulation of capital" useful for examining modern accounting practice. This model conceives of the business process in three stages. The first involves the capitalist buying raw material, machinery and labour. The second involves combining these in the production of a commodity (goods or services). The third involves selling commodities at a profit. This model gives rise to class distinctions such as productive worker, unproductive worker, supervisor, capitalist, investor, accountant, auditor, etc (Bryer, 2006a).

Generalising Bryer's approach to understanding political economy through accounting practice, one of the most important debates in finance is the question of 'agency' (Arnold, 2002), how capitalists control their agents (wage workers of all kinds). Specialists in organisations and society study the agency issue as "managerialism" (Rowlinson *et al*, 2006). Jensen and Meckling (1976) are seminal for these and other specialist approaches (Armstrong, 1991; Ryan *et al*, 1992) and, despite the fact that they work with the concepts and methods of neo-classical economics, the essential elements of political economy feature in their analysis. The powerful economic groups involved are shareholders and managers, and the core of the debate concerns the extent to which shareholders monitor and control managers. Levels of directors' remuneration and the various forms it adopts (fixed salary, profit share, share options, etc) feature in the debate.

Following Ricardo and Marx, a political economy of the agency problem would place the agent in the context of a wider set of relationships, including workers, government and financial intermediaries, taking a more holistic approach, shifting the emphasis from individual decision-making towards conflict between classes. Interpreting agency within political economy transforms the concept into something more general, more akin to control (Neimark and Tinker, 1986), suggesting links with labour process, value theory (Bryer, 2006a; Rowlinson and Hassard, 1994), and power (Allen *et al*, 1992, p.385). In Hopwood's (2005, p.585) review of thirty years of *Accounting, Organisations and Society* "forms of calculation and control" have emerged as the strongest themes. A major contribution is Armstrong's sociological approach to agency and the "raw materials of control" (1991, p.12) that provides an alternative to the political economy of agency, generating perspectives that this thesis attempts to constructively critique. Another contribution is Bryer's link between 'calculative mentalities', accounting, forms of accountability, and the transition to capitalism. In short, there are strong but undeveloped links between classical conceptions of political economy and major debates in accounting, finance, organisations and society.

A major reason for this neglect is undoubtedly that following the contributions of Ricardo and Marx, controversy, conflict and divergence has riven political economy, exacerbating the difficulty defining it. Debate about transforming values in to prices (Steedman, 1977; Foley, 2000; Keen, 2001) and the abandonment of value theory by many Ricardian and some Marxists scholars, such as Baran and Sweezy (1968), fractured the tradition. Nevertheless, a distinctive core remains around the classical world-view dominated by powerful economic groups or classes, which has the advantage that we can draw into it ideas and methods from other perspectives. For example, managerial perspectives (Baran and Sweezy, 1968; Rowlinson *et al*, 2006), the monopoly capitalism tradition (Kalecki, 1939; Cowling, 1982), sociology of the professions (Roslender, 1992; Armstrong, 1985; Johnson, 1972), and from classical Marxism (Reuten and Williams, 1989; Elson, 1979). In this thesis, all these play a part in shaping the political economy of the accounting firm.

**Defining accounting**

The difficulty in defining accounting stems from the fact that two antagonistic theoretical approaches co-exist, the accountability approach and the decision making approach (Bryer, 1999b, 2006a), reflecting the differing perspectives of political economy and neoclassical economics respectively. The accountability approach argues that accounting enables managers to demonstrate to shareholders an adequate return on capital in a particular period of time (Bryer, 1999a; Bryer, 1999b). The decision making approach argues that accounting enables individual investors to make investment decisions (FASB, 1980). The strength of the accountability approach is that it reflects modern accounting practice, for example, the continued use of the profit and loss account using the realization and matching principles of accrual accounting. The decision-relevance approach stems from economists' theories of what accounting should be, which we can see as an ideological vision that is often quite different from the reality of modern accounting practice (Bryer, 1995; 1999a, 1999b, 2006b).

The accountability approach also provides a unified basis for understanding financial accounting, management accounting and auditing. Financial accounting relates to external accountability to shareholders, while management accounting traces this accountability into the company, down to production (Bryer, 2006a). Auditing represents an independent check on the accounts to ensure they are an 'objective' basis (defined below) for accountability to shareholders. Economists' definitions of accounting, on the other hand, tend to dichotomise it because they characterise the decision-making needs of shareholders as different to those of managers. In reality, most companies operate a unified financial and management accounting system, exposing economists' lack of conceptual or empirical understanding of accounting (Shiozawa, 1999; Bryer, 2006b, 2007).[4]

I use the term "accounting" throughout this study to describe the process of managers' accountability to shareholders, underpinning financial and management accounting and auditing. Bryer (1993a, 2000a, 2000b, 2005) has shown this definition has strong historical roots and, as a result, I use the term "traditional accounting" interchangeably with "historical cost" and "accruals" based accounting.[5]

Another advantage of the accountability definition of accounting is its strong links with concepts such as control, power and management practice. Bryer (2006a) emphasises two forms of control, action control and results control. Action controls dictate the

[4] Bryer (2006b) shows that the need to integrate financial accounting with management accounting was reflected in a number of comment letters to IASB, including the Financial Directors of the Top 100 UK plc's (Comment letter 126)

[5] The term "accounting practice" is avoided because of the possible confusion with accounting firms.

labour process while results control focuses on the outcome of the labour process, the prime results being a rate of return on capital. Accounting is a form of results control involving setting managers a target return on capital. Failure to achieve target, leads to punishment, such as lower pay or loss of employment. A common form of action control, on the other hand, is "Taylorism", breaking down of complex tasks and craft skills into innumerable smaller tasks designed by the capitalist (Allen *et al*, 1992) and closely supervised or machine driven.

The accountability approach leads to a robust definition of the accounting firm. We can define an accounting firm as one that operates in the sphere of accounting and accountability, preparing financial statements for shareholders, auditing accounts, preparing taxation returns for government, and other matters such as insolvency and systems that support accountability to creditors and shareholders.[6]

The definitions of "political economy", "accounting" and "accounting firm" provide a necessary foundation for this thesis. To understand their strengths and weaknesses we must look more closely into the general philosophical character of political economy, and doing this will identify the major themes running through the thesis.

[6] I do not refer to accounting firms as 'professional practices' or 'accounting practices', as these popular terms prejudge the questions raised here as they could be used to legitimate them.

**Strengths and weaknesses of political economy**

One possible weakness of political economy when narrowed to Marxist political economy is that it incorporates value theory, labour process approaches, and class, which since the 1970's many claim are inconsistent or incompatible (e.g., Carter, 1995; Rowlinson and Hassard, 1994). However, Bryer (2006a) shows that the differences between these approaches can be reconciled through an understanding of the social roles of accounting, and the thesis supports this view by applying all three elements of Marxist political economy to create and test a model of the accounting firm.

Because political economy is a world-view, the quantity of evidence, such as quantitative data or case study details, required to prove or test hypotheses is considerable, and potentially overwhelming. In contrast to political economy, modern economics is often narrow, but well defined. Economists generate manageable and well-defined sets of data to test specific hypotheses (Koutsoyiannis, 1972, p.5). The amount of data required to present or prove propositions drawn from political economy is often very large and the boundaries of the data uncertain. Bryer (1991, 2000b, 2008a, 2008b) are all good examples of the amount of data needed to sustain political economy.

Another perceived weakness of political economy is that its practitioners often see individuals as exemplars of classes. Marx, for example, appears to lose sight of the individual when he explains that:

> "Here individuals are dealt with only in so far as they are personifications of economic categories, embodiments of particular class relations and class interests" (1954, p.21).

At face value, this appears to say that classical political economy does not recognize the uniqueness of every individual, or the role of individuals in shaping organisations and innovation. This, however, is the view of Marx focusing on "capital in general" in *Capital*. If we consider all Marx's work, including his early work on the nature of social reality, we see that, as a world-view, political economy has to work through many layers of detail, or levels of determination, before placing the uniqueness of the individual in a proper context. Consequently, the individual often does not feature in classical political economy, for example, Marx (1954). This does not mean that we cannot incorporate the individual in Marxist political economy (see, for example, Ricoeur, 1986; Avineri, 1968), and Bryer (2005) locates individuals (capitalists) in political economy. Deutscher (1963), who examined the role of Lenin in the Russian revolution, provides another example. In this thesis, several opportunities emerge in chapters eight and nine to locate individuals and their mentalities within the explanatory framework.

In this era of "globalization" and international capital markets a clear strength of political economy is that world-views are more relevant than micro approaches. Further, there appears to be a growing recognition that rich nations exploit poor (Stiglitz, 2001), and that we should explore this and related problems within political economy rather than within neo-classical economics or post-modernism, because class conflict is inherent in its theoretical framework. As the thesis adopts a 'world view' or global perspective, explaining the impact of differing regulatory environments, for example, a comparison of UK financial regulation with the US system (e.g., Bush, 2005), is a second order problem that will not be pursued here.

A major strength of political economy is its philosophical robustness. Burrell and Morgan (1979) pointed to two common forms of ontology in modern organizational and social research, the realist and the phenomenological (nominalist or idealist), representing the domains that exist independent of the human mind and the domain of human thinking. This distinction, although a useful one for the purposes of planning research, is ultimately false because the only known resource for explaining human activity is the human mind (Reuten and Williams, 1989, p.12). Nothing human or natural can exist as a subject of inquiry independent of the human mind and, as a result, in explaining human behaviour we cannot segregate the real and the nominal. As a world-view, political economy provides a theoretical framework for reuniting the two domains and studies them as elements of an integrated system. From a realist perspective, institutions, contracts, rules and regulations, which all exist independent of the mind, characterize powerful economic groups. Idealists, on the other hand, tend to characterise classes by knowledge bases, language, symbols, etc. Within political economy, relationships between classes simultaneously exist in both domains. Thus, for example, we must study the agency relationship through share option arrangements (the real) and through shared cultures and motivations (the ideal). This unifying character is a major strength of political economy.

Political economy has a distinctive approach to causation revealing further strengths and some weaknesses. In economics and business, arguments about causation often rest on the distinction between exogenous and endogenous variables, for example, unemployment (endogenous) is caused by labour market inefficiencies (exogenous) (Fleetwood, 2001). The distinction between exogenous and endogenous variables is redundant in political economy because all variables are endogenous to a world-view. In the context of explaining the industrial revolution, for example, Hobsbawm (1968, p.34) argues that:

> "It cannot be explained primarily or to any extent in terms of outside factors such as – for instance – the imitation of more advanced techniques, the import of capital, the impact of the already industrialized world economy".

The burden of understanding causation, consequently, has to fall on the relationships between economic groups. Within political economy, classes are in a constant state of interaction with each other. Complex reciprocities may emerge between them, sharing some of the characteristics of game theory (Willmott, 1991), and these may develop exponentially if unchecked. This complex view of causation can lead, therefore, to the argument that everything depends on everything else. In short, causation can be over complex and chaotic in political economy.

We can see this weakness in dealing with the causes of change in the array of ideas regarding the development of the capitalist system. These include theories based on “imperialism” (Lenin, 1917), “finance capitalism” (Hilferding, 1981), “managerialism” (Baran and Sweezy, 1968), “monopoly capitalism” (Cowling, 1982), “de-skilling” (Braverman, 1974), “Fordist” to flexible regimes of accumulation” (Allen *et al*, 1992), socialised capital and wage labour (Bryer, 2000a, 2000b), and from individual to social capital (Toms, 2005). Exponents of political economy disagree about the changing nature of capitalism and its causes.

Scholars working in the political economy tradition find practical ways of avoiding chaotic over determination. Armstrong (1985, 1987a, 1990), for example, examined the process of the development of managerial control strategies leading to his interdisciplinary competition model. “What is needed first of all is a theorization of how management control strategies are generated” (Armstrong, 1991, p.7). Similarly, Bryer (2005, p.28) identifies key factors (social relations of production, capitalist mentalities and accounting) and examines the reciprocity between them.

However, political economy has to function as a general framework, not one relevant only to well defined questions, hypotheses or key factors, and as a result, it needs a method of controlling and disciplining causation. Some Marxists argue that this is the role of philosophical dialectics in Marx, a conceptual framework for understanding change and disciplining causation. The term dialectics refers to modes of thought where conflict and contradiction give rise to the forces of change, a way of thinking which is sometimes referred to as ‘unity in difference’. The essence of a contradiction in dialectical thinking is two forces simultaneously attracting and repelling one another. A classic example is Marx's (1954, p.43) interpretation of a commodity as comprising use value and exchange value. Two forces simply attracted to one another is an example of functionalism. If two forces repel one another, there is no on-going relationship, correlation or trend to study. If two forces simultaneously attract and repel, this creates a continuous tension and relationship. Reuten and Williams (1989) use "systematic dialectics" to discipline and structure complex arguments, showing the links between general theory and government policy. Without dialectics political economy tends to become static, or dependent on exogenous factors or events, in which case it is logically incoherent. In this thesis, political economy is combined with systematic dialectics to seek a better understanding of accounting problems and capitalism.

A recurrent theme in discussion of political economy and Marxism is the accusation of "economic determinism" (Tinker, 1999). As a world-view, the notion of the economic in political economy is broad, including methods of production, exchange, and distribution of rewards. Within these different facets of the economic are aspects outside the boundaries of the economic sphere (Dobb, 1973, p.168). Methods of production, for example, encompass work place discipline, power, and ordering the individual. Distribution raises the issues of fairness and equality. In addition, political economy often takes a historical perspective (Marx, 1954; Hobsbawm, 1968; Thompson, 1995). There is, therefore, nothing limiting or deterministic about political economy because its concept of the economic is diverse.

A criticism of political economy often advanced along side economic determinism is that of empiricism, but the fact that political economy integrates the ideal and real is sufficient to disprove the accusation of empiricism (e.g., by Tinker, 1999). The distinction between 'inside' and 'outside' investors plays an important part in finance (e.g., La Porta et al, 2000) and financial history (e.g., Maltby, 1999), and political economy can be criticised for assuming that investors and capitalists are a homogenous group. In this thesis I will start from the position that investors are a class with common characteristics (particularly, a shared calculative mentality and collective exploitation of labour), but I will develop my theory of the accounting firm using the idea of 'competition between capitals' (Marx, 1959) to reveal the conflicts within this group. Because political economy has strong roots in economic theory and has evolved rich concepts such as "value" and "social relations of production", it is perhaps difficult at first sight to understand how such criticism can be taken seriously. These criticisms are, in fact, products of the many weak definitions of political economy which this chapter has criticised.

**Methodology and political economy: ontology of connectivity**

Although political economy is an important framework for business and social research it is still a minority interest, needing further development to maximize its potential. This section suggests a methodological approach to political economy, termed the ontology of connectivity, to make political economy more operational and practical.

The ambitious, large-scale and holistic nature of political economy is its theoretical strength and its practical weakness.  It is around this meta-theoretical idea of a ‘whole’ or ‘system’ or ‘totality’ that we need development.  Bryer (1993a, 1994a) for example has demonstrated the importance of the concept of “total social capital” and like other Marxist scholars such as Althusser (1977) and Lukacs (1968), and Williams (1963, p.146), has firmly established the holistic view as a key aspect of Marx.  In the context of this thesis the intellectual challenge is therefore how to realize this total vision for the accounting firm; how, in other words, to grasp the multifarious connections that link together the whole of accounting and society?

Established research methodologies and methods (discussed in chapter five) are suited to smaller and well-defined problems.  The researcher in political economy often has to modify or invent methodology, methods and terminology.  The key to the methodological basis of political economy is to rethink the classical and philosophical idea of ‘truth’ and redefine it as the connections and linkages holding the system together.  We can make political economy practical by defining truth as knowledge about the relationships between classes.  The truth sought in political economy is not within the individual, firm, company, industry, government or country, but lies in between them, in what Marx termed the “social relations of production” (1986, p.45).

Truth is the relationships that link powerful economic groups together both in terms of real institutions, like the accounting and auditing rules and regulations governing the New York Stock Exchange, as well as in theories, language and symbols.  I will term this idea the “ontology of connectivity” to signal the fact that it represents a particular methodological approach to political economy and an alternative foundation for labour theory of value which, in chapter four, will be contrasted with those suggested by Sweezy (1942) and Mohun (1994b).

I argued earlier that political economy can over-complicate causation and needs the discipline of dialectics to provide a tractable dynamic theory of capitalism. The ontology of connectivity when combined with systematic dialectics (Reuten and Williams, 1989) provides a framework for this. The former focuses attention on the relationships between classes and the latter conceptualises these relationships as 'unity in difference', providing a basis for exploring the process of change inherent in capitalism. Systematic (or systemic) dialectic imposes priorities on the process of development of class conflict, production first and circulation second (see chapter six), while the ontology of connectivity allows these conflicts in relationships to evolve in both the real and ideal domain. 'Truth' lies in the relationships between classes, which should be grasped as a series of contradictions evolving, step-by-step in the real and ideal domains. Chapters four (value) and five (methodology) apply these ideas to the accounting firm. The justification for doing this is that accounting can allow us to measure these contradictions, and thereby provides the epistemological foundation of the ontology of connectivity.

**The relationship between accounting and political economy**

Accounting measures the rate of return on capital and directs managerial attention to problem areas. Part of the task of measuring the profit available to shareholders is measuring the claims that other groups or classes (banks, managers, government, workers, suppliers, etc) make on the surplus generated by companies. In short, accounting measures the key variables in political economy, the production and distribution of profit between classes.

Applying the perspective of the ontology of connectivity, however, the relationship between accounting and political economy appears deeper. Within this framework, accounting exists in the spaces between classes, mediating the relationship between them (Tinker, 1980). Objective annual reports, for example, allow shareholders to observe the effectiveness of managers. Tax accounting mediates the relationship between companies and government. Management accounting mediates the relationship between workers and managers (Bryer, 2006a). Interpreted in this light, accounting is the medium for governing relationships of accountability. The methodology of ontology of connectivity sees accounting as the social technology holding the system together.

Accounting, like political economy, works in both the real and nominal domains. The institutions of accounting, such as accounting firms, and the rules of accounting, such as accounting standards, and the impact of decisions based on accounting data, are all firmly in the domain of the real. However, Foucauldian accounting scholars such as Grey (1994) have shown that we can analyse the impact of accounting processes on the mind of the individual. The introduction of a strict system of budgeting, for example, alters the thinking and behaviour of departmental managers by forcing upon them “self control”. The fact that shareholders receive regular financial reports plays an important part in shaping the thinking of senior managers, imposing on them investors’ priorities and ensuring the success of “results control” (Bryer, 2006a).

We have seen that as a world-view, political economy focuses on generalised, worldwide processes rather than those specific to one country (O’Brien and Williams, 2005). By contrast, historically accounting has played a more important stewardship role in some economies than others (Ball, Kothari and Robin, 2000; Ball, 2005). The process of globalisation, however, is introducing more accounting discipline in more countries, industries, and sectors and, consequently, stewardship accounting is becoming more widespread. In addition, the introduction of IFRSs is making accounting more consistent as well as more generalised. Accounting is an emerging global practice and, therefore, increasingly shares the scope of political economy.

From the idea of ontology of connectivity, therefore, an important conclusion emerges regarding accounting. Accounting meets the criteria of truth. It gives us evidence of the relationships between powerful economic groups; it is a worldwide large-scale system of accountability; it works in the domain of the real and the nominal; it evidences class conflict, which we can interpret dialectically. We can therefore say that accounting is a ‘modality of truth’, a moment that combines all the elements of socially objective truth.

This gives us an insight into the relationship between political economy and accounting. Given its intellectual prominence and history, it might seem that the “political economy of accounting" (PEA) refers to the application of the concepts, models and methods of political economy to the sphere of accounting, leading to a better understanding of accounting. However, the combination of accounting and political economy brings a practical reality into political economy, helping realize its potential. Perhaps the principal beneficiary of a PEA will be political economy and not accounting. More likely, political economy and accounting can benefit mutually from partnership.

Having discussed the methodological approach, I turn to the empirical domain for investigation – the neglected issue of the political economy of the accounting firm.

**Accounting firms**

Only a few critical accounting scholars (Hanlon, 1994; Dirsmith *et al*, 1997: Cooper *et al*, 1998) have investigated the origins and historical trajectory of accounting firms even though recent years have witnessed the rapid growth in size and influence of accounting firms. The total fees generated by the top four firms in UK alone in 2007 were £6.7 billions (2006 £6.1 billions). A process of consolidation has long been at work in the accounting industry leading to the emergence of four major accounting firms (Price Waterhouse Coopers, Deloitte and Touch, KPMG, Ernst and Young). The key events in this process include the merger of Price Waterhouse with Coopers in 1990 and the disappearance of Arthur Andersen in 2002 because of their involvement with Enron. In addition, there has been a gradual increase in the size of accounting firms through numerous smaller mergers. Comments made by the EU Internal Market Commissioner reported in *Financial Times* (27th October, 2006, p.7) suggest that the oligopolistic character of accounting firms is widely viewed as unsatisfactory. Searching the *Financial Times* in electronic format reveals that the situation has been referred to as a "monopoly" or "virtual monopoly" on more than five occasions between 2005 and 2008.

Another landmark event as yet unexplored by the literature was The Limited Liability Partnership Act (2000) providing accounting firms with the opportunity to work under the protection of limited liability, which other firms had enjoyed for almost one hundred and fifty years (Bryer, 1997). Before the enactment of limited liability partnerships, all partners were liable for all their personal wealth, but they were exempt from the requirement to disclose profits, hampering research into accounting firms.[7]

This highlights a general difficulty in researching accounting firms, which has been, and to some extent remains, a lack of easily available public data. I therefore focus my efforts on uncovering and constructing evidence around key events in the development of accounting firms (mergers, Enron and LLP status). In the period between 1985 and 1996, accounting firms made some limited voluntary disclosures of fees charged and the staff numbers employed. I combine these disclosures with salary data to reveal a trend in large accounting firm profit margins, which correlate closely with merger activity. The collapse of Enron took place at a time when auditor independence was already under scrutiny. A fuller picture is revealed by tracing the development of the debate from initial SEC concerns in 1996 through the Independence Standards Board Report of 1997, SEC Hearings and Reports (1998 – 2001), the Sarbanes-Oxley Act (2002), to the re-

[7] Not all accounting firms have taken advantage of limited liability partnership status, see chapter nine.

evaluation of Sarbanes-Oxley Act (2002) cut short by the ‘credit crunch’ of 2007. The emergence of LLP status imposed full financial disclosure on accounting firms providing a richer and growing source of evidence in the period 2004–2007. The thesis uses evidence from all these sources.

The perception among accounting scholars of a lack of data relevant to accounting firms has also hindered theoretical development. The economists “theory of the firm” has been rarely challenged (Baker, 1993 is an exception dealt with in chapter three). The first task of this study is, therefore, the development of a theoretical model of the accounting firm based in political economy.

**Structure of the thesis**

Chapter two reviews the literature on PEA highlighting the strengths and limitations of political economy developed above. A consequence of the classical definition of political economy is that Bryer’s and Armstrong’s models can be seen as the dominant and alternative approaches within PEA. Two clear imperatives emerge: first the need to theorize the relationship between accounting, capital markets, and corporations, particularly the balance of power between them, and second the need to incorporate the commercial aspects of accounting, that is, the accounting firm. Chapter three gives a literature review of accounting firms and shows the need for more evidence on accounting firm mergers and profits. The chapter goes on to argue that the two literature reviews share a common concern with the profits of accounting firms, which then justifies the development of a theoretical model of the profits of accounting firms. Chapter four begins this by examining the relationship between value and accounting and criticizes "qualitative value theory", providing a foundation for identifying the best methods for developing the theoretical model, which are examined in chapter five.

Chapter six is devoted to the development of a Marxist theory of the accounting firm from the text of Marx's *Capital*. To facilitate this, I interpret Bryer's ideas on Marxist theory of accounting dialectically; identifying the fundamental contradiction in accounting as the fact that it has to disguise the exploitative nature of capitalist production.[8] Two behavioural predictions come from Marxist theory of the accounting firm. First, that despite claims to the contrary, they will pursue profit in the same manner as any other capitalist firm and, second, that this means they will make claims of objectivity that are false. Chapter seven uses quantitative data published by accounting firms to test the first hypothesis, which shows a close relationship between accounting firms' profit margins and mergers.

Chapter eight develops the lack of accounting firm objectivity hypothesis into the arena of auditor independence. A review of the literature on audit independence shows that the causes of the problem have never been fully theorised and a Marxist model is developed, identifying the key variables and contradictions driving audit independence. It predicts that as the level of profits and labour militancy rises, so do investors' demand for disguise. I present evidence from SEC reports, hearings and material made available by

[8] Bryer (1999a) has shown that the economists' "conceptual framework" for accounting is the basis for this disguise and that economists' theories of profit are also an attempt to disguise the origins of profit. Bryer (2008a, 2008b) argues that conservatism and secrecy are two other common aspects of accounting disguise.

the Independence Standards Board consistent with the trends predicted by the model. Chapter nine tests both hypotheses by examining the emergence of limited liability partnerships. Quantitative data drawn from accounting firm reports and accounts reveals the capitalist character of accounting firms and historical evidence shows that LLP status reduces the independence of auditors. Chapter ten summarises the contribution to knowledge and discusses future research opportunities. As the model predicts long-run trends and turning points in the relationship between investors and accounting firms, it argues that the best approaches to strengthen and refine the model are in depth accounting history (e.g., Maltby, 2009) and more formalised quantitative research that will become possible as the published data set grows.

## Conclusion

The definition of political economy developed in this chapter has a number of features. It is developed from the ideas of Ricardo and Marx; it stands in opposition to neoclassical economics; it provides a framework for integrating sociological insights on class and labour process; and it is philosophically robust, rebuffing accusations of economic determinism and empiricism. I conclude that the theoretical framework is broad enough to encompass the problems and discourses of accounting and the agency debate.

The sociology of the professions (Johnson, 1972; Roslender, 1992) exposes many of the claims of “professional status” as false, including accountants’ claims. This thesis accepts the arguments of Sikka and Willmott (1995), but by placing them in a political economy framework builds on them theoretically. Here concepts such as ‘legitimation’ and ‘jurisdiction’ are linked with accounting firm profits and processes of control, emphasising their real dimension and placing them in the context of modern financial markets. This reveals claims of professional status to be deep seated and real ideologies. Rather than limiting them to “social action” (Weber, 1968), the thesis works to give them a material basis in the real life of individuals (Ricoeur, 1986).

# CHAPTER TWO

## The political economy of accounting literature

### Introduction

The thesis aims to develop a theory of the accounting firm from political economy to gain a better understanding of the problems of accounting. The aim of this chapter is to discover the existing state of knowledge in political economy of accounting (PEA), including the results so far obtained, concepts, theories and models used, methods and methodologies employed, unresolved problems and gaps in the literature. These explorations will refine the research aim and point the way towards methodology and methods, the subjects of chapters four and five.

The existing literature on PEA is distinct from that on accounting firms. PEA is a recognized branch of critical accounting, alongside the labour process tradition, Foucauldian scholarship, and critical theory approaches (Cooper and Hopper, 1990). In contrast, the literature on accounting firms is dominated by mainstream thinking, that is, the application of economics to accounting (Otley, 2002). Strictly speaking, an accounting firm literature does not exist. Rather, there are a number of papers addressing a range of topics such as audit fee determination, for example, Pong and Whittington (1994), and concentration studies, for example, Moizer and Turley (1989), which obliquely address accounting firms. In only a few studies are accounting firms the main subject, for example, Dirsmith *et al* (1997), and many in which the accounting firm provides only part of the context of the study. Because of the sharp distinction between the literatures, this chapter focuses on PEA while chapter three is devoted to literature on accounting firms and the development of the research aim. PEA has only reached maturity in the last 15 years and, consequently, this review covers most of the published papers on the subject, including those on its boundary. Literature on accounting firms, on the other hand, is more diverse and some selectivity is required.

**Tinker: origins of political economy of accounting**

The first paper attempting a PEA was Tinker (1980) which was inspired by the "capital" debate (Dobb, 1973; Keen, 2001). In this debate, critics of neo-classical economics suggested that its notion of capital was not meaningful, and profit could not therefore be understood as a return on capital, and profit was not determined in the neo-classical system. This was a theoretical argument having little relation to the practicalities of accounting. Tinker (1980), however, saw in accounting a means of enlivening the debate. The paper was termed "towards" a PEA, because it did not attempt to give a full exposition of what a PEA might entail, but it powerfully made the point that distribution of profit was a social process.

Chapter one argued that a difficulty with political economy is its lack of an agreed theoretical framework. This created an immediate difficulty in Tinker (1980), who recognised that there was no agreed framework within which to craft a PEA. Working from within the "capital" debate, Tinker (1980, p.153) begins with the concept of capital:

> "Political Economy differs from neo-classical (marginalist) thought in that it recognises two (not one) dimensions of capital: firstly as (physical) instruments of production and secondly as man's relationship to man in social organisation. The first dimension represents the economic forces of production, the second the social relations of production".

Tinker (1980) argued that the "institutional realm" links these two dimensions. Here, different types of society create the institutions (legal, political, educational, etc) to organize physical production. Tinker (1980) places culture and belief within the institutional realm and his model does therefore have the capability of combining the real and the nominal, for example, by showing how accounting can be a legal institution and "power knowledge". The two domains of capital have a reciprocal relationship. Following Marx, Tinker argues that changes in physical production, such as technical change, can influence the social relations of production as well as social relations determining physical production.

The empirical element of the paper was a case study, the detail of which contrasts sharply with the broad theoretical framework. The case involved financial information from an African company over a period of 46 years showing the distribution between different capitalist agents and African constituents. The 46 year period was broken down into sub-periods, early colonial, late colonial, and post colonial, each sub-period representing different institutional regimes. The numbers revealed changing patterns of distribution as the level of colonialism declined.

The first problem was that the change in the pattern of distribution was not significant and the causality unclear. Over the whole period, African participants' received a 17.25% share, which in the different sub-periods reached a high of 20.75% and a low of 11.25% both of which were in the post colonial era. It is not clear whether the decline during colonialism represents institutional change or a change in the social relations of production. The second limitation of Tinker (1980) was that it did not study changes in the physical aspects and therefore did not consider the reciprocity between social and physical dimensions.

In a discussion of Tinker (1980), Cooper's (1980) main concern was with supporting the criticism of neo-classical economics. In so far as it was concerned with PEA, Cooper (1980) suggested that Tinker (1980) was successful, but had reservations about making generalizations from one case study, the appropriateness of the periods, and the fact the model does not account for increasing black salaries. He suggested some ideas for future research in 'knowledge as capital' and 'accounting as ideology', directing PEA into the idealist realm, but neither he nor the critical accounting community have followed up these ideas.

Tinker, Merino and Neimark (1982) is a theoretical paper that does not directly promote a PEA, but gives a detailed treatment of the labour theory of value (LTV), a theoretical framework long associated with political economy (Dobb, 1973). In this paper Tinker *et al* trace the development of value theory to make the point that theories reinforce the societies creating them, a view they call “historical materialism”:

> “We illustrate the application of historical materialism by means of a brief history of Value Theory. Our review highlights the central role that arguments about the meaning of value have played in social struggles through history” (Tinker *et al*, 1982, p.168).

Tinker *et al* perform an important service by illustrating how theories of value reflect power struggles in society, but they accept the main criticism of value theory is that it may be unnecessary or incoherent (e.g., Dobb 1973; Elson, 1979; Bryer 1994a). The fact that Tinker *et al* (1982) explain how powerful groups manipulate the idea of value does not help answer this criticism. Chapter four argues that Tinker *et al’s* historical approach to value reduces the current political relevance of the concept.

The concept of control and the limits of neo-classical approaches to control is the subject of Neimark and Tinker (1986). As chapter one has already shown, the concept of control is a key focus of political economy and accounting, encompassing agency, labour process, and value, but Neimark and Tinker’s approach to it is based on dialectics alone rather than a partnership of dialectics and political economy. The concept of dialectics employed has four major elements: the pervasiveness of social change; contradiction as the source of social change; the reciprocal relationship between organizations and environment; the academic as part of social change. This approach is similar to Cooper and Sherer's (1984, see below) "features and imperatives" approach to political economy. The problem with Neimark and Tinker's dialectic is the lack of a sense of priority or discipline. There are many contradictions and reciprocities between firms and society. Reuten and Williams (1989) show the importance of establishing priorities or "systematic dialectics" as they term it. Neimark and Tinker's dialectics provide a possible framework for understanding control but, without a sense of priority, control can take any number of trajectories. In short, they provide a context for understanding the ideology of control rather than a theory of control in real life. The empirical aspect of the paper, a study of General Motors, throws more light on internationalization than control. Chapter one argued that political economy needs dialectics and Neimark and Tinker (1986) shows us that dialectics has little meaning without political economy.

Tinker (1988) exposes weaknesses in mainstream accounting research compared to PEA, but Tinker (1999, p.645) is openly hostile to political economy, labelling it "empiricism". Tinker abandons political economy because of an intensified methodological desire to emphasize the phenomenological and ideological aspects of accounting and society. The obvious problem with Tinker's developed philosophical position is that he now does not consider data, evidence and facts as tests of hypothesis, an extreme view having more in common with post modernism than political economy.[9] No basis therefore exists on which to build theory and, as a result, Tinker falls back on an extended (and often pointed) critique of others.

[9] This point is returned to in chapter five.

Cooper and Sherer (1984) studied the perspectives of users of accounts. This suggested that accounting information should meet the needs of users, that different forms of accounting may help different users, and that a single set of accounts must be a compromise between users. Cooper and Sherer (1984) criticized existing approaches, because they did not accept accounting as social, and suggested a political economy approach. The lack of agreed theoretical tools again presented a difficulty for the authors, which they avoided by sketching the PEA in terms of "features" and "imperatives".

The authors identified three features of PEA (1984, p.218): that it "recognizes power and conflict in society"; that it should be placed in a "specific historical and institutional environment"; that it should involve a "more emancipated view of human motivation", that is, it should be aware that self-interest is not a universal motivation. The first two are consistent with the classical definition of political economy, but the third is not. I argued in chapter one that political economy tends to treat individuals as exemplars of groups, which is limiting. As a world-view, we must seek solutions to this limitation within political economy, for example, by making more explicit the role of individuals within powerful economic groups. The imposition of a particular view of 'human nature' from outside contradicts the nature of a world-view. Although the account of the individual offered by political economy is often partial and limited, we cannot correct this by the imposition of an assumption about human nature. We must find the solution to the problem within, rather than exogenously impose it.

Cooper and Sherer (1984) identified three imperatives for doing PEA, which are good common-sense advice for any critical researcher that the thesis accepts. The first is that the researcher must explicitly state the normative elements in their work. The other two imperatives are to be descriptive of the ‘real life’ of accounting, what Burrell and Morgan (1979) termed an “ideographic” methodology, and to be critical, to be aware that accounting knowledge tends to serve interest groups in society. However, Cooper and Sherer fail to engage with any major theories that might illuminate the whole system of accounting, and therefore do not make any theoretical advances. One critical accountant who has engaged with this problem as a theoretical task is Bryer, who offers a Marxist theory of accounting.

**Bryer: a Marxist theory of accounting**

Rob Bryer’s work is the first sustained research effort at developing a PEA, characterized by close study of the historical development of the capitalist system, mainly but not exclusively in the UK, and close attention to the text of Marx’s *Capital* (1954, 1956, 1959). In his early work, Bryer *et al* (1982) performed a “financial analysis of the failure of British Steel”, which was not explicitly a PEA, but placed accounting close to the issue of mass redundancies. The facts of the British Steel case, Bryer *et al* (1982) argued, exemplified the importance of accounting in the modern political and economic process.

Bryer and Brignall (1986) sought to develop an understanding of the power of investors and the relationship between investors, managers and financial accounts. In particular the paper argued that:

> "… the development and implementation of inflation accounting was designed both to motivate managers to make divestment decision from manufacturing, and to provide information which allows investors to monitor them" (Bryer and Brignall, 1986, p.127).

Here accounting does not merely reflect social ordering (Tinker, 1980); it is an active participant in a system of order, for example, investors using accounting to order plant closures. In this paper, Bryer clearly identifies accounting as directly serving investors' interests.

Railway manias in 19th century UK were the subject of Bryer (1991) and certain important tendencies become apparent. It is a more explicitly Marxist political economy, more consciously a PEA and explicitly aware of other contributions to critical accounting research, for example, Armstrong (1987a) and Tinker (1980). It also shows an awareness of links between accounting and financial theory such as the capital asset pricing model. In common with Bryer and Brignall (1986), it links accounting with investment decisions. The paper begins by noting the size of the investment required to develop the railway network, taking up a significant portion of GDP. As all students of British economic history know (Hobsbawm, 1968, p.110), the development of the network has been widely interpreted as a “mania” which itself has been understood as a natural part of the “free market” system. Bryer (1991) notes that Marx suggests a railway “swindle” and looking closely at the published evidence on railway accounts of the period, argues that:

> “The accounts published by railway companies were deliberately manipulated as part of an orchestrated scheme perpetuated by the ‘London wealthy’ on the manufacturing and middle classes who were lured into investing into the railways during the ‘mania,’ and were forced to sell out at a loss” (1991, p.483).

One of the techniques of manipulation used was failure to depreciate fixed assets leading to overstatement of profits. Despite the mass of evidence presented, Bryer suggests only that the “swindle hypothesis” warrants serious consideration. McCartney’s and Arnold’s (2003) subsequent research questioned the significance of depreciation accounting, but the swindle hypothesis does not stand on particular facts, but on layers of determination and leaving no stone unturned (for example, Arnold and McCartney do not justify their judgement of ‘significance’ or consider other accounting manipulations). Bryer (1991) argues that the evidential material does not constitute final ‘proof’ of the hypothesis, showing an appreciation of the issue in political economy, highlighted in chapter one, regarding the amount of evidence required to explain a whole system.

Bryer (1993a) turns explicitly to theory building, explicitly contrasting two models, a new one he calls ‘investor capitalism’ and the existing managerial capitalism model dominating mainstream thinking, and tests them against the history of capitalist accounting. Bryer's “accounting to investor capitalism” (AIC) model can be summarised as follows:

1. Managers report to capital markets, and take decisions to suit capital markets.

2. Financial accounting ensures that capital markets observe and therefore are able to control managers by holding them accountable for their actions.

3. Traditional financial accounts (prepared on a historical cost and accruals basis) are reliable and if they are manipulated it is usually for the benefit of the capital markets not managers.

4. Discipline by traditional financial accounts is effective enough to overcome agency problems.

5. Individual shareholders (capitalists) can move into and out of companies freely in order to maintain a diversified portfolio.

6. The purpose of financial accounting is accountability rather than decision-making.

Bryer collates evidence suggesting that we can explain the early development of financial accounting as AIC:

> “Conventional accounting history explains the rise of modern financial accounting in the late nineteen century ... as a response to the emergence of ‘managerial capitalism,’ the divorce of ownership from control. It is almost universally suggested that modern financial reporting has no clear conceptual foundation and that management were able to manipulate published accounts in

> their own interests … It is argued here that Modern Financial Reporting was clearly conceptualised, and the hypothesis is explored that its emergence and functioning … can more plausibly be explained as a response to the rise of 'investor capitalism,' the generalised socialisation of capital that Marx predicted" (Bryer, 1993a, p.649).

Bryer argues that the rise of modern financial reporting was a response to the demand of investors collectively for assistance in managing the new social relations emerging between them and management. In terms of the relationship between capital and labour, Bryer (1993a) highlights the fact that managers often have to understate profits for fear of igniting unrest among workers and, as a result, these manipulations are in the interest of capital not managers. Bryer shows that authorities on accounting were aware of the 'labour danger' (1993a, p.678). Chapter six interprets this as the fundamental contradiction in accounting, leading to a focus on the question of disguise.

Double entry bookkeeping's (DEB) appearance in the context of medieval northern Italy is the subject of Bryer (1993b). DEB remains the foundation of financial accounting and its origins and development, therefore, are important to understanding modern financial reporting. This paper begins, as Tinker (1980) does, with the "social relations of production", broadened to include the social relations of trade. Bryer (1993b) argues that, in northern Italy, some capitals accumulated during the Roman Empire remained intact through to medieval times. The activities of feudal merchants then grew to such an extent that they had to raise substantial capital, which they could do in a number of ways by pooling capital and risk. This made demands on bookkeeping, particularly the need to demonstrate an equal return for equal capital. Consequently, accounting systems had to be able to show the return on capital at any time, which is what DEB achieves. In this paper, Bryer reminds critical scholarship that the pooling of capital is an ancient practice, not a modern invention, and that understanding its origins in social capital links DEB to modern capital markets.

Existing explanations of DEB, Bryer (1993b) argues, fail to explain its “double” character. Double entry aids decision making, but single entry records can also. Here Bryer makes a key point against economists’ notions of agency, that what is double in DEB is accountability for capital: debits are uses and credits are sources. Economists characterize the principal-agent relationship as a bilateral one, a contract negotiated between two parties. The pooling of capital in medieval northern Italy, however, was not bilateral rather it was multilateral, including not just relationships between the provider and user of capital, but between the providers as well. Bryer’s theorisation of the socialization of capital shows that DEB transcends bilateral agency relationships, it represents and controls a social and not simply economic process, which implies that, by contrast, the economists’ ‘theory’ of DEB merely describes the process.[10] Put another way, Jensen and Meckling (1976) conceptualize agency at the level of the firm, but in reality the discipline imposed on managers by capital markets is general, not firm specific. Other scholars have sought to explain double entry as an application of scholarly skills, a Foucauldian “power knowledge” (Hoskins and Macve, 1986). Bryer

[10] In this theory debits increase property and decrease equity while credits decrease property and increase equity (Paton, 1917).

(1993b) argues the "power knowledge" approach cannot explain the "double" character of DEB.

While Bryer (1993b) focuses on medieval northern Italy, he generates a perspective on the modern issue of "agency theory". From this paper, a feature of Bryer's accounting history is its direct relevance to modern accounting and business controversies.[11] However, the AIC model, as presented in this paper, is an exclusively realist affair using the social relations of production to explain accounting. It is widely known, however, that accounting acts powerfully on the mind of the supervised (Armstrong, 1994; Grey, 1994), and it is a necessary part of political economy to explain both the real and the nominal. For these two reasons, the AIC model needed development to unify the real and nominal domains. I discuss below how Bryer (2000a; 2000b) achieves this integration in the context of accounting history using the concept of "calculative mentalities".

First, however, running alongside his accounting history is Bryer's theoretical engagement with Marx. The link between accounting and value theory first suggested in Bryer (1994a) motivates this thesis. Philosophically, Bryer recognises value as a rich concept (see, for example, Elson, 1979), and his linking of value and accounting takes his research in a new direction. Bryer (1994a) argued:

[11] Bryer (1997) regarding total social capital and Bryer (2000a) regarding the nature of capitalism, are two examples. Bryer's (1998) notion of accounting history as a contribution to PEA of the present is very different from that suggested by Keenan (1998) which stands or falls on the idea of "historical explanation".

> "At the heart of all theories of accounting lies a theory of value and the origin of profit. Throughout the history of economic thought two conflicting theories of value have competed for intellectual dominance, the marginalist theory of economics and labour theory of value of political economy" (1994a, p.313).

Marginalists, Bryer (1994a) argued, see profit as the change in the present value of expected future cash flows while the labour theory of value (theory of surplus value), on the other hand, identifies profit with unpaid labour. It is a characteristic of accounting research that it often uncritically accepts marginalist theories because economics has eclipsed political economy. Bryer (1994a) argues that understanding the concept of total social capital resolves the so-called "transformation problem" (Steedman, 1977) in Marx's *Capital* (volume 3). Once we understand that the rate of profit is a disciplining force on all firms, logically prior to the profit of the individual firm, we remove the difficulty of transforming values into prices (Bryer, 2005).

Marx's ideas about the circuits of capital, Bryer (1994a) argues, provide an explanation of many accounting practices, for example, depreciation accounting, a major issue in industrial capitalism. He highlights that Marx's (1956, p.160) model of the circulation of capital distinguishes between 'fixed' and 'circulating' capital. Bryer observes that, like accountants, Marx argues that the value of fixed capital transfers to products "bit by bit" (Marx, 1954, p.360), reflecting the use made of machinery and their useful life. This model, like the whole of the first two volumes of *Capital* (Marx, 1954, 1956), is at the level of "capital in general" and the use of machinery, therefore, should be understood as reflecting best practice in the industry or sector or an average level of efficiency. The same is true of the useful life of machinery. Bryer (1994a) argues that Marx's model of the transfer of value provides a framework for understanding modern depreciation accounting. In contrast, proponents of neoclassical economics accept that it provides no basis for understanding how capitalist accountants' think about and practice depreciation accounting.

Marx's theory of the transfer of value from machines to commodities has been the subject of some debate by Marxists. Perelman (1999), in particular, argued this process is not subject to logical analysis, likening it to "rational Marxian expectations" (1999, p.721). It is worth dwelling a little longer, therefore, on Marx's meaning. The transfer of value is not a physical one, nor is it one that can be determined by the individual firm. Rather, the foundation of the value transferred is the average levels of efficiency or best practice in a competitive market, that is, "socially necessary" depreciation (Bryer, 2007). Some value remained in the machines, what accountants call "net book value". Therefore, some of the capital remains in production while some attaches to a commodity and enters the realm of circulation. Perelman's (1999) ideas will be subject to detailed critique in chapter four.

The transition from feudalism to capitalism has been widely debated in economic history and is the subject of two long papers by Bryer (2000a, 2000b). This debate underpins some fundamental question for social scientists such as "what is capitalism?" which is a question so large it can only be approached and appreciated from a historical perspective.

The origins of Bryer's approach can be traced back to Bryer (1994b) linking the development of capitalism out of feudal relations with the development of DEB and accountability for capital employed from charge and discharge accounting. Bryer (1994b) highlighted Marx's view that feudal relations generated a surplus of cash or commodities, evidenced by charge and discharge accounting, while evidence of capitalist social relations and exploitation was DEB and cost and accruals based accounting. Accounting, therefore, was a "mirror" of the transition to capitalism.

Bryer (1995), like his (1986) paper, turns his AIC model to explain a specific accounting question, goodwill. He argues that conventional goodwill accounting for only purchased goodwill and amortization allows capital markets to observe the generation of profits. The anomaly of SSAP 22, the UK standard for goodwill accounting at that time, introduced by the Accounting Standards Committee (ASC) in 1984, was that it allowed the distortion of profit by encouraging managers and auditors to write off goodwill directly against capital reserves. This overstates profit because management charge no amortization to the profit and loss account. Bryer explains the anomaly by the demand of social capital to take dividends out of manufacturing capital at that time.

Bryer (1999a) looks at the question of a conceptual framework for accounting, the most important and controversial debate in accounting research (Gore, 1992; IASB, 2006). He identifies the weakness in mainstream research as its characterization of the business process, as follows:

> “. . . business corporations are seen as raising money from ‘savers’ those who wish to ‘invest cash saved to bring in more cash in the future.’ According to this theory the investment decisions of individuals and business are essentially the same, simply the investment of money for more money” (Bryer, 1999a, p.3).

Thus, the US Financial Accounting Standards Board (FASB) concluded that financial accounting should ideally provide individual investors and creditors with economic valuations based on cash flow forecasts. On this basis, the figures presented on profit and loss account are often irrelevant. This argument, however, stands in apparent contradiction to the continued widespread use of and support for the profit and loss account.

Marx characterized the production of capital as a circuit in which the production of goods is one part. In this circuit, money (plus profit) returns to the entity after it has been put to productive use and the goods produced have been sold. Bryer (1999a) uses Marx’s circuits of capital to derive definitions of revenue, expenses, profit, assets and liabilities. He argues that this provides a conceptual framework for understanding accounting histories and practices in their social, political and economic context.

Bryer (1994b, 2000a, 2000b) argues that Marx distinguished between feudalism and capitalism as a difference in the method of extracting surplus. The feudal lord extracted surplus directly by appropriating product and labour. The capitalist appropriated by buying labour power and selling the product (Marx, 1954). Marx’s (1954 p.667) theory of the evolution of capitalism in England focused on the interaction between agriculture and trade. Agriculture, Marx argued, became capitalistic when some farmers saw the possibility of buying labour to maximize the surplus, but this is only half the equation. Capital, Marx argues, emerges first in trade and develops in combination with agriculture to produce the capitalist mentality, the pursuit of maximum profit on capital from exploiting wage labour in production. Bryer (2000a, 2000b) argues that the history of accounting tests and supports Marx's ideas. Bryer (2000b) highlights the English East India Company and reveals the development of bookkeeping from focusing on consumable surplus to fixation with the return on capital. This, he argues, was the transition from feudal trade to the first capitalist company in England.

The importance of Bryer (2000a) and (2000b) for this study lies not so much in the contribution to the transition debate, but in the ways in which the strengths and limitations of political economy are dealt with. He controls the tendency to over determination of causation by a focus on key sectors (agriculture and trade), and the nominal and real are combined using the notion of "capitalist mentalities" in key sectors. The size of the case study is appropriate to the scale of the theorizing while remaining manageable.

Bryer (2006a) argues that Marx also provides a basis for understanding management accounting and, in doing so, started to breakdown the barriers between value theory, labour process theory, and class, which have been so damaging to the development of Marxist political economy (Rowlinson and Hassard, 1994; Carter, 1995). The rediscovery of these links could provide an opportunity for a revival of Marxist political economy. The starting point for this revival should be the objective character of accounting which stems from the social and the physical world and from its richly social character in practice, the fact that investors in general hold all managers accountable for capital. The idea that management accounting has an objective character provides the basis for unravelling the complexities of overhead accounting and exposes Braverman's (1974) approach as limited, concerned only with the material technicalities of controlling "useful" labour. Bryer (2006a) argues that Braverman (1974) lacks a subjectivist (idealist) dimension and does not integrate technical processes within the "valorisation" process, the circuit of capital in value terms.

From the PE perspective another benefit of Bryer's approach is that the contradictory and dialectical character of accounting starts to become evident as:

> "… in the very process of controlling the generation of profit, accounting generates conflicts that tend to undermine it" (Bryer, 2006a, p.9).

Chapter six develops this point as a fundamental contradiction in accounting, and hence of capitalist accounting firms.

Bryer (2007) returns to the links between value and accounting, focusing on the development of Marx's views over a number of years in conjunction with Engels. This process reveals that the labour theory of value provides a theory of accounting at the level of the firm not just within “capital in general”. This carries the implication that value categories such as “socially necessary labour time” and “abstract labour” appear in the firm, that accounting directly measures unpaid “socially necessary labour”.

With knowledge of selling price, capital invested and average rate of profit, managers have a target cost, a cost per unit that delivers the average rate of profit and reflects socially necessary labour time. The context in which cost per unit exists is, therefore, not initially that of the firm or corporation, but of capital markets in general. Costing exists in a social context where investors hold diversified portfolios and collectively discipline managers, a social context or totality that Marx called ‘total social capital’. The first concept in costing is, therefore, target cost not actual cost (Bryer, 2006a). Put another way, managers must ensure actual costs meet target cost. Managers calculate costs per unit in advance of production. At the time of the investment decision, managers’ focus will have been on achieving at least the average rate of profit. A logical extension of this capitalist mentality is a required cost per unit or planned target cost.

The calculation of cost per unit comprises direct costs plus factory overheads absorbed (Owen, 2003b, p.301). Overheads refer to costs of work in the factory not directly linked to production but essential to the process of production, for example, purchasing, stock control, equipment maintenance, etc. Cost accountants calculate overhead absorption rates to reflect the use of overhead processes and services often entailing a calculation of the target number of units of output given the equipment and labour available. Actual overhead per unit is, therefore, an estimated or average cost. "Actual" cost per unit is always an estimated or average figure.

Cost accountants put systems in place to control overheads and bring them back on target, for example, standard costing, budgeting, activity based costing. These systems work to ensure that materials and labour costs are in line with target cost. Managers, therefore, do not simply accept an 'actual' cost, but plan and control to achieve a target cost per unit set by investors as a social totality. Managers' cost per unit is therefore a "socially necessary" cost per unit.

Actual costs per unit are in money. Marx (1954, p.75) shows the development of money as "universal equivalent form" of labour. Money is, therefore, a form or representation of labour time. Capitalist cost per unit is consequently a form of socially necessary labour time. Surplus value as the excess revenue over socially necessary costs is, in turn, therefore equivalent to capitalist profit. Accountants' practices support this theory because, where costs are greater than target costs, for example, because of equipment failure and write off, IAS 2 requires accountants to write these costs off directly against profit rather than including them in costs of production. This practice is consistent with the "law of value" because only socially necessary costs are included in cost per unit and value. It is also consistent with social accountability because inclusion of excess costs in the cost of production per unit would hide the cause of the failure of managers to achieve target cost. The relationship between value and accounting is, therefore, much closer and more direct than has been previously understood. Accounting concepts and calculations are the direct empirical counterparts of value categories and concepts (Bryer, 1999a, 2007). Accounting is the empirical form of appearance of value and value provides the general theory of accounting.

Bryer (2008a, 2008b) shifts the focus to the history of US accounting and uses the concept of ideology to theorize the implication of the "labour danger" in the US. In the US, as modern corporate capitalism emerged, the relations between workers and capitalists became more conflictual and, as a result, disguise played a large role in determining accounting. Bryer shows how the contradictory nature of accounting led to a wide ranging debate about accounting theory before the great depression, and that an inchoate labour theory of value based framework emerged which disguised the exploitative nature of capitalism by systematically understating profits ("conservatism" in the US sense).

In summary, Bryer has contributed to accounting theory and history as well as PEA. These contributions amount to a revival of Marxist political economy because, based on the circuit of capital model and the idea of total social capital, value emerges as a powerful concept linking together the labour process and class (exploitation). When accounting is placed in the context of the ontology of connectivity it takes on the character of truth, a striking transformation in the significance of accounting as a focus for critical social research. The AIC model sees financial and management accounting as connectors. The model characterizes accounting as the medium through which messages are conveyed between capital markets and managers concerning the investment of capital and its performance. Consequently, the model represents a practical application of the strongest aspects of political economy. Bryer's work is ambitious; he intervenes in key debates regarding agency, value and the meaning of capitalism, and powerfully reaffirms the potential of meta-theory, reinforcing the view that political economy is not merely a multi-disciplinary exercise.

The importance Bryer attaches to Marx's concept of total social capital has profound implications, many of which are not yet explored. Bryer (1994a, 1999a, 2004, 2006a) argues that Marx conceived of capital as a social force disciplining workers, managers and capitalists. Scholars of modern business and society use the term globalization as a broad description of business trends. The globalization of capital markets is an important aspect of this trend and a key driving force. Bryer's work lays the foundation for interpreting Marx's conception of capital as an anticipation of global capital markets, and that the machinations of modern capital markets can be understood as the realization of Marx's vision. The increasingly close relationship between stock markets all over the world (global portfolios) and between interest rates and exchange rates in different countries, together with the introduction of IFRSs are evidence that capital is becoming a single fund of money undifferentiated by country or industry or legal form, seeking the highest possible return on capital.

In Bryer's work the idea of setting tests or "hypotheses" is important. Scholars usually test Marx by the extent to which his theories are logically coherent and relevant to modern conditions (Marginson, 1998; Steedman, 1977). An implication of Bryer's work is that these tests are inadequate because Marx anticipated modern capital markets. If Marx is interpreted as anticipating global capital markets, the true test is the extent to which modern capital markets display the character of total social capital and the process of the average rate of profit. Langley (2004 p.541), working in the Weberian tradition, has described the transition from a Fordist to finance-led capitalism. However, Marx's idea of total social capital anticipates the power of capital markets and the emergence of finance-led capitalism.

This thesis develops Bryer's AIC model by incorporating the commercial aspects of accounting. The mundane reality of accounting firms is that they organize for profit just like other firms. Accounting firms have existed since the 18th century (Mathews *et al*, 1998; Jones, 1981), before accounting achieved its "professional" status (see chapter three). They thrived during professional regulation, and through their mergers and worldwide growth they now threaten professional regulation. The AIC model focuses on the functionality of accounting for capitalism to criticise and correct the dominant alternative view that accounting was subjective and ineffective, and therefore ignores the potentially dysfunctional commercial reality of accounting as an activity pursued for profit. We can, therefore, develop Marxist political economy and the AIC model by incorporating the accounting firm, theorizing accounting as both a commercial, profit-making practice, as well as a technical or professional practice for the control of management. In addition we can develop the dialectical dimension of Bryer (2006a), making Marx's political economy more philosophically robust. Someone who shares many of Bryer's concerns, and was the source of some of them, but arrives at a different worldview of the links between capitalism and accounting, is Armstrong (1984, 1987a, 2005, etc), who brings a powerful sociological approach.

**Armstrong: sociology and political economy of accounting**

An advantage of the classical definition of political economy is that it can incorporate sociological insights, for example, Marx's definitions of class. Sociologists have made a major contribution to critical accounting (Hopwood, 2005; Cooper and Hopper, 1990), the work of Peter Armstrong in particular stands out for regularly crossing the boundaries between sociology and political economy. Armstrong's work is often associated with the "labour process" tradition, stemming from Braverman (1974) and summarized by Thompson (1983). In reality, however, his interests are broader, touching on subjects as diverse as managerial work (Armstrong, 1984), design and entrepreneurship (Armstrong, 2005). Armstrong (1987a, p.417) focused on the "extraction of surplus value" and argued that accountants are a powerful professional group and, consequently, the ideas developed in that paper relate closely to political economy. Armstrong's ideas on agency and trust (1989, 1991), in contrast, are more closely related to social theory and cannot be classified as political economy. Consequently, this review deals with Armstrong as both a contributor to PEA (his interdisciplinary competition model, IDC) as well as a critic of PEA (agency and trust), but does not consider all of his writing.

Armstrong's sociological background was a distinct advantage for the study of accounting in that the sociology of the professions was already in place, a body of theory ready to be applied to accounting. The dominant question in the sociology of the professions is “what is a profession?’. The leading Marxist contribution has been that of Johnston (1972, p.45) arguing that:

> “There are three broad resolutions of the tension existing in the producer consumer relationship, which are historically identifiable.
>
> 1. In which the producer defines the needs of the consumer and the manner in which these needs are catered for. This type will be referred to as collegiate control.
>
> 2. In which consumers define their own needs and the ways in which they will be met. This type includes oligarchic and corporate forms of patronage.
>
> 3. In which a third party mediates the relationship between producer and consumer”.

This framework is useful for understanding how powerful economic groups define and control the work of others, with possible links with political economy. A more robust philosophical position would be to consider all economic relationships as having aspects of these three resolutions, conceived as a unity in difference (see chapter one). This would allow for a continual process of negotiation between classes and it will emerge below that Armstrong has used this type of dialectical thinking in theorizing accounting and the nature of managerial work.

Armstrong (1985) begins from the empirical observation that accountants are more numerous in the management of UK companies than they are in Germany and Japan. To explain the deeper significance of this, he turns to sociology. He observes, since the 1950's within sociology, a tendency to "structural functionalism", that is, looking at the structures in society as performing a function for 'it', and that under critical scrutiny, in the 1970's, the title "functionalist" became a term of abuse (e.g., Blackburn, 1972). Armstrong carries on this critical tradition, seeking to expose the weakness in *any* argument suggesting that social realities emerge because they perform a function.

Armstrong (1985) examines the argument that the emergence of "Scientific Management" can be explained by the fact that it performs the function of controlling the labour process. Armstrong does not argue this is wrong, rather, he argues it is necessary to identify the precise means by which scientific management emerged as a solution. Armstrong (1985) is only against the notion of simple functional causation. He demands details showing how states of the world develop and emerge. It is worth recalling at this point the over-complication of causation often characteristic of political economy (see chapter one). We can envisage a continuum from simple functionalist causation at one extreme and chaotic, over-complex causation developed from unconstrained political economy at the other. Between these two poles lie practical approaches to causation and explanation, which I will argue are philosophically underpinned by the approaches developed by Elson (1979), and Reuten and Williams (1989) as well the ontology of connectivity (see chapters four and five).

Armstrong (1985) argues that the emergence of certain techniques of management is not simply the result of need, but also the result of competition between professional groups. Engineers, he argues, were in a good position to direct and manage capital, but they failed because other managerial professions, in particular accountants, poached their knowledge base. This lays the foundation of what I will call his "interdisciplinary competition" (IDC) model, a long term process of group level competition for access to key decision making roles in capitalist corporations. The characteristic behaviours predicted by the model include redefining capitalist problems; sponsoring particular solutions; rubbishing other professional group's solutions; adopting the knowledge bases of other groups.

To get an empirical grasp of the nature of management, Armstrong (1986) looks at management teaching syllabi in the light of IDC:

> "… the British idea of what constitutes management has changed over time, partly in response to changes in corporate structure but also as a function of the dynamics of the British 'management movement' itself. The current end result is a conception of management centred on the direction of enterprise strategy rather than on the improvement of productive efficiency at the operational level" (Armstrong, 1986, p.2).

He focuses on the evidence, teaching texts, and the syllabi of management education, albeit over a considerable period. He uses this data to support an argument that the skills developed by managers are not the skills needed to run companies, but those they need to further their economic interests.

Armstrong (1987a) describes in detail the steps taken by UK accountants to achieve their positions of power, starting in liquidation and audit, developing through wartime controls and into the era of corporate takeover. Armstrong (1987a) makes use of Carchedi's concept of (1977) "global functions of capital" to grasp changes in the capitalist system, and this pushes him away from political economy even though Carchedi's work concerns class, an issue closely associated with political economy, addressing the question "what is the middle class?" in Marxist analysis.

Carchedi (1977) argues that certain aspects of the capitalist system are fundamental or pure and, therefore, cannot change while other aspects of the system can change. Carchedi, therefore, distinguishes between "pure capitalist structure" and "capitalist socio-economic system". The idea of a "pure structure" suggests that some aspects of the social relations of production are essential. The secondary conception suggests different types of systems, which retain the pure relations. The distinction between systems is secondary to their essential unity. Carchedi identifies four pure relations:

1. Producer - Non-Producer Relationship
2. Owner - Non-Owner Relationship
3. Laborer - Non-laborer Relationship

4. Relations of Distribution

However, Carchedi does not ground these relations in any empirical work or in formal logic. They are assumptions and therefore provide a weak basis for understanding capitalism. Because Carchedi makes assumptions about "pure capitalism", he assumes away the very question at issue. As Roslender (1992) and Carter (1995) have argued, Carchedi's distinctions are more conceptual than real.

The concept of total social capital has important implications for class analysis and exploitation (Bryer, 2006a; 2007). One implication is the necessity for managerial work (de Vroey, 1980). Therefore, managerial work and the new managerial class (Roslender, 1992) cannot be seen as causing a problem for Marxists (Carter, 1995). Rather, Marx was fully aware of the importance of managerial work. Further, when Marx speaks of two classes he is speaking in relation to the production of surplus value. Other sub-classes or groupings become apparent as we incorporate the circulation of capital and competition between capitals, for example, merchant capital. When viewed from the perspective of "total social capital" there is no need to introduce Carchedi's distinctions, for example, "contradictory class locations", because they are already present in Marx's analysis. Armstrong (1987a) does not rely on Carchedi's detailed distinctions but does employ the general idea of "global functions of capital". In Bryer's work, Marx's "circuit of capital" model is used to describe capital's stages and processes and it is difficult to see what Carchedi's idea of "global functions of capital" adds to this.

Armstrong (1987a) uses historical evidence to argue that accounting emerged as dominant first by establishing the auditing role, then exploiting the particular needs of war-time controls before finally sponsoring and exploiting takeovers. The paper covers a long period and, consequently, the evidence presented in any one part of that period is not substantial. In Bryer's (1991) terms, enough evidence exists to suggest taking the hypotheses seriously, but insufficient evidence to "prove" the hypothesis. Maltby's (1999) auditing history is broadly consistent with Armstrong's (1987a) theory providing evidence of the capture of advisory services and group level competition. Maltby (1999) also pointed out that the distinction between inside investors and speculators (what Marx calls 'fractions of capital') played an important part in the development of auditing.

Armstrong's (1989) examines "labour process" approaches to management, previously criticized as "functionalist". Armstrong (1989, p.308) points out that Braverman argued that the entire apparatus of administrative control had become a labour process, exactly analogous to the manual and mental labour process. That is, "the routine aspects of capitalist functions, as distinct from the intellectual labour of production, are now said to constitute a labour process" (1989. p.308). It is not difficult to point to instances of the deskilling of managerial work, as Armstrong (1989, 2002) does, and the same applies to deskilling of auditors in large accounting firms. It is, rather, the logic of deskilling in a Marxist framework that is at issue. For Marx (1954, p.173) the labour process was the productive process of making use-values with exchange value and surplus value and the fact that many managerial roles are capitalist and, therefore, not productive, means that they cannot be described as a labour process. In short, management is often not productive so we cannot describe it as a labour process.

Armstrong's (1989) critique of Braverman (1974) reveals the importance of adherence to the distinction between the production of capital and its circulation (Marx, 1954, 1956, 1959) and reinforces Bryer's critique (2006a). In addition, Foley (1986) emphasises the importance of levels of analysis (production, circulation, etc) in the interpretation of Marx's *Capital*. Developing this as an agency theory, a necessary part of Marxist analysis of managerial work is to carefully distinguish at least five aspects: work in production of surplus value; work in circulation of capital; work in coordinating production and circulation (the circuit as a whole); managers' relations with capitalist investors;[12] group level competition between managerial groups (Armstrong's IDC model). Braverman (1974) fails to distinguish these different levels of analysis and this issue re-emerges later in this thesis in the context of value theory (chapter four), in theorising the profits of accounting firms (chapter six), and below in understanding the contradiction in the capitalist agency relationship (Armstrong, 1991).

Armstrong (1989, p.308) highlights that Braverman's labour process is a trans-historical, technical and general process, which is inconsistent with Marx's "usual method". For political economy, this point gains additional significance because the adoption of trans-historical interpretations of labour process contradicts its historical focus on dialectically unfolding social totalities. The capitalist class shapes capitalist production and the idea

[12] These could be described as managers' roles in the 'global functions of capital' but more accurately as managers' functions in the circulation of capital.

that production exists in a space or historical time in which it is not shaped by a slave owner, feudal lord, or merchant, has no place in political economy. In addition, when viewed in this light, Johnson's historical investigations (see above) are flawed because all societies reflect a particular mode of exploitation. I will argue in chapter four that a trans-historical use of Marx's concepts, which Armstrong (1989) finds in Braverman (1974), is the root of many misinterpretations of value theory such as Sweezy (1942) and Elson (1979).

A powerful characteristic of the agency concept, Armstrong (1989) argues, is that it can account for the difficulties involved in defining management. The elusiveness stems from the fact that management is primarily about relationships in a hierarchy rather than about skills and abilities. Another feature of the agency approach to management is the recognition of the power principals exercise when they appoint agents and train them in their own image. Armstrong (1989) goes on to argue that trust is a key aspect of agency and that delegation always involves some reliance on trust. The creation of trust, he argues, comes from training and socialization. Difficulties arise from the high costs of creating trust and the key dynamic in management is the contradiction between the need for trust and its high cost. A constant tension exists in management hierarchies between trust and control, often taking the form of accounting control. Armstrong argues that we can theorise the history of organizations using agency and by directly comparing the costs and benefits of accounting control to those of trust.

When viewed from a political economy perspective, it is temping to interpret Armstrong (1989) to mean that only capitalist investors need trust, but his agency relations refer to the whole management hierarchy not just the top strata that are in contact with investors. The contradiction in trust is present at all level of management, including at junior levels, for example, managers closely connected with production. Bryer's (2006a) notion of accountability enforced through management accounting, parallels Armstrong's agency concept in cascading down into the corporation. In Bryer (2006a), however, management accounting replaces trust while in Armstrong trust and management accounting exist in a tense dialectical relationship. Armstrong's agency concept is under-determined, but its relation to political economy is close. Trust describes a relationship not a managerial attribute or skill, and it has dimensions in both real and nominal domains (cf. Giddens notion of structuration) as well as dialectical contradictions. Armstrong's agency, therefore, reflects many of the aspects of the ontology of connectivity. The distinction between Bryer and Armstrong is whether investor's power is hegemonic, and the different levels of analysis that are involved, particularly Bryer's focus on capital market accountability compared to Armstrong's focus on corporations. In chapter six a more dialectical interpretation of Bryer's agency concept is developed which is capable of integrating Bryer's and Armstrong's perspectives.

Armstrong (1990) is a reply to the criticisms of Murray and Knights (1990). Because Armstrong was closely associated with labour process tradition, Murray and Knights (1990) wrongly ascribed to him views that are widely held in that tradition, but which Armstrong does not hold. Oddly, they accuse Armstrong of functionalism, which is something we have seen he had argued against for many years. Roslender (1999) also attempted a critique largely based on distinguishing financial and management accounting, but neither this study nor Armstrong distinguishes between them for the reasons given in chapter one.

However, there is a weakness in IDC theory that Murray and Knight (1990) and Roslender (1999) failed to identify, its artificial segregation of the professional from the commercial practice of accounting. The IDC model does not ignore commercial practice, but argues that the domain of "inter-professional competition" has a causal effect on "capitalist management hierarchies" (Armstrong, 1990, p.275). Clearly, the IDC theorises the general domain of professional practice as separate and distinct from the general domain of commercial practice. It was argued above, however, that the professional practice of accounting is also a commercial practice, and as such, it cannot be designated as separate. Put more empirically, the development of the large accounting firm necessitates a theory of professional practice that incorporates commercial practice.

Armstrong (1991, p.8) further develops a critique of neoclassic approaches to agency, using Burrell and Morgan (1979), and explores the relationship between agency, control and power. In this paper, the influence of social theory on Armstrong's thinking, rather than the sociology of the professions is dominant, so it is not concerned directly with PEA. The application of the idea of contradiction to agency, however, is fruitful. For example, Armstrong (1991, p.12) argues that the basis of control of an agent cannot be the "construction of ingenious patterns of self interest within contractual relationships", strengthening the argument that a radical theory of agency needs to be based on the concept of trust. Armstrong highlights the fact that capitalist contradictions find their way into the agency relationship:

> "The unsatisfactory treatment of monitoring is a major analytical flaw in agency theory as it now exists. What goes unrecognized is that monitors are agents too, even though they may be engaged by those they are supposed to monitor" (Armstrong, 1991, p.13).

This important insight re-emerges in chapter six of this thesis in the context of understanding the fundamental contradiction of disguise in accounting, and is developed in chapter eight into a Marxist theory of auditing and auditor independence.

Armstrong (1993) looked at the syllabi of management accounting. He notes that the increased success of management accounting has made it less specialized and more generalist. Armstrong (1993) notes a number of tensions in the mobility process including the fact that the management credibility of professional knowledge is in tension with its possession, and that the credentialism of professional knowledge is in contradiction to pragmatic management culture. This paper powerfully illustrates the use of 'contradictions' in management research. Mathews *et al* (1998), Edward and Walker (2007) and Maltby (1999) provide further historical evidence of the tensions in professional development caused by ease of entry into accounting, the fractions of capital, and accounting's diverse character.

Armstrong (1994) illuminates the realist/nominalist distinction as well as the status of the individual by summarising Foucault as follows (1994, p.27):

> “Early in the nineteenth century there occurred a radical discontinuity in the immediate exercise of power characteristic of Western Societies. Under earlier regimes of sovereign power punishment took the form of symbolic and public reassertion of the possession of the subject by the sovereign. These typically took the form of torture, amputation or the seizure of property. In the prisons, clinics and asylums of nineteenth century France sovereign power gave way to quite a different form of power exercised in the name of behavioural reform, as this was defined by the emerging human sciences. Besides defining desirable norms of behaviour these sciences also define the practitioners of reform, its human objects and the relationship between them. Since these relationships were importantly characterised by an asymmetry of power, Foucault used the word ‘power knowledge’ to refer generically to the human sciences”.

Armstrong (1994) criticizes this argument because it suggests that the modern entails acting upon the individual when in fact it was the creation, development and promotion of the individual that characterized the modern. This may provide a starting point for the proper integration of the individual into political economy. In response to Neimark's (1994) criticisms, Grey (1994, p.9) takes the following view:

> "Disavowal of the materialist ideal dualism might be seen as a key feature of Foucault's work …. For example Foucault's now famous account of the panoptican involves an architecture which allows the surveillance of prisoners and the exercise of disciplinary interventions upon them, the effect of which is to inculcate self regulation. It is not possible to separate the ideal and the material aspects since the materiality of the prison is not separate from the idea".

This suggests that Foucault, like political economy and Marx's *Capital*, integrates the real and the ideal (Ricoeur, 1986, provides a full discussion).

Armstrong (2002) examines activity based costing and management, looking in detail at the purchasing function. This paper reveals the exaggerated claims made on behalf of purchasing by the Chartered Institute of Purchasing and Supply, interpreting them as part of a social mobility project, and this contrasts with ABC's interpretation of purchasing as mechanistic and limited, which Armstrong interprets as the politics of agency. Rather than trusting purchasing to achieve complex managerial tasks, ABC has reduced it to mechanistic procedures that are subject to accounting controls. This has the impact of reducing staff costs and shifting power to accounting away from purchasing. Viewed from Bryer's (2006a) perspective, ABC is the pursuit of accountability at a more detailed level, while Armstrong points to the machinations of agency relations.

The starkest contrast between Bryer (2006a) and Armstrong (2002) on the ABC issue is that Armstrong terms direct costs "real" while Bryer argues that ABC represents objective target costs, suggesting that overheads are just as objective and real. These two positions reflect the different levels of analysis and priorities mentioned above. For Armstrong managerial work in the corporation is the phenomenon that we must explain, while for Bryer the company is an epiphenomenon, distracting researchers from the real source of capitalist power, which is the wealth of capitalist investors exercised through accounting. As a result, Armstrong understands ABC as negotiated in the corporation while Bryer finds its drivers outside the corporation which are, therefore, objective.

In summary, Armstrong rightly warns us against the dangers of simple functional causation and rightly demands the detail about how accounting has emerged as a force in modern society. The quantity of evidence required to sustain the IDC hypothesis is greater than that provided by Armstrong. The IDC model must incorporate accounting as a commercial practice, as well as a professional practice. However, Armstrong's agency concept provides a useful broader framework for the IDC model, one that, importantly for this thesis, sets limits to the power of accounting.

**Conclusion: Bryer and Armstrong's theoretical models of PEA**

A review of the literature of PEA reveals that it incorporates two substantive theoretical models, AIC and IDC. The first based on the concept of social capital and drawing inspiration from Marxist political economy, whilst the second is sociological and concerned with managerial work within the capitalist corporation. Neither model incorporates the mundane reality of accounting as commercial practice.

Although similar in some ways, such as the way agency cascades down the corporation, the models offer a conflicting account of the relationship between accounting and capital. AIC suggests that accounting is, in general, in the service of capital. It provides the information that allows social capital to supervise management. The IDC model suggests that accounting can, and does, manipulate capital. It argues that accountants have defined the ‘key problems’ facing capitalism and have taken the best from other disciplines to construct themselves as the solutions. Clearly, there lies an unresolved issue at the heart of PEA, the relationship between accounting and capital markets.

To illustrate the difference, consider an important accounting debate, the meaning of a “true and fair view”, which has played a role in mainstream understanding of accounting and incorporates a large degree of indeterminacy. The two models give different reasons for this indeterminacy. On the one hand, within the AIC model, this indeterminacy could meet the needs of capital to manipulate financial accounts, for example, to increase dividends. Within the IDC model, indeterminacy allows accountants to retain the exercise of professional judgement over financial accounts. Later in this study (chapters six and eight), this topic will re-emerge and a much fuller account of indeterminacy will be offered based on the notion of disguise. Supporting this analysis, Rowlinson *et al*’s (2006 p.13-15) “roadmap” of the “ownership and control” debate also distinguishes between the two models. They classify Bryer as “Marxist anti-managerialist” and Armstrong as “radical managerialist”. Later chapters seek to resolve this distinction by addressing the key question, how do managers escape the power of investors?

Finally, the review has shown that Tinker's original (1980) paper initiated a research project that has steadily grown in stature and it is now proposing solutions to the most difficult questions in accounting, finance, organisational, and historical research. The philosophical space occupied by political economy has certain inherent strengths and limitations many of which carry through into PEA. One specific criticism of PEA, however, has a different character, the outstanding and, I will argue, resolvable contradiction between Bryer and Armstrong on the relationship between accounting and capital. To develop, PEA also needs to incorporate the fact that accounting has both a commercial and a professional nature. Since the emergence of the large accounting firm, it is no longer adequate to theorize just its professional nature. I therefore now turn to the literature on the accounting firm.

# CHAPTER THREE

## Accounting firms: literature and research aims

### Introduction

The purpose of this chapter is to review the literature relevant to accounting firms to develop the research aims of the thesis to incorporate commercial behaviour. Chapter two noted that literature on the accounting firm is diverse and care has to be taken in specifying its boundaries. UK accounting firms are the main concern of this thesis, so existing results relevant to UK firms have greater emphasis. I review the models and methods used in studies in other countries, but the results have less coverage. Concentration studies and audit fee determination studies are the two most significant themes developed in the mainstream literature, but auditor switching, non-audit fees studies, and the history of the accounting firm, are also addressed here. A convenient starting point, however, is the critical accounting work because methodologically it is the closest to PEA.

### Critical accounting and accounting firms

During the 1980's, critical accounting scholars sometimes unwisely ignored the existence and influence of accounting firms. Willmott (1986, p.560), for example, suggested the

Institute of Chartered Accountants in England and Wales controlled the number of recruits entering the profession. The mass redundancies of 1990 showed, in fact, that accounting firms controlled the supply of new accounting labour (Owen, 1995). One of the first critical studies of the accounting firm was Baker (1993). This was self consciously a methodological paper, promoting qualitative methodology, that pointed out three challenges to accounting firms including the conflict between the independence of auditing versus the provision of other services, threats of increased regulation, and changing technologies. The main responses to these, the paper argued, were maintaining relationships with clients and others as well as building firm image or brand. Baker (1993) raises some interesting issues regarding accounting firms, but does not offer a systematic basis for theorising the accounting firm.

Hanlon (1994), working from a sociological perspective, focused on the "commercialization of accounting", which involved examining the behaviour of accounting firms without making them the dedicated aim of the study, reflecting the general disinclination to focus on accounting firms. Hanlon (1997) argued that accounting was:

> "… Undergoing a process of transformation. Among other things this … entails a shift from social service professionalism to a commercialized professionalism" (1997, p.843).

The main theoretical tool Hanlon employed, reflecting his sociological background, was the distinction between Fordist and flexible regimes of accumulation (Allen *et al*, 1992). The idea behind "flexible specialisation" was that capitalist firms were concentrating on providing consumers with greater choice and establishing manufacturing systems facilitating rapid response to consumer preferences. A recurring feature of this approach was the comparison of the Ford motor company to Toyota as an illustration of general trends. Interest in this idea rapidly waned as it became apparent that the dominant trend in capitalist economies was globalisation, for example, the growing influence of China, and the fact that the Japanese economic miracle was short lived.[13] Ideas such as "finance lead growth" (Boyer, 2000) quickly replaced flexible specialisation, making Hanlon's (1994) ideas dated. In common with Johnson (1972) and Armstrong (1987a; 1989), Hanlon (1994, 1997) drew on the Marxist tradition, but did not develop a PEA.

A number of criticisms of Hanlon's ideas emerged, including inadequate empirical evidence (Dezalay, 1997, p.826), inadequate attention to the social construction of accounting knowledge (Dezalay, 1997, p.827), excessive concentration on audit (Willmott and Sikka, 1997, p.832), and confusion regarding the relationship between accounting and corporations (Willmott and Sikka, 1997, p.836). These four criticisms were not fatal to Hanlon's hypothesis, but indicated a need to deepen and broaden the theoretical and empirical scope of the work. From the perspective of this thesis, another criticism is that investigation of the "commercialisation" of accounting needs a far

[13] These trends also account for the reduction in interest in Activity Based Costing

sharper focus on accounting *firms*, compared to (say) accounting professional knowledge bases, or accounting as a form of ideology.

The fourth criticism of Hanlon mentioned above, is worth examining in more detail because it has parallels with the distinction between Bryer and Armstrong identified in chapter two. Willmott and Sikka (1997) argued that in Hanlon's work accounting sometimes drives flexible specialization of capital and at other times flexible specialization determines accounting. The direction of causation is unclear. Put more generally, the institutions of capital markets and corporations sometimes dominate accounting, while at other times accounting is capable of dominating capital markets and corporations. Hanlon's (1994, 1997) confused causation is similar to the distinction drawn in chapter two between Bryer and Armstrong, in which Bryer characterised accounting as in the service of investors, while Armstrong characterised accounting as manipulating corporations, revealing a conceptual link between the literature on PEA and critical theories of the accounting firm.

There is another sense in which Hanlon's work relates to Bryer and Armstrong. Chapter two argued that both had paid insufficient attention, in different ways, to the commercial aspects of accounting. Hanlon's (1994) study of the commercialisation of accounting therefore had the potential to fill an important gap, but its fatal weakness is its failure to theorise commercialisation, which remains at the level of common sense. This link between the two literatures gives the first research aim of the thesis, to rectify Hanlon's failure to specify the relationship between accounting and capital markets, which means he does not theorise the commercial role of accounting firms, particularly the commercial aspects of the audit function that these firms perform.

Dirsmith *et al* (1997) also approached accounting firms from a sociological perspective, particularly influenced by Giddens concept of “structuration”. This is the idea that class is a concept that is lived, experienced, and mixed with a host of ethnic, religious and gender factors (Whittington, 1992; Thompson, 1995, gives the historical perspective). Dirsmith *et al* (1997) use this approach to carry out an interpretive study of management problems in a selection of large US accounting firms. The chief problem uncovered is the tension between the normal processes of capitalist control imposed in large firms and the accounting partners’ obvious desire to be involved in decision making. Dirsmith *et al* (1997) use the idea of “management by objectives” (MBO) to characterise normal capitalist controls and, like Hanlon’s (1994) flexible specialisation, this links their study to a short lived and outdated idea.

Although Dirsmith *et al*’s (1997) use of MBO is successful, future studies of this kind need a stronger basis for grasping management control systems. One particular theoretical opportunity spurned by Dirsmith *et al* (1997) is the application of Armstrong’s (1989, 1993) contradictions and, as a result, the concept of dialectic remains underdeveloped in the paper, for example, the dialectical tension between trust and control is not developed. However, the structuration approach combined with MBO provides a framework for understanding processes within large accounting firms far more robust than Hanlon’s (1994), and provides the type of detail that Baker (1993) lacks. The detailed insights that Dirsmith *et al* (1997, p.10) reveal are ground breaking, particularly regarding the culture within accounting firms, for example, "Around here its an 'I'm OK, every one else is an asshole' attitude". This reveals a selfish and individualistic culture consistent with commercial capitalist values, and provides the first evidence in the accounting literature relevant for the development of a critical theory of the accounting firm.

It is the relatively narrow scope of the approach, however, that is its key weakness, as accounting firms are not theorised in the context of capital markets and corporations. Chapter one described the breadth of accounting problems. Some of these problems affect companies, others affect accounting firms, others stock markets, and others society in general. The approach adopted by Dirsmith *et al* (1997) is too narrow to grasp the problems of accounting as a whole because it stays within accounting firms and does not highlight links between capital markets and corporations. Bryer's framework has a broader scope as 'total social capital' is a disciplining force on companies and, as such, there are good reasons to suppose that political economy will provide a better basis for theorising the accounting firm because the scope of the approach is appropriate to the scope of the topic.

The involvement of Arthur Andersen in the collapse of Enron shows that any theory of the accounting firm that does not highlight the impact of accounting firms on stock markets and corporations is of little value. Fuerman (2004), for example, in a special issue of *Critical Perspectives on Accounting*, argues that AA was a source of risk for stock markets. Put more generally, critical accounting must engage with the problems of accounting and the critical theory of the accounting firm must involve consideration of accounting problems.

The useful aspect of Dirsmith *et al* (1997) is that it interprets real life in an accounting firm, exploding the myth that it is based on logical and technical decision making, but it is not critical in the sense of engaging with accounting problems or accounting in society having real effects. The number of redundancies caused by the collapse of Enron highlights the need to go beyond interpretation and theorise the real impact of accounting firms and problems. The qualitative approach adopted by Dirsmith *et al* (1997) combines the real and nominal domain, but its idea of the real is limited to institutions and structures. By contrast, using Marx's political economy chapter two argued that Bryer linked accounting with the measurement of exploitation which, combined with abundant evidence of inequality in wealth (e.g., Stiglitz, 2001), can expose the real character of exploitation. Exploitation and the consequence for auditing are absent from Dirsmith *et al* (1997), and the concept of power and control employed in the study is, as a result, a weak one.

Cooper *et al* (1998) explored the international aspects of accounting firms using a case study of planned expansion in Eastern Europe. This case revealed the desire of accounting firms to move to where they could generate substantial fees and profits. Being a case study, the ideas are not easily generalised, but they reveal the accounting firm as a commercial practice and provide a counter-balance to the Dirsmith *et al*'s

(1997) interpretive approach. Burrows and Black (1998) strengthen this by revealing the importance of profit sharing in the accounting firm. Mitchell *et al* (1998) link accounting firms with money laundering operations. These studies again therefore reveal the need for a critical theory of the accounting firm that straddles capital markets and corporations, combines interpretation with the real, and one that blends the particular and characteristic nature of accounting firms with their capitalist character. The review of PEA in chapter two suggests that it can provide such a theory. In chapter eight the influence of sociologists on the theory of accounting firms re-emerges in the context of understanding auditor independence.

**Mainstream accounting research relevant to accounting firms**

In contrast with the qualitative character of critical research, the mainstream has adopted a predominantly quantitative approach. The first systematic industry level insight into the behaviour of accounting firms in UK emerged from concentration studies, starting with Moizer and Turley (1989). Their data is audit fee disclosures in *Financial Times* Top 500 company annual report and accounts, 1972 and 1982. They calculated Herfindahl Index (H) and Concentration Ratio (CR) measures and concluded that concentration had significantly increased in the period. In particular, the nine-firm Concentration Ratio increased by 19% over the ten-year period to 0.822 and H increased by 32% to 0.094. The results show that merger was the single most important cause of concentration, but the authors did not measure the extent of that relationship, nor did the paper identify the relationship between concentration and audit fees.

Beattie and Fearnley (1994) worked with the entire population of UK quoted companies, some 2,078 observations, and recorded the auditor for each company between 1987 and 1991. They calculated a range of Concentration Ratios and identified a continued increase in concentration. In particular, the eight-firm concentration ratio increased by 23% over the five-year period to 0.793. Of that 23% increase, 14% was attributable to mergers, but they make no link between this and the commercial existence of accounting firms.

Pong (1999) worked with all fully listed UK companies as well as those listed on the junior market (USM) in the period 1991 to 1995, collecting the audit fee and assets for each firm in each year. The CR and H ratios were calculated using fees and number of engagements. The results showed a small increase in concentration in the period 5% on number of audits and 3% on the fees basis. Again, the study provides no link to commercial behaviour.

Researchers have conducted concentration studies worldwide, for example in Australia Gilling and Stanton (1978), and in the USA Eichenseher and Danos (1981) (see Yardley *et al*, 1992, survey paper). Tomczyk and Read (1989), also in USA, took a different approach to concentration. They measured audit fees using the disclosures made by accounting firms and used these disclosures to calculate concentration. Perhaps because this research drew no serious conclusions, no further work using this approach has appeared, but chapter seven of this thesis exploits this UK source of data to gain a better understanding of accounting firm profit margins.

Since the reduction in the number of large accounting firms to four, the concentration of accounting and auditing work has become self evident and widely understood. The *Financial Times* (26th February 2007 special report p.1) referred to the situation as an ‘oligopoly’ and on a number of occasions a “virtual monopoly”. The audit of every top 100 UK Company is by one of the big four audit firms. In the USA, the SEC became concerned about the situation as long ago as 1995 (see chapter eight for details). Much of the recent debate on this issue has been about the problems that concentration poses for regulators, for example, in the event of the bankruptcy of another large accounting firm (see the *Financial Times*, January 23rd 2006, p.28). The spectre of a single monopoly accounting firm haunts capital market regulators in Europe and USA. In summary, the trend towards concentration in UK (and elsewhere) is clear and it is widely understood as problematic. One issue that needs exploration in more detail is the relative importance of different causes of concentration, such as organic growth and mergers. The potential of Tomczyk and Read’s (1989) direct measurement approach also needs development and both these issues are addressed in chapter seven.

The other substantive body of work relevant to, although not directly about, accounting firms, is the audit fee determination literature, for example, Simunic (1980). In this tradition, audit fees are measured, but the associated costs are not, ignoring the accounting firms’ profits. A convenient starting point for understanding this approach is the survey paper prepared by Yardley *et al* (1992), which reviewed the literature relating to US accounting firms. Yardley *et al* (1992) presented a theoretical model from industrial economics. The main elements of the model were behaviour (e.g., collusion), structure (e.g., concentration), performance (i.e., profits) and determinants (e.g., elasticity of demand).

Yardley *et al* (1992) argue that structure (concentration) can determine performance (profit), as well as the alternative hypothesis that performance determines structure. It becomes apparent in their substantive review, however, that no papers have explored the impact of structure on performance. Despite the huge literature, no-one had examined the relationship between merger, concentration and profit. The main papers cited in the section of the review concerning performance are Dopuch and Simunic (1980), which concerns collusion rather than concentration, and Simunic (1980), which uses the cost of auditor's liability as a surrogate for audit costs.

Most of the quantitative work in the UK has also not explored profits, restricting attention to audit fees. Taylor and Baker (1981) make the first contribution, finding that audit fees closely relate to company size and complexity variables. Chan *et al* (1993) undertook a more detailed UK study, using interviews to provide a richer context for empirical work, and introduced a number of new independent variables into the determination of log-transformed audit fees. The population, extracted in 1989, was of all UK quoted companies, a cross section of some 985 observations, on which they performed a multiple regression. One of the results that emerged from the study was that the size of the auditor was a significant variable in determining the size of the audit fee. This could mean a link between concentration and profits, but that the link is not strong because the study took no account of accounting firm costs.

Pong and Whittington (1994) extracted a sample of 577 UK listed companies from *The Times* top 1,000 companies in the period 1981–1988. The authors paid particular attention to correct specification of the model. Taking into account the identification problem (Stewart and Wallis, 1981), they pointed out that audit fee determination models are only meaningful under the assumption of a fixed supply curve while the demand curve shifts between different auditees. They also pointed out that the commonly used logarithmic transformation of audit fees therefore restricted the usefulness of the results. They found evidence of a big firm fee premium. However, they also found that larger accounting firms were more efficient at dealing with complex audits. There was evidence of low-balling, but not when a large audit firm was the incumbent.

In summary, the UK evidence does show some link between the size of audit fees and the size of the auditor. This suggests that large accounting firms may charge more for the same services than other accounting firms. Chapter nine of the thesis provides evidence that accounting firms earn higher than average profits.

A variation on the audit fee determination approach suggested by Ferguson *et al* (2005), is that rather than specify the audit fee as the dependent variable, substitute the change in audit fee and examine the relationship between changes in audit fees and the predicted change under the standard audit fee determination model. This they argue is a test of audit fee rigidities and market frictions. They find that market frictions do exist, exacerbated by increases in concentration. McMeeking *et al* (2006; 2007) extracted a large pooled data set including 7,522 observations of UK plc companies in the period 1985 – 2002. In their 2006 paper they included a dummy variable to capture the big firm premium along side a range of other explanatory variables, drawn from previous audit fee determination literature (above), acting as control variables. They found evidence of a big firm premium but the evidence suggested that this was related to specialization rather than monopoly power. In their 2007 paper they combined a study of concentration with a study of audit fee determination by using dummy variables to capture the impact of individual mergers. They found a link between concentration and audit fee determination, but they attributed this to differences in the accounting firms, such as product range, rather than monopoly power. In the period, the four firm CR ratios increased from 0.59 to 0.88 and H increased from 0.13 to 0.23. In summary, mainstream scholarship has not explored the issue of accounting firm profits and, therefore, it has not begun to look at the relationship between concentration and profits.

Other studies of a more sporadic nature have explored different aspects of the accounting firm, such as the impact of non-audit services on the pricing of audit fees, for example, Firth (1997, 2002). The underlying hypothesis of this type of study is that low audit fees lead to more lucrative consulting and IT contracts. Firth (1997) tested a model similar to the audit fee determination models discussed above on data drawn from the top 50 companies on the Oslo Stock Exchange during 1991 and 1992. No evidence of a relationship between lower audit fees and higher non-audit fees was found. The study, however, shows it is a relatively simple matter to introduce more critically inspired variables into positivist frameworks.

Firth (2002) developed this approach to consider the possibility that higher fees may be related to a lower probability of a qualified audit opinion finding that high non-audit fees were associated with a lower possibility of qualified audit opinion. The link between fees and audit opinions as an aspect of commercial behaviour is one that will be developed and theorized further in chapter eight of this study in relation to auditor independence. Another type of study tests the hypothesis that low fees gain more clients (termed "low balling"). Butterworth and Houghton (1995) investigated this possibility by using regression analysis on Australian data, but found no evidence to support the claim. Gregory and Collier (1996), using regression analysis on UK data 1987-1991, found the evidence of "low balling" was weak, but they did not discuss the relevance of this for understanding accounting firms' commercial behaviour. For example, the question of how therefore, if at all, accounting firms pursue profit advantage.

Another type of approach has been the study of auditor change, which also has unexplored commercial implications. Beattie and Fearnley (1995) used a questionnaire about auditor characteristics to gain a better insight into the client auditor relationship. An important limitation of the study was that it focused on consideration of auditor change not actual auditor change. On the other hand, the approach had the advantage of combining qualitative aspects with quantitative and in doing so bridges the gap between critical and mainstream research. Beattie and Fearnley (1998) investigated the impact of tendering also using questionnaires. This study found that fees and the "chemistry" of the relationship between auditor and management were the most important factors. These types of papers are individually well defined, but as a whole they do not lead to a coherent theory or framework of the commercial nature of the accounting firm.

The accounting firm has not featured prominently in accounting history research, but a number of interesting questions bearing on this issue have already come to light. Mathew *et al* (1998, p 18) found that the first records of accounting firms in UK date back to 1780. These specialist firms combined accounting with a range of other services just like the modern accounting firm. The Liverpool Society of Accountants was formed in 1870 (Walker, 2004) and was one of first professional societies. The Liverpool based accounting firm Harmood Banner, however, can be traced back to 1805 (Mathew *et al*, 1998, p.294) illustrating the fact that the existence of accounting firms is not dependent on professionalisation of accounting. Research has also shown that early accounting firms were not dependent on stock market companies, but rather developed in close association with many types of businesses including merchants, manufactures and banks.[14] The early accounting firms were small by modern standards but progressively increased in size, mirroring the increasing in the size of corporations. The capital needed to set up an accounting firm was low and, as a result, competition was fierce. When viewed from a historical perspective Hanlon's (1994) idea that accounting is

[14] Walker (2004) has shown that the Liverpool Society developed to take advantage of opportunities in bankruptcy administration and that the legal profession were instrumental in the development of the Liverpool Society. See the further work section in chapter ten.

‘commercialising’ seems misplaced. Accounting has its origins in commercial practise and its commercial nature has a longer pedigree than its professional nature.

In summary, hampering mainstream research on accounting firms is a lack of interest in profits and, therefore, a lack of interest in data on profits. As a result, researchers have not explored the impact of increasing concentration on profits. Critical accounting research on the accounting firm has been largely interpretive (Dirsmith *et al*, 1997), and does not properly incorporate the impact of capital markets and corporations. The criticism of Hanlon (1994) that his causality concerning the relationship between capital markets and accounting is unclear, is similar to the causality debate between Armstrong-Bryer discussed in chapter two, providing an important link between the two literatures.

**The research aim**

The imperatives that have emerged from the literature reviews in this and the previous chapters provide the basis for stating the research aim of this thesis. The review of PEA (chapter two) revealed the need to resolve the Armstrong-Bryer dispute, the differing accounts of the relationship between accounting and capital markets, in addition to incorporating the commercial reality of accounting. The criticisms levelled at Hanlon’s (1994) work on the commercialisation of accounting revealed a similar contradiction and the first objective of this study must be the resolution of the Armstrong-Bryer-Hanlon contradiction, which also has the advantage of providing the context that Dirsmith *et al* (1997) lack. The review of mainstream accounting firm literature revealed another gap, the need to link the profits of accounting firms with factors such as concentration, which amounts to a test of the "structure-performance" model (Yardley *et al*, 1992; Cowling, 1982). These two imperatives exist on different planes. The Armstrong-Bryer-Hanlon contradiction exists on a theoretical plane, a contradiction between two theories (IDC and AIC) as well as within the ideas of Hanlon. The second imperative exists on an empirical or operational plane, resolving the problem of the lack of data or sources from which to measure the profits of the accounting firm. The first imperative exists within critical accounting and the second within the mainstream.

Despite existing on differing planes, these two imperatives share a common concern with the profits of accounting firms. Hanlon's (1994, 1996, 1997) work on the commercialization of accounting suggests the profit motive is an important force in accounting. A better understanding of the profits of accounting firms would therefore help to test and develop the commercialisation hypothesis. In the AIC model (Bryer, 1993a) accounting is a powerful tool, but the mundane commercial reality of accounting is not yet integrated. Inclusion of the profits of accounting firms within the AIC model would penetrate the day-to-day reality of accountability at a deeper level. Within the IDC model (Armstrong, 1987a) the profits of the accounting firm measure the success of professional mobility projects.

The lack of a theory of the profits of the accounting firm in the Bryer and Armstrong models explains how differing views on the relationship between accounting and capital can arise. Without a theory of the origins of the profits of accounting firms and the factors that determine those profits, the process of negotiation between corporations, capital markets, and accounting firms, lacks focus. A fuller understanding of the process of determination of the profits of accounting firms would involve the fuller understanding of the relationship between accounting, companies, and capital markets, resolving the Armstrong-Bryer-Hanlon contradiction.

The aim of this study is therefore the development of a theory of accounting firm profits and the development of a model giving insights into the factors that determine those profits. A theoretical model is an operational model explicitly developed from underlying theory and concepts. The aim of this study is, therefore, the development of a theoretical model of the profits of accounting firms from within political economy. The aim is not a set of equations, but the identification of key variables, their relationships, and processes, without estimating the size of parameters.

The research question exists in both theoretical and empirical planes. Specified in this way the research aim has a number of facets. It aims to deepen scholarly understanding of accounting firms, to resolve a dispute in PEA, to explore ways of testing the structure performance model that has so far eluded mainstream accounting scholarship, to contribute to understanding the institutional context that accounting firms operate in, and to complement the work of Dirsmith *et al* (1997). The development of a theoretical model of the profits of accounting firms could pay a substantial intellectual dividend. Attention must now turn to the methods used to develop such a model.

# CHAPTER FOUR

## Value and accounting

### Introduction

The aim of the thesis is to develop a theory of the accounting firm from Marx's political economy. Value is the hallmark of classical political economy (Marx, 1954; Ricardo, 1971). Bryer (1994a; 2006a; 2007) has found a close link between value and accounting, but other value theorists such as Elson (1979) have taken value in the opposite direction, suggesting that Marx gave us only a qualitative value theory. This chapter critically analyzes the idea of an exclusively qualitative value theory (or a pure qualitative value theory), and develops a robust dialectical value concept integrating the subjective and the objective, which I use in chapter five to develop the theory of the accounting firm. This is a necessary preliminary because a pure qualitative value theory of the accounting firm will *prima facie* be of limited empirical relevance.

The first section focuses on the value form tradition (Arthur, 1979a), which has a close relationship with Marx's philosophical roots and provides the dialectical dimension needed by political economy (see chapter one). The value form tradition has close parallels with Bryer's (2006a; 2007) accounting theory and the circuit of capital model and, as a result, I argue it provides a more philosophically and empirically robust foundation for value theory than Marxist economists' approaches.

Next, I explore the neglected topic of the historical dimension of value, paying heed to Marx's (1986) warnings about the concept of "production in general" to identify an underlying weakness in many qualitative value theories such as Sweezy (1942). I argue that many value theorists have replicated Braverman's (1974) error of treating Marx's categories as trans-historical "universal principles". Despite the fact that Marx (1954; 1986) clearly distinguishes the historical development of capital from the theory of capitalist production (Foley, 1986), I argue that value theorists such as Mohun (1994b), Sweezy (1942) and Elson (1979) have confused these two approaches, weakening the value concept. I use Rubin's (1994, 1972) two part interpretation of Marx's method to explain the relationship between Marx's theory of capitalist production (value, surplus value, etc) and his historical studies (transition from feudalism to capitalism), reconciling dialectical value form concepts with approaches that are more empirically and historically based.

The third section analyses Marx's treatment of the quantitative and qualitative (Q/Q) distinction in *Capital*, and shows both dimensions bound inextricably together. Consequently, I argue we cannot find the idea of qualitative value theory in Marx's *Capital*. Next, I criticise Sweezy's (1942) *Theory of Capitalist Development*, the origin of the Q/Q distinction for not maintaining Marx's distinction between capitalist development and capitalist production and, as a result, weakening the value concept by placing too great an emphasis on its qualitative dimension. This critique provides a platform for a critique of qualitative value theorists such as Perelman (1999) and Elson (1979).

The concept of value developed in this chapter has a close relationship with methodology, especially dialectics and history. It is important to emphasise, however, that Marx's political economy is not a methodology, but is a theory, and therefore I discuss methodology only to the extent that it is needed to develop a robust value concept.

Marx's *Capital* (1954, 1956, 1959) has an eclectic view of method. In volume 1, for example, Marx (1954) employs logical argument (analysis of the commodity, p.43), historical argument (transition from feudalism to capitalism, p.671), dialectical argument ("relative and equivalent form", p.55) empirical argument ("length of the working day", p.278) and critique of other authors (the history of theory approach). Apart from comments in the preface (p.19), there is little or no methodological direction. The most detailed document on methodology left by Marx is the unpublished introduction to *Contribution to Critique of Political Economy* (Horowitz ed, 1968, p.21; Marx and Engel's, 1986, p.17). The fact that it was not included in the *Contribution to Critique of Political Economy* (Marx, 1987) indicates that Marx did not intend a specific or rigid methodological framework. In addition, Marx's comment in the preface to *Capital* (1954, p.19), "I presuppose of course a reader that is willing to learn something new and therefore to think for himself", does not suggest a ready-made methodological framework or structure. Marx took a pragmatic view of method. The importance of Rubin's two-part interpretation of Marx's method, explored below, is that it reconciles Marx's methodological eclecticism with his dialectics.

## 1. Value debates and 'value form'

The progressive publication of Marx and Engel's (1986, 1987, 1988, 1989a, 1989b) complete works and the translation of texts such as Lukacs (1968), Rubin (1972) and Rosdolsky (1977) into the English language, gradually revealed to an Anglo-Saxon audience the "philosophical" Marx, termed by Nicolaus (1972) the "unknown Marx". These continental influences stimulated methodological debate particularly regarding the role of dialectics (Mepham and Rubin, 1979; Reuten and Williams, 1989). Debates about dialectics and methodology quickly crossed over into value theory giving rise to the "value form" tradition (Arthur 1979a, 1979b, 1993, 2001; Elson, 1979). Incorporating the concept of contradiction and the distinction between essence and appearance, value in this tradition was seen as taking on different "forms of appearance". Marxist economists such as Foley (1986) have begun to integrate philosophical and methodological insights with their empirical and model building approaches (see his methodological introduction, p.1).

An advantage of the value form concept is that is has parallels with Bryer's linking of value and accounting. I argued in chapter two that part of Bryer's interpretation of Marx has been a greater emphasis on the circuit of capital idea, which highlights the changing *form* of capital: money capital; productive capital; commodity capital; money capital. This in turn has striking similarities with the modern concept of working capital management (Owen, 2003b, p.1).

An approach to value that emphasises the different forms of value is clearly relevant to theorising the changing forms of capital in the circuit of capital. In addition, the value form concept brings a dialectical dimension to the changes in form within the circuit of capital. This opens the way for interpreting accounting as a value form. Bryer (2006a) shows that target cost, standard cost and budgeting are all forms of socially necessary labour time and, as a result, they are forms of value. In chapter six the dialectical character of accounting will be developed by interpreting Bryer's (1993a) "labour danger" as the fundamental contradiction in accounting, and Reuten and Williams' (1989) idea of "systematic dialectics" will be used to show the consequences the contradiction has for value creation by accounting firms.

**2. The historical dimension of Marx's value concept**

As well as having a dialectical dimension, a robust value concept also needs a historical dimension. This section will argue that interpreting value historically is the root of many misinterpretations of value such as Sweezy (1942) which have, in turn, lead to the mistaken qualitative interpretation of value theory such as Elson (1979). An example of the historical misinterpretation of Marx's concepts was Armstrong's (1989) criticism of Braverman's (1974) misinterpretation of Marx's concept of "production" and "labour process". Braverman (1974) treated production as general production when Marx's subject was capitalist production. Foley's (1986) methodological introduction generalises this point, arguing that the first principle of interpreting Marx's *Capital* is that it applies to “specific social formations” (p.1), and must not be interpreted as “universal principles”.

In the unpublished introduction to *Contribution to Critique of Political Economy* (Marx & Engels, 1986 p.23; Foley, 1986 p.2) Marx used the concept of “production in general” to explain the relationship between capitalist production and capitalist development.

> “Thus when we speak of production, we always have in mind at a definite stage of social development, production by social individuals. It might seem that, in order to speak of production at all, we must either trace the historical process of development in its various phases, or else declare at very beginning that we are dealing with one particular historical epoch, for instance with modern bourgeois production, which is indeed our real subject matter …. Production in general is an abstraction, but a reasonable abstraction in so far as it actually emphasises and defines the common aspects and therefore spares us the need of repetition…..But although most highly developed languages have laws and categories in common with the most primitive ones it is precisely what constitutes their development that distinguishes them from this general and common element. The determinations which apply to production in general must rather be set apart in order not to allow the unity which stems from the fact that the subject, mankind, and the object, nature, are the same- to obscure the essential difference. On failure to perceive this difference rests, for instance, the entire wisdom of modern economists who are trying to prove the eternity and harmony of existing social relations”.

Here Marx argues that “production in general”, although at first sight a useful and rational concept is inherently conservative because it focuses on the fact that all societies have common elements which are unchanging. “Production in general” tends towards what Burrell and Morgan (1979) term “sociology of regulation” rather than “sociology of radical change”. Marx’s intentions in *Capital* are to show the disproportionate power of capitalists over workers and therefore he favours categories that directly reveal the power of total social capital, particularly value and surplus value.

The unpublished introduction (Marx, 1986) discusses many issues and problems surrounding the historical dimension of categories such as “possession” and “money” (p.41), as well as “production in general”. Marx’s conclusion, however, is clear, “It would be impractical and wrong to arrange the economic categories in the order in which they were the determining factors in the course of history” (1986, p.47). [15]

Carrying this logic over to his main work, in the first sentence of *Capital* Marx explains “The wealth of those societies in which the capitalist mode of production prevails presents itself as ‘an immense accumulation of commodities’” (1954, p.43). At the very start of Marx’s *Capital* it is clear that it does not deal with the “historical process of development” of capital, but with capitalism as a “particular historical epoch”.

Further evidence that Marx made a distinction between theories of capitalist production and historical studies is his treatment of the “so called primitive accumulation” at the end

[15] Engels (1859) took the view that the starting point and development of theory ‘will be simply the reflection, in abstract and theoretically consistent form, of the historical course’. See also: Engels (1975).

of *Capital* (1954, p.667). This section of Marx's *Capital* is given over to the historical process that gave rise to capitalist production, for example, "Expropriation of the Agricultural Population From the Land" (1954, p.671). No attempt is made by Marx to develop theoretical concepts such as value and surplus value, since these concepts are already established earlier in the text. The purpose of these historical studies is to justify the starting point of *Capital*, to show capitalist production emerged from a specific process of history, and, to show its relevance to the future (*Capital* appeared in 1867), he devotes the final chapter to colonisation, that is, the capitalist development of America. Marx's studies of "primitive accumulation" evidence the struggles that gave rise to capitalist production, but they do not provide the foundation for concepts that make up the theory of capitalist production. In short, Marx's (1954) concept of value is not directly or actively historical; rather, its foundation is historical study.

As mentioned earlier, evidence of conservative bias in the historical interpretation of Marx's categories can be found in Braverman (1974). Marx's (1954) intention was to show that capitalists, managers and other agents did not contribute to value (1954, p.173), and were not part of the labour process, whereas Braverman (1974) uses the category trans-historically, leading to the conclusion that managers are part of the labour process (Armstrong, 1989). Braverman's (1974) historical use of the category labour process, consequently, makes it a less effective tool for examining the power of capitalists. In *Capital,* Marx did not interpret the concept of labour process historically and, as a result, as Armstrong (1989) and Bryer (2006a) have already shown, Braverman's (1974) use of the category is not consistent with Marx (1954).

Toms (2005) is another example of failure to respect the distinction between capitalist production and capitalist development, leading to a weakening of the concepts of total social capital and value. Toms (2005) suggests a capitalist trajectory from individual capitalism to social capital and uses this process as a framework for accounting history. Toms (2005, p.628) describes his approach as Marxist "political economy" without realising that this means focusing on capitalist production rather than on the history of capitalist development. This is not a question of terminology. Toms' (2005) failure to maintain the distinction encourages his unsubstantiated view that a phase of capitalism existed based on individual capitalists, that individual 'capitalists' existed before capitalism existed as a social system, and, as a result, he abandons the concept of total social capital and, therefore, abandons Marx. Bryer argues that total social capital is essential to Marx's theory of capitalist production (1999a, 2006a, 2007), and Toms says he agrees, but his history contradicts this assertion. According to Marx, the institutional or legal forms that capital first appears in - family firms, partnerships, limited companies, global corporations, or limited liability partnerships - may vary, but within capitalism, we must understand all these institutional forms as subject to the discipline of social capital, the process of the average rate of profit. The idea that an individual capitalist is not disciplined by total social capital can therefore have no place in 'Marxist' theory of capitalist production. Therefore, idea that the historical trajectory involves moving from individual to social capital may be a rational and potentially useful one in particular historical contexts (for example, the transition to capitalism in America), but it cannot be described as an essentially capitalist trajectory. Rather, it is a part of capitalist development not capitalist production, as Marx defined them. A key aspect of Bryer's (1994a, 1999a, 2007) critique of Marxist economists is that they implicitly apply an individual capitalist model, and Toms' (2005) approach tends to encourage this error by suggesting that in England there was an era of individual capitalism.

Toms' inclination towards an individual capital approach has implications for his treatment of value. The concept of total social capital interprets capital as a powerful force in society, while the concept of individual capital is far less powerful and, therefore, a less effective tool for exposing capitalist exploitation. Bryer's interpretation of total social capital argues that the firm is an epiphenomenon and that the real source of power, control and accountability lies in the capital markets. Toms (2007) examines "tacit knowledge" in the value process within the capitalist firm without first placing firms in the context of total social capital and the power of the stock market. As a result, the concepts of power, control, agency and accountability are not powerfully articulated.

Bryer's historical studies show that Marx clearly distinguished between capitalist production and capitalist development. Bryer (2000a, 2000b) for example has shown that Marx took a two-stage approach to the transition from feudalism to capitalism, showing that Marx's approach to theorising his historical studies differed fundamentally from his approach to theorising capitalist production. The process of transition from feudalism to capitalism does not reveal the detailed workings of capitalism. The tactics and strategies used by merchants and farmers to construct capitalist society are not necessarily the best foundations for understanding the workings of capitalist production. Capitalist production, for example, abolishes the distinction between merchants and farmers and replaces it with more general categories, the "rate of surplus value" and total social capital. Marx (1954) develops a capitalist dialectic not a historic dialectic, and not surprisingly, the term 'historical materialism' is never used in Marx's *Capital* (or elsewhere in his works).[16]

In summary, evidence from categories such as labour process, production in general, and total social capital, as well as Toms use of the imagined individual to social capital transition, shows that failure to respect the distinction between Marx historical studies and his theory of capitalist production can lead to errors of interpretation and a weakening of Marx's theoretical concepts.

Rubin (1972 p.254) has argued that a common reaction to the problem of transforming values into prices has been the search for a historical foundation to value. As a result, the failure to respect the distinction between capitalist development and capitalist production is widespread in Marxism, including Mohun (1994b), Sweezy (1942) and Elson (1979) explored below. Mohun argued:

> "Value is labour time because of an essentialist ontology that what defines human existence as specifically human is purposive productive activity. Marx historical materialism interpreted such activity in terms of its ability to transform the environment in which it was located, transformation which then changed the producers themselves and thereby changed their productive activity. This focus

[16] Engels (1975) uses the term "materialist conception of history".

on human labour immediately provokes a labour theory of value" (Mohun, 1994b, p.216).

Mohun treats value as having a trans-historical or technical basis in the same way that Braverman (1974) misinterpreted "labour process". Here value loses its link with the power of capitalists and, as a result, in Marx's view it loses its political dimension. Value also loses its links with the circuit of capital, making it less relevant to capitalist production (see above). It is of course universally true that all societies must produce and that labour is the main element in all production, irrespective of its social form. Marx however, fashioned his value concept as a tool for theorising the specifically capitalist form of production, not as a general theory for all societies for all time.

I present more evidence of the damage done to the value concept when it is treated trans-historically in relation to Sweezy (1942), and this leads the discussion to the pure qualitative value theorists. Before moving on, however, it is important to consider in more detail the fundamental question of the proper relationship between Marx's historical studies and his economic theories. What is the relationship between history and value theory? What is the historical dimension of value?

Rubin (1994, p.36) is authoritative on this question:

> "Marx observed that an economic investigation can be conducted according to two methods: by the transition from the concrete to abstract and conversely by movement from the abstract to the concrete".

These Rubin termed these the 'analytical' and the 'dialectical' (or genetic) method. Marx did not conceive of these as a choice, but worked with both methods. As Rubin puts it "But, Marx says, however necessary the use of the analytical method is in the first stage of scientific enquiry, it cannot satisfy us in itself and it must be complemented by the other". Rubin's interpretation of Marx's method suggests that induction (the analytical stage) and deduction (the dialectical stage) should not be separated but combined in a research cycle. Evidence to support Rubin's interpretation of this aspect of Marx's method can be found in the unpublished introduction to *Critique of Political Economy* (p. 39):

> "If we start out therefore with population and we do so with a chaotic conception of the whole, and by closer examination we will gradually arrive at simpler ideas; thus we shall proceed from the imaginary concrete to less and less complex abstractions until we get to the simplest conception. This once attained we might start back on our return journey until we would finally come back to population but this time not as a chaotic notion of an integral whole but as a rich aggregate of many conceptions and relations".

Further evidence to support Rubin' interpretation can be found in Bryer's (2007) detailed investigation of Marx and Engels' correspondence on accounting, revealing the role of accounting in both the analytical stage, for example, capitalist depreciation accounting as well as the dialectical, for example, accounting as "socially necessary labour time". In delving into the detail of bookkeeping (analytical stage), Bryer argues that Marx found the key to the whole structure of *Capital* over three volumes (dialectical stage).

The importance of recognising the two aspects of Marx's method is that it reveals how simple empirical analysis and historical studies can be combined with more philosophical and dialectical forms of presentation. Marx's historical studies, critiques of other scholars (history of theory), and empirical analysis, are part of the analytical stage not the dialectical. The literature on the making of Marx's *Capital* (Bryer, 2007; Rosdolsky 1977; Mepham, 1979) reveals the different plans and structures that Marx considered. Marx never considered organising *Capital* on the basis of a historical dialectic or the dialectic of "transition". The underlying cause of the problem of the historical dimension of value is methodological, including the distinction between history and theory and the two part interpretation of Marx's method, and it will be argued below that the same errors underpin "qualitative" value theory.

## 3. Marx's use of the qualitative/quantitative distinction

A logical starting point for the critique of qualitative value theory is Marx's use of the Q/Q distinction and his application of it in the first chapter of *Capital*. Marx took careful account of both dimensions of value which were closely related and interdependent in his analysis of the commodity and value. He refers in the heading to "Chapter One, Commodities, Section One, The Two Factors of a Commodity: Use Value and Value (the Substance of Value and the Magnitude of Value)" (1954, p.43). He treats the two aspects of the commodity, "substance" and "magnitude" together.

Marx argued, "Every useful thing, as paper, iron etc., may be looked at from the two points of view of quality and quantity" (1954, p.43) and, as a result, value has both a quantitative and qualitative dimension. He goes on to argue, "Exchange value, at first sight, presents itself as a quantitative relation" (1954, p.44) and, therefore, the quantitative dimension is more readily appreciated than the qualitative, but his analysis of the commodity accommodates both dimensions. For example, Marx argues that "the magnitude of the value of any article is the amount of labour socially necessary, or the labour time socially necessary for its production" (1954, p.46), so the quantity or "magnitude" is directly derived and inseparable from with the qualitative, the "social" character of labour.

In other words, the quantitative and qualitative aspects of value are simultaneous and unified and the quantitative aspects of value make no sense without the qualitative and visa versa. When coats are exchanged for linen (1954, the example on p.49), commodities that are qualitatively different are quantitatively equated, revealing the value behind apparent exchange value. Both the qualitative difference and the quantitative equality play a role in value.

The qualitative nature of the labour that lies behind Marx’s value concept is ‘homogenous abstract labour’. The concept of ‘abstract labour’ is achieved by reducing all the different types of labour and craft skills to a common element of undifferentiated social labour, and this is what is expressed in value. As a result, the qualitative nature of the labour in Marx’s value concept is the key to understanding the quantitative expression of value. In other words, he binds the Q/Q dimensions together.

Marx (1954, p.48) argued that the labour embodied in commodities has a two-fold character, useful labour and abstract labour which he claimed was an original contribution to political economy. Both of these characteristics or aspects of labour have qualitative and quantitative dimensions. The qualitative nature of useful labour is specific, “a productive activity of a definite kind and exercised with a definite aim” (1954, p.49). The quantitative aspects of useful labour are the basis of “material wealth”, useful labour delivers use values which “constitute the substance of all wealth, whatever may be the social form of that wealth” (1954, p.44). The qualitative aspect of abstract labour, its homogenous and undifferentiated nature, is striking. The quantitative aspect of abstract labour is “socially necessary labour *time*”, the disciplining force of society acting on exchange. Marx (1954) draws attention to the paradox that

> “… an increase in material wealth may correspond to a simultaneous fall in the magnitude of value. This antagonistic movement has its origin in the two-fold character of labour” (1954, p.53).

Marx's explanation of this contradiction draws on both the Q/Q dimension of useful labour as well as Q/Q dimensions of abstract labour:

> "Productive power has reference, of course, only to labour of some useful concrete form, the efficacy of any special productive activity during a given time being dependent on its productiveness. Useful labour becomes, therefore, a more or less abundant source of products in proportion to the rise and fall of its productiveness".

Here "productiveness" expresses the quantitative aspects of the qualitative category "useful labour". Marx goes on to argue "the same change in productive power, which increases the fruitfulness of labour, … will diminish the total value of this increased quantity of use values, provided such change shortens the total labour time necessary for their production" (1954, p.53). Marx uses the idea of a reduction in necessary labour time to express the qualitative category abstract labour. In short, both characteristics of labour, useful and abstract, have qualitative and quantitative dimensions.

Marx's (1954) treatment of the Q/Q dimensions of value suggests that the idea of pure "qualitative" value theory is an absurdity. How could such a theory become tenable? Below, I examine the arguments in favour of a pure qualitative value theory and criticise them. I adopt the "value form" approach as it emphasises the dialectical aspects of value, adding a dynamic dimension to political economy. I will argue that value can take on a wide variety of forms both quantitative as well as qualitative, and that the link between value and accounting, the close link between the Q/Q dimensions of value, reflect the close relationship between Q/Q dimensions of accounting. The recent IASB (2006, p.44) discussion paper emphasised the "qualitative characteristics of decision-use financial information" implicitly recognising this logical necessity. Two of the key qualitative characteristics identified are "timeliness" and "relevance", and the discussion paper rightly argues that any quantitative information is useless if it does not also have 'qualitative characteristics'. This inexorable truth has escaped some leading Marxists.

## 4. Sweezy: the origins of qualitative value theory

The distinction between qualitative and quantitative aspects of value can be traced to Sweezy (1942) who attempted a *Theory of Capitalist Development* sitting along side many other theories of the capitalist trajectory such as flexible specialisation, globalisation, etc,.[17] Sweezy's (1942) project was distinct from Marx's (1954, 1956), but was a logical extension because it considered the development of capitalism into mature forms such as "monopoly capitalism", post capitalism, as well as pre-capitalist forms. However, as a result of Sweezy's emphasis on the capitalist trajectory, the notion of the "circuit of capital" plays a minor role, and this undermines the relevance of the value concept. The historical perspective and pre-capitalist formations on the other hand, played a key theoretical role in Sweezy (1942) who, like Toms (2005), attempted to develop the historical aspects of capitalism, capitalist development, within the framework that Marx (1954) set out for theorising capitalist production. This represents an

[17] See chapter one.

inconsistency in Sweezy's approach and the greater emphasis placed on the Q/Q distinction is, therefore, not well founded.

Sweezy (1942, p.20) gave serious consideration to Marx's methodological underpinnings and was especially influenced by Lukacs' (1968) historical perspective. The methodological texts that later stimulated the emergence of the value form approach, such as Rubin (1972, 1994), were not available to him, and the two-part interpretation of Marx's method was not well developed. He understood the fact that Marx's method may "appear strikingly similar to that of classical predecessors" (1942, p.11), and on this basis could be described as "abstract deductive" or "successive approximations" and he also understood the other dimension, "what to abstract from" (1942, p.12).

Sweezy's (1942, p.12) understanding of "what to abstract from" rests on the selection of the problem and identification of its main elements. In Sweezy's view, understanding class struggle is Marx's "problem" and he argues that in *Capital* Marx abstracts from all elements that are irrelevant to this (1942, p.17). Sweezy (1942, p.20) takes a historical view of class struggle and this, combined with his desire to uncover "developments" in capitalism, leads to the now discredited view that Marx's *Capital* adopts a chronological form of presentation, in particular that the analysis of the commodity involves a pre-capitalist or abstract economy, has to start from 'simple commodity production'.

Sweezy (1942, p.23) argues, "Marx begins by analysing 'simple commodity production', that is to say a society in which each producer owns his own means of production".

Seeking to uncover the source of the capitalist trajectory therefore leads Sweezy to adopt a universal theory of class struggle, rather than a capitalist theory of class struggle, which is inconsistent with Marx's declared aims in *Capital*. Sweezy describes history and social theory as "the process of change inherent in a specific set of relations" (1942, p.20), but Marx's subject in *Capital* was narrower, specifically capitalist production and its contradictions.

A framework for studying class struggle and exploitation such as Bryer's (2005, p.29) therefore becomes an indispensable tool for historical study because it clarifies the point that capitalism involves a particular form of exploitation, and evidences it with different historical forms of accounts. Sweezy (1942), however, mistakenly interprets the value categories of Marx's theory of capitalist production as categories appropriate for the analysis of exploitation in general. Bryer's interpretation of Marx's (1954) framework suggests that the logical starting point for theorising the capitalist trajectory is the contradiction in capitalist production, the capitalist dialectic, not the dialectic of history, or Landes' (1998) global economic history.

Interpreting the analysis of the commodity as involving a pre-capitalist economy leads Sweezy to the idea of the distinction between Q/Q dimensions of value. He argues that:

> "Commodity production, in other words, is not the universal and inevitable form of economic life. It is rather one possible form of economic life, a form, to be sure, which has been familiar for many centuries and which dominates the

> modern period, but none the less a historically conditioned form which can in no sense be claimed to be a direct manifestation of human nature. The implications of this view are striking. Commodity production is withdrawn from the realm of natural phenomena and becomes the valid subject of socio-historical investigation. No longer can the economist afford to confine his attention to the quantitative relations arising from commodity production; he must also direct his attention to the character of the social relations which underlie the commodity form. We may express this by saying that the tasks of economics are not only quantitative but they are also qualitative" (1942, p.24).

Developing this further he argues:

> "The great originality of Marx's value theory lies in recognition of these two elements of the problems and in its attempt to deal with them simultaneously within a single conceptual framework. The same considerations account, in no small degree, for the great difficulty in understanding the theory, which is almost invariably experienced by those brought up in the main tradition of economic thought. For this reason it has seemed advisable to separate Marx's value theory into its two component parts and attempt to deal with them one at a time" (1942, p.24).

Here Sweezy separates the Q/Q dimensions even though he does not argue that there is only a ‘qualitative’ value theory, but rather a qualitatively separate dimension to value theory. However, he puts qualitative theory first:

> “We have reached these conclusions through purely qualitative analysis and it may appear that they have little bearing on the quantitative problem. This, however, is not so. The truth is that the basic significance as well as the main tasks of quantitative value theory are determined by the qualitative analysis”.

Although scholars claim the authority of Sweezy (1942) for the idea of pure ‘qualitative’ value theory, for example, Fleetwood (2001), in fact, Sweezy (1942) stresses the distinction, and prioritises the qualitative, but he does not deny the two dimensions of value.

A pure qualitative historical perspective on class struggle is the main force behind Sweezy’s (1942) theorising, rather than dialectics. This reduces the idea of class relations to historical and on-going conflict rather than contradiction, meaning both conflicts over the social produce, a distributional question, and control of the labour process designed to increase the surplus product capitalists’ receive. Marx’s (1954) idea of contradiction involves more than class conflict. A contradiction involves two forces that both attract and repel, which are the source of movement from essence to appearance. A dialectic view of class conflict therefore involves understanding the capitalist need of workers as well as the workers need for capitalists, and the conflict in the relationship and, consequently, it is always a two-dimensional process of reciprocity.

By contrast, Sweezy's (1942) class conflict is a simpler conception, not two-dimensional. Sweezy is open to the criticism that, in deciding "what to abstract from" (Rubin's analytical stage), it was not just the issue of historical class conflict that concerned Marx, but the shaping of a fundamental universal contradiction capable of animating the whole of capitalist production, not capitalist development, quantitatively in its many forms.

The drift away from quantitative Marxism begun with Sweezy reaches its ultimate form in the work of those, such as Perelman and Elson, who deny the very possibility. Clearly, if this is so, the viability of a political economy of accounting and the accounting firm has reached its nemesis.

## 5. Perelman: the impossibility of quantitative value theory

Perelman's (1987) reading of Marx emphasises the fact that Marx developed his categories as qualitative responses to the political situation of the time, and discourages a reading of Marx as a formal, timeless truth with quantitative dimensions. Perelman (1987, p.3) argues for example "I will show that the concept of organic composition of capital was not nearly as abstract as it has been interpreted by later readers. It was developed to respond to the particular conditions of the time".[18] More important for the

[18] The organic composition of capital is the balance between labour, material and fixed capital equipment in a capitalist firm.

purposes of this thesis, Perelman's concludes that Marx's value theory cannot be interpreted quantitatively, because of the "impossibility of correctly measuring" (1999, p. 719) the transfer of value from constant capital to commodities.

Perelman (1987, p.129) devotes a chapter to constant capital, of which fixed capital is a form of appearance, and this leads to an exploration of reproduction schemes and Marx's distinction between expanded reproduction and simple reproduction. Perelman suggests Marx's distinction between simple and expanded reproduction has a parallel in value theory of "simple value theory" and reproduction value:

> "In the first volume of *Capital*, Marx analysed commodities at their most abstract level. We might refer to the quantitative value theory that Marx presented there as a presentation of 'simple value,' to indicate an affinity with simple reproduction or the most simplistic version of Marx's model of expanded reproduction" (Perelman, 1999, p.719).

Perelman (1999) concludes that the quantitative aspects of value theory breakdown when applied to expanded reproduction and goes on to develop a qualitative interpretation of value theory that links it to capitalist crisis. He argues quantitative value theory breaks down because, in the face of technical change, capitalists do not know how long machinery will last. They cannot calculate, therefore, how the value of machinery transfers into commodities. Put another way, when capitalist are left with obsolete machines, simple value theory breaks down and capitalist crisis breaks out. In short, the quantitative aspects of value theory are impossible. Perelman (1999) also has doubts about the quantitative aspects of value theory in general (1999, p.721), arguing that attempts to measure abstract labour involve weighting each labour hour using the wage rate. He argues (as have others) that this procedure is circular because the price system is used to measures value, when the purpose of value is to explain and understand the price system. Perelman (1999) therefore employs both general and specific arguments against the quantitative aspects of value.

However, Perelman's (1999) methodological understanding of Marx, like Sweezy's (1942), lacks a full appreciation of dialectics and Rubin's (1972, 1994b) two-part interpretation. Perelman argues that:

> "… most of the literature on Marx accepts the assertion that Marx's general method was to begin with a very abstract analytical approach, which he would progressively modify as he applied his theory to more concrete levels of analysis. Value theory is a case in point. Marx continually developed his value theory as he moved to more concrete levels of analysis. This value theory was not a formal model to be used to derive a mathematical rule for establishing prices but rather a way of understanding the laws of capitalism" (Perelman, 1999, p.720).

Sweezy (1942) understood there was more to Marx's method than "successive approximations", and many other commentators have argued for a dialectical interpretation of Marx's method (see Foley, 1986). Perelman is incorrect to suggest that "most of the literature" takes this approach.

The idea that Marx progressively modifies the LTV betrays a lack of understanding of the role of dialectics in Marx. In a dialectical interpretation of LTV the animating force of contradiction is present from the start in the "cell form" and develops through successive forms of appearance (Marx, 1954, p.19). Perelman's notion of an ad hoc process of adjustment is incorrect.

Because Marx works through the analytical stage before embarking on the dialectical, he has already worked out the stages in the development of value theory, and they are present in the "cell form", in its inner relations, as "potential". The development of value theory is therefore not "*ad hoc*". Evidence that Marx makes no distinction between simple value and reproduction value theory is the fact that Marx (1954, 1956, 1959) never uses the term.[19]

Perelman presents the general argument against quantification of LTV (1999, p. 721) as follows:

> "How can labour values be measured in terms of abstract labour? … Either we can measure the total amount of labour hours … or we can weight each hour by the appropriate wage rate".

[19] Electronic versions of Marx's work, that is, word documents, which have only recently become available, have been used to confirm this. The only time Marx ever used the phrase "simple value" was in Grundrisse where it meant the starting capital

Perelman correctly interprets the first method as wrong, but incorrectly dismisses the second as “circular reasoning”, because he says “It suggests that we have to use the price system to get a handle on the value system, which was supposed to go beyond the price system in the first place”. When viewed in the light of Rubin’s two-part interpretation of Marx’s methods it is readily apparent that we should examine every topic twice, in both the analytical and dialectical stage. These two stages can be understood as illustrating how the essential contradiction takes on “forms of appearance”. Alternatively, stripping away dialectical terminology, the validity of this process lies in the deeper understanding of the subject achieved in subsequent consideration. What began in volume 1 as a market given wage within capital in general (where value equals price), the ‘appropriate wage rate’ by volume 3 becomes a target cost within total social capital.

Revisiting topics is, in fact, Marx’s normal method (Foley, 1986, p.5). For example, Marx (1954) starts in the sphere of the circulation of the commodity and derives the concept of value. This concept is used to comprehend the production of surplus value. Then Marx (1956) returns to the sphere of circulation, now comprehended as the sphere of the circulation of capital, rather than the circulation of the commodity. As a result, Marx visits all subjects twice. Perelman’s (1999) general argument against quantification of value is therefore wrong, leaving us with the supposed specific difficulty with constant capital, where he argues:

> "According to simple value theory, capital goods unrealistically depreciate according to predetermined patterns, just as they do in neoclassical production theory. If a tool is to be used over a fixed period of time with a known pattern of intensity, we can develop a rule to measure the rate at which the labour embodied in the tool is deposited in the flow of commodities. To argue the realism of such conditions is tantamount to proposing some sort of 'rational Marxist expectations" (1999, p.721).

Developing the argument into the realm of expanded reproduction:

> "… if unpredictable technical change can make a tool obsolete in the near future how do we develop an appropriate rule to allocate the transfer of value from the tool to the final product" (1999, p.721).

According to Bryer's argument, managers are accountable to investors who enforce this relationship by comparing the return on capital to target return and target cost to actual expenditure. Because of accountability, managers have a detailed understanding of costs, including the costs of machines and the patterns of use of machines (Bryer, 1999a; 2006a). As a result, depreciation is something that is easily and commonly calculated in capitalist businesses. In 19th century capital-intensive businesses, such as railroads, these calculations were well understood and common-place (Bryer, 1991). The transfer of value from fixed capital to commodities causes few practical problems in the normal course of capitalist business.

The problems apparently posed by technical innovation and the development of new machines have a particular fascination for many scholars, but the incorporation of these new machines poses no problems for value theory. The key to understanding this is the fact that capitalist firms sell new technology to other capitalist firms. The sellers have to present a detailed case that new machines will reduce costs and this involves estimating all the costs of the new machine, including the operating costs, the life of the machine, and the pattern of use. This business case is, in turn, examined in detail by potential customers. If the likely benefit of buying the new machines is not quantifiable the new machine will not be adopted and Perelman problematic disappears. If the new machine is adopted, the costs useful life and patterns of use will have been worked out in detail during the evaluation process and depreciation is a simple matter.

Where the estimated pattern of use is incorrect or obsolescence is encountered, the firm will write off the machine as an unproductive expenditure, reducing the return on capital (Bryer, 2006a). Because the write off is unproductive it has no impact on true cost calculations. Similarly if some firms continue using outdated and inefficient machines this will also reduce return on capital and result in corrective action. If maverick entrepreneurs introduce new machines which have not been proven and have not been widely adopted, two possibilities arise: the failure of the new machines to increase return on capital, or their success in doing so. In the case of failure, capitals will be withdrawn and in the case of success machines will be widely adopted resulting in lower costs and lower socially necessary labour time. In short, as Bryer (1999a, 2007) has already argued, there are no difficulties in operationalising Marx's theories of constant capital and machinery.

Perelman's (1987 p.129) instinct that "constant capital is a social relation" is sound, but he has developed the idea into an argument against quantification. Bryer (2006b, 2007), on the other hand, has shown that quantification is deeply permeated by social relations of accountability and is determined by those relations. In short, quantification has a social nature.

I have emphasised the importance of Bryer's focus on the "circuit of capital" and Perelman's (1999) neglect of this core idea inevitably weakens his approach. The decisive stages in the development of Marx's *Capital* are between production of capital, circulation of capital, and the complete circuit. Perelman's (1999) error therefore arises from his focus on "simple" and "expanded" reproduction that he does not reconcile with the stages of the "circuit of capital" (Foley, 1986 p.3). However, his fundamental error is his failure to focus on the determination of value, an approach given an influential justification by Elson (1979).

## 6. Elson's value theory of labour

Elson (1979) developed a different type of "qualitative" value theory, the methodological foundation of Perelman (1999), and closer to the value form tradition. Elson (1979) treats value and labour historically in a similar way to Sweezy (1942) and Braverman

(1974) and, as a result, does not maintain a distinction between capitalist development and capitalist production. Also like Sweezy (1942), Elson (1979) does not emphasise the circuit of capital, reducing the focus on the value concept. Elson (1979) does this because she argues that the purpose of Marx's LTV is to gain a better understanding of labour. In the same way that Braverman (1974) attempted to refocus Marxism on the labour process, Elson (1979) refocuses the LTV to explain labour itself, arguing that the purpose of LTV is to understand labour rather than to understand value. This leads Elson (1979, p.115) to the idea of "value theory of labour".

Elson (1979) argues that Marx did not intend the LTV as a proof of exploitation or a theory of price. She argues that the 'proof of exploitation' approach "tends to dehistoricise value" (1979, p.116). This is easily dismissed as it reflects the universal principles interpretation of Marx's *Capital* which Armstrong (1989) and Foley (1986) have shown to be incorrect, and it ignores the warning that Marx gave about the limits of some historical categories such a "production in general" examined above. Value in general is not a concept found in Marx (1954). As Marx observes (quoted by Elson), "Capital did not invent surplus labour" (1979, p.115).

Marx's difficulty, as Dobb (1973) observes (also approvingly quoted by Elson, 1979, p.116), is to "reconcile the existence of surplus value with the reign of market competition and of exchange of value equivalents". The theory of surplus value achieves this, but Elson argues that this does not mean value theory is proof of exploitation. This is a puzzling conclusion. Theorising the capitalist form of exploitation, exploring in detail the capitalists' method of generating profit through the stages of the circuit of capital, is a proof of exploitation. In other words, Marx uses value and value in process to prove the existence of capitalist exploitation and, therefore, Elson's (1979) premise that surplus value is not a proof of exploitation is incorrect. The quotes from Marx and Dobb that Elson (1979, p.115) says prove her argument are also consistent with the argument that Marx did intend value to be a proof of exploitation by revealing the detail of the capitalist form of exploitation.

It is also argued by Elson (1979, p.116) that treating LTV as proof of exploitation makes value synonymous with labour time. Value stands in its closest relation with labour time when, reduced to its abstract, it is exactly equal to the social necessary abstract labour time. Marx initially assumes this is the case and later relaxes the assumption. It cannot be argued, therefore, that value is synonymous with labour time and treating LTV as a proof of exploitation does not mean collapsing the distinction between the two.

Elson (1979, p.130) argues that economists' simplistic views of causation tend to lead them to a simplistic idea of the relationship between value and labour time. Elson (1979, p.116) also argues that treating LTV as a proof of exploitation makes the distinction between surplus labour and surplus value redundant. However, this takes no account of the fact that Marx's theory of surplus value and "circuit of capital" model reveals the level of control capitalists must impose on workers to generate surplus value and also that they must, in addition, sell the commodity before realising surplus value. The distinction between surplus labour and surplus value is an important part of the “valorisation” process, again irrespective of the issue of proof of exploitation.

Rather than quantify exploitation, Elson argues that LTV only

> “… gives us a tool for analysing how capitalist exploitation works, and changes and develops; for understanding capitalist exploitation in process” (Elson, 1979, p.171).

The argument that LTV is not a quantitative proof of exploitation is not supported by the evidence or arguments that Elson (1979) provides.

Elson (1979) also argues that LTV is not intended as a theory of price. Elson (1979, p.116) does not dwell on the circuit of capital model, but has to accept, “It was necessary that a product be sold and translated into money”. Given this it is difficult to comprehend how Elson (1979) can argue that the LTV has no relationship to price. Marx evidently intended price to be a moment of LTV because he gives it a critical phase in the circuit of capital model, making it an integral part of value in process. Price is not the sole purpose or even the main purpose of Marx’s value concept, but value in the circuit of capital represents a quantitative theory of price.

Rather than emphasise exploitation and price, Elson (1979 p.128) takes up Braverman’s (1974) position emphasising the concept of labour and, as a result, tends to treat the relationship between labour and value as a universal relationship rather than a specifically capitalist relationship. Like Sweezy (1942), Elson (1979, p.140) has a strongly historical perspective arguing that:

> "Marx saw the determination of social forms as a historical process, a process eventuating through time in which every precipitate form becomes in turn dissolved, changes into a new form, a process whose dynamic is internal to it, which has no external cause, existing outside history which is an effect".

In contrast to her views on the purpose of value theory, Elson's (1979) arguments regarding the methodological underpinning of LTV and the implications for causation are powerful, and have already played a part in forming the approach adopted in this thesis. Chapter one noted that the idea of cause takes on a different nature in political economy because of the absence of exogenous variables. It was argued that political economy's theories of capitalist production had to be dialectical in order to be logically consistent. Elson (1979) argues that Marxist economists have imposed mechanistic views of causation in value theory. In particular,

> "All the readings of Marx's value theory so far discussed have in common a misplaced concreteness, in that they understand that theory as a relation between certain already determined, 'given' independent variables located in the process of production, and certain, to be determined, dependent variables located in the process of circulation" (1979, p.130).

Further,

> "When questions about determination are raised it is usually only to discuss the choice of independent and dependent variables" (1979, p.130).

The implication of this, Elson (1979, p.131) argues, is that Marxist economists have adopted a view that

> "… assumes that the phenomena of the material world are like the symbols of arithmetical and formal logic, separate and self bounded and relate to each other in the same way".

Elson (1979) argues that a consequence of this is the collapse of the distinctions between value, labour time and exchange value.[20] In short, Elson (1979) argues that Marxist economists (and neo-Ricardians) have misunderstood value because of causation.

Elson (1979) powerfully argues that a dialectic view of causation based on an idea of forms of appearance allows all the different aspects of value and labour to exist separately, avoiding economists' simplifications. In particular, Elson (1979 p.135) argues that:

[20] Fleetwood (2001) also shows the limits of economists' methodologies, showing that they rely on correlation and have no explanatory power.

> "… in the argument of *Capital* labour time value and exchange value (price) are not three discretely distinct variables, nor are they identical to each other. There is a continuity as well as difference between all three".

When Elson (1979) links Braverman's (1974) emphasis on labour with a dialectical view of causation and the idea that exploitation and price are not key aspects of value theory, the result is a "value theory of labour", a qualitative reorientation of LTV. The strengths of this approach stem from the dialectical view of causation and the resulting forms of value and labour. The weaknesses are equally clear: treatment of the relationship between labour and value as a universal principle; failure to maintain the distinction between capitalist production and capitalist development; the argument that quantifiable exploitation and price are not important to LTV, reducing the political relevance of value.

When Elson (1979) jettisons ideas of simple causation, she also jettisons quantification. Causation and quantification is not the same thing. Many economists that employ simplistic views of causation also employ quantitative techniques such as regression analysis. There is no reason, however, why dialectical views of causation cannot also employ quantitative techniques. I will later present evidence that dialectics are a useful framework for employing both quantitative and qualitative data.

Section 3 above argued that Marx's *Capital* integrates dialectics with quantitative data. Bryer (1999a) has shown that value theory articulates the 'principles' of accounting (1999a). Foley (1986) has developed a formal model of circuits of capital and Reuten and Williams (1989) incorporate the average rate of profit into systematic dialectics. Looking at the relationship between dialectics and quantification more generally, the "analytical stage" admits of all types of data collection, such as historical studies and empirical analysis, in order to determine key contradictions. As a result, when dialectical presentation is attempted it naturally develops as much in the quantitative domain as in the qualitative. Further, the holistic nature of political economy suggests that the integration of both dimensions should be actively sought in the same way as the real and nominal domains are actively integrated. Elson's (1979) "value theory of labour" therefore fails ultimately because quantification is at the heart of Marxist dialectics.

**Conclusions**

The idea that Marx's LTV is only a qualitative value theory does not survive close examination. Marx's *Capital* actively integrates Q/Q domains. Qualitative value theory follows Braverman's (1974) misinterpretation of the historical dimension of Marx's *Capital* by examining class, exploitation and production in general rather than focusing on the capitalist class and capitalist production. Evidence provided later, as well as the work of Bryer (1999a, 2006a, 2007), Foley (1986) and Reuten and Williams (1989), shows the quantitative dimension plays an important role in dialectics and value theory.

I conclude that the relationship between value and accounting is a strong one, and that the value form perspective is a solid conceptual foundation for political economy. The following chapter uses these conclusions to derive an appropriate methodology for building a theory of the accounting firm, and specifies the sources of evidence we need to test it.

# CHAPTER FIVE

## Methodology, theory and sources of evidence

### Introduction

The aim of this chapter is to establish a methodological foundation for deriving and then testing a theoretical model of the profits of accounting firms. The methodological foundations will be developed from readings in research methods, particularly Ryan *et al* (1992) and Smith (2003), which I combine with ideas presented in previous chapters regarding value form, accounting and political economy.

Chapter three argued that the chief impediment to understanding accounting firms has been a lack of data, and this has also stifled the development of theoretical models. Consequently, in addition to methodology, this chapter addresses theoretical and empirical methods, outlining a Marxist approach to the development of the theory of the accounting firm as well as three sources of secondary data. This chapter considers the advantages of using a "tests of hypothesis" approach in political economy and argues that we can do this without losing explanatory power (Fleetwood, 2001). The three sources of data provide a potentially falsifying test of the Marxist theory of the accounting firm, over a number of years, across a range of issues and problems, thereby providing evidence of its validity.

## Methodology

The publication of *Research Methods and Methodology in Finance and Accounting* (Ryan *et al*, 1992) represented an important step in the development of accounting research. Previously, methodological debate tended to emerge from discussion of the physical (Kuhn, 1962) or social (Smith, 1998) sciences. One of the most influential contributions, for example, was the application of "sociological paradigms" to organizational analysis (Burrell and Morgan, 1979) taken up by a range of critical accounting scholars including Bryer (1998b) and Armstrong (1991). Ryan *et al* (1992) and subsequently Smith (2003) addressed the problems of accounting and finance research directly, identifying the most appropriate methodologies and methods. Easterby-Smith *et al* (1991) performed a similar function, examining the particular problems of methodology and methods in "management research", identifying the need to adapt methods to the eclectic nature of management as well as the need to take into account the "economic interests" of managers (1991, p.5)

Methodological issues relating to value, dialectics and political economy have already been raised in previous chapters. This chapter places these issues in the context of a general discussion of the methodological approach to finance and accounting, revealing the methodological robustness of the classical approach to political economy. Compared to sociology, economics is methodologically unsophisticated, a consequence of the dominance of the neo-classical approach (Shiozawa, 1999). An example is Milton Friedman's notion that we should accept a model, however absurd, because it makes verifiable predictions (Smith, 2003; Fleetwood, 2001). This lack of sophistication carries through to mainstream accounting research, especially in finance (Ryan *et al*, 1992, p. 26), and an important theme in this chapter is the methodological and philosophical superiority of political economy over economics.

Ryan *et al* (1992, p. vii) start their discussion by arguing that research is undertaken "to learn more about our environment", which in the context of this thesis means learning more about the role of accounting firms in the problems of accounting. Ryan *et al* (1992) are quick to point out the importance of underlying assumptions and like Cooper and Shearer (1984), they encourage researchers to be explicit about underlying assumptions rather than allowing them to remain implicit. The assumptions, termed the "philosophy of research", are presented as opposites (1992, p.5 to 9), as follows: empiricism and rationalism; realism and idealism;[21] relativism and methodological rationalism; positivism and instrumentalism. In this section, these four pairs are used to structure the methodological argument, providing a basis for exploring in more detail the particular problems of methodology in political economy, particularly the role of dialectics and the relationship between theory and data.

The Greeks strongly believed in the power of reasoning and logic, an epistemology (theory of knowledge) that philosophers have termed "rationalism". Typically a rationalist believes the best methods of running a business, or society, can be determined by rigorous thinking and debate. In the eighteenth and nineteenth century, the post renaissance or modern era of trade and manufactures (Berg, 1985; Hobsbawm, 1968), a

[21] Often referred to as 'nominalism.'

different epistemological tradition emerged. Apprentices and trades people learned by observing, copying and repeating and knowledge was transmitted by observing and doing. The epistemology leaned towards "learning by doing" which philosophers termed empiricism, a practical everyday approach to learning.

Empiricism is limiting because learning is limited to observing and experiencing what is happening now. In order to "learn *more* about our environment" (Ryan *et al*, 1992, emphasis added) research must transcend empiricism, which is merely what is happening now, and combine both rationalism and empiricism. More generally, Kuhn (1962) demonstrates the limitations of empiricism by arguing that "scientific revolutions" are not driven by evidence.

Ontology is the theory of reality, that is, the nature of reality. A common sense ontological proposition is that observation of the world around us provides evidence of something that really exists. An alternative to this realist view is that perception and mental processes mediate observation, the nominalist or idealist position. Under this regime nothing in business or society is independent of individual perception and mental models. Some individuals, for example, may regard social and work-place processes, such as management and accounting, as oppressive while others view them as liberating.

Many writers have remarked on the all-pervading influence of theories, models and concepts. Kuhn's (1962) classic study (Ryan *et al*, 1992; Smith 2003; Bryer, 1998b; Keenan, 1998) describes the characteristic process of escaping from one paradigm to another. Keynes spoke of the struggle to escape the classical system as “a struggle of escape from habitual modes of thought and expression” (quoted in Dobb, 1973, p.214). Foucault has argued powerfully (see chapter two) that observation changes perception and behaviour (Foucault, 1977; Armstrong, 1994; Grey, 1994). Bryer (2000a, 2005) has developed the concept of ‘capitalist mentality.’ Consequently, although the realist position smacks of common sense, the nominalist (idealist) position is equally persuasive. The researcher should therefore combine both realist and idealist approaches. Because political economy is holistic in nature it provides a framework for combining different ontology and epistemology, deriving methods that are philosophically robust.

Scholars of the social sciences, economics, history and business cannot conduct experiments in the same controlled conditions as the natural sciences. The desire to emulate the natural sciences, however, is evident in business, economic and social research. One example is the idea that objective criteria exist for deciding between competing theories, leading to the intuitively appealing idea that facts are arbiters of truth. This approach is termed the methodological rationalist position (Ryan *et al*, 1992, p.8).

There are, however, strong arguments for suggesting that facts are not the only arbiter, which is termed the relativist position (Ryan *et al*, 1992). Reliance on facts depends on the correct specification of hypothesis. It also relies on the assumption that the underlying model takes into account of all the necessary variables. Further, idealism argues that facts are mediated through perception and may, therefore, not be reliable. A balance, therefore, has to be struck between methodological rationalism and relativism. To successfully construct an experiment in the social or business context in which facts are the ultimate arbiters of truth, requires attention to theoretical foundations, model development, hypothesis specification and data collection (Bryer, 2000a, 2000b is an example).

The combination of empiricism, realism and methodological rationalism provides the basis for positivism, the dominant methodological paradigm in finance research (Ryan *et al*, 1992). Positivism is what most accounting and finance researchers do and, therefore, it provides a useful benchmark for all methodologies and methods. The audit fee determination literature (see chapter three) is a classic example of the positivist approach, as is agency theory (Jensen and Meckling, 1976; Armstrong, 1991). The general framework is that of the theory of the firm, derived from neo classical economics and rational utility maximizing individuals (Keen, 2001; Dobb, 1973), from which a specific formal model is developed. Data come from published accounts to estimate the parameters of the model. Hypothesis are accepted or rejected on the basis of the sign, size and reliability of the estimated parameters (Koutsoyiannis, 1972, p.8).

Tinker (1988) has been critical of positivist methods pointing out: they accept the culture and norms of the existing order; assume profit maximizing individuals; lack a historic and social perspective (no notion of time and space); ignore the larger environment using simplified models. An additional criticism is that positivists do not combine idealism and realism. Tinker (1988) completely rejects positivist methodology, but other contributors to PEA have taken a different view. We saw that Armstrong (1985) argued that functionalism, rather than being incorrect, is incomplete or partial. Armstrong's methodological position is that researchers should work at a detailed level combining function and dysfunction to explain the state of managerial work. This means adding different dimensions to functionalism, not simply rejecting it. More generally, dialectical thinking encourages pairing of forces that simultaneously attract and repel, suggesting that the "sociology of regulation", for example, can pair with "sociology of radical change" (Burrell and Morgan, 1979), and that we should combine functionalism with dysfunctionalism or conflict. Armstrong's (1991) development of the idea of contradictions in agency is an example.

There are, therefore, good reasons for not rejecting positivist methodology, but adding to it with an awareness of its limitations. In this thesis, following Bryer (1994a, 1999a, 2000a, 2000b, 2006a, 2007), the notion of methodological rationalism, the tests of hypothesis approach is used in the context of political economy. Hypotheses developed in political economy are different from those in economics. They predict at the group level the behaviour of investors in general, for instance, rather than predicting the behaviour of particular firms and individuals. Hypotheses in political economy are not exclusively statistical or quantitative in nature but also qualitative. Using dialectics, pairs of hypothesis may be developed allowing different reactions to contradictions, reflecting both the sociology of function and dysfunction. Despite the fact that hypotheses are different in political economy, this thesis retains the idea that evidence determines the acceptance or rejection of hypotheses.

Having explored Ryan *et al*'s (1992) four philosophical aspects I now look in more detail at methodology in political economy and, in particular, the relationship between theory and data and the role of dialectics.

Research involves concepts, theories, models and data. The strength of the relationship between these is a powerful test of the robustness of particular methods, for example, hypothesis testing. Consider concepts such as 'value', 'division of labour', 'capital' or 'profit'. These are, on the one hand, commonly understood features of modern society, but are, on the other hand and apparently contradictorily, subject to differing interpretation and debate (Dobb, 1973; Marx, 1988). There is no contradiction because concepts generalize features of modern society. Theories often use or incorporate general or common-sense concepts, developing them into causes, explanations and relationships. The economists' notion of utility in "utility theory", for example, attempts to explain human behaviour. The labour theory of value suggests that behind the price of every commodity lies the cumulative effort of all the workers having a hand, however remote, in its production (Marx, 1954; Bryer, 1994a, 2007). 'Models' are therefore vehicles for making theories operational, specifying key variables and relationships between them in readiness for measurement. We can develop them into formal models or sets of equations allowing manipulation and simplification (Koutsoyiannis, 1972; Stewart and Wallis, 1981; Cowling, 1982). A feature of working with formal models is that we must find proxies for all explanatory and predicted variables, and employ techniques such as regression to estimate the sign and size of 'parameters' and formally test hypotheses.

A powerful test of the robustness of methods employed in economics and political economy is therefore the existence of a demonstrable and logical unity between concepts, theories, models and data. Concepts turn into theories which, in turn, develop into models for testing against data. Fleetwood (2001) shows that economists often develop "toy" models that are never tested against data or they develop mathematical models that are not grounded in theory or strong concepts and do not have "explanatory power". In this study the tests of hypothesis approach will be employed in such a way that the logical unity of concept, theory, model and data remains intact.

A long-standing argument, associated with Popper (Ryan *et al*, 1992; Bryer, 1998; Smith, 2003), is that all theories should be testable, and if a theory is not refutable it is not valid, often referred to as "Popperian falsification". However, business is an activity carried out with a certain amount of secrecy. Testing a model about business, consequently, can involve practical difficulty and may be impossible, but that does not mean the model is invalid. Popper rightly requires only that a theory is potentially refutable, but he is wrong to suggest that falsification is the only basis of the validity of a theory, although if a model cannot be tested against data in its widest sense it has little practical meaning or purpose. The methodological position adopted here is that all theories and models should be capable of being compared to or tested against data, but this is not the only basis of their validity and the tests need not be formal statistical tests of hypothesis.

The principle of logical unity of concept, theory, model, and data, is one that most scholars in both economics and political economy would accept as an important test of any method. Confusion arises in using the term “concept” or “idea” to describe a key term in operationalising theory, which logically is a research “construct”, proxy or component of modelling (cf. Smith, 2003 p.41). Another source of confusion regarding the use of “concepts” (e.g., Blumer, 1954) is the fact that the idea of logical unity of concept, theory, model and data, plays no role in interpretive research, because it does not seek general rules. The issue, as Fleetwood (2001) has shown, is how to achieve this unity in practice. Induction and deduction are two approaches for dealing with the relationship between theory and data, but Rubin (1994, p.36) argued that Marx used both “analytical” and the “dialectical” (or genetic) methods and, as a result, combined induction and deduction. This is my methodological approach.

In chapter four I argued that Marx’s *Capital* (1954, 1956, 1959) is not a methodological work, rather it displays an eclectic view of method. Rubin’s (1994) two-part interpretation of Marx’s method reconciles Marx’s apparent eclecticism with his dialectics. As long as the eclectic methods are restricted to the “analytical” dimension they do not contradict dialectics, rather, they reflect two stages of a unified research project. Marx’s use of a wide range of methods corresponds to the analytical stage that cannot stand independently and requires integration with the dialectical stage. Rubin’s two-part interpretation allows dialectics to sit along side empiricist approaches. This reinforces the argument that Tinker (1988) is premature in simply rejecting the role of empirical evidence. Rubin’s two-part interpretation is also helpful in managing the problems of causation (see earlier). The chaotic over-determined idea of causation can be accommodated as part of the analytical stage and the dialectic stage imposes order.

In summary, this methodological discussion points towards the benefits of adopting a hypothesis testing approach in political economy, but one that combines real and ideal, maintains as the unity of concept, theory, model and data, and incorporates dialectical contradictions. Having established this methodological foundation, focus now shifts to the approach I adopt to deriving a theoretical model of the profits of accounting firms.

**An approach to deriving a Marxist theory of accounting firms**

Chapter two showed that the theoretical origins of modern PEA were Marxist. The theory of the profits of the accounting firm is therefore developed here from Marx's *Capital* (1954, 1956, 1959).

Chapter four argued that *Capital* can be usefully broken down into value theory, providing a platform for the whole study; the theory of capitalist production including theory of surplus value, average rate of profit, circuit of capital; the critique of other theories (e.g., Ricardo and Smith); empirical evidence. Rubin's two-part interpretation of Marx's method clarifies the relationship between these different elements. The theory of value and the theory of capitalist production should be a logical and dialectical argument, while the empirical evidence, critique and history, reflect the analytical stage of the argument and appear as reinforcements of the argument.

Marx's theory of the accounting firm must therefore commence from the concept of value, Bryer's exploration of value, accounting, and the concept of total social capital. This is not a selective reading of Marx (1954, 1956, 1959), but one in which certain passages, concepts and categories relating to the accounting firm are subject to a detailed study and development while others remain in the background. It adheres to the discipline of levels of analysis, maintaining the distinction between production and circulation.

Volume 1 (Marx, 1954), the theory of surplus value, the production process of capital, applies to the capitalist system as a whole rather than specific institutional forms of the system or fractions of capital, and I take this for granted. I focus on volume 2 (Marx, 1956), on Marx's views regarding the "time of buying and selling" and "cost of circulation". Marx's comments on bookkeeping, when combined with his ideas on the costs of circulation, form the basis of a theory of accounting firm profits. Volume 3 (Marx, 1959) is set in the arena of competition between capitals. Of particular relevance to this study will be Marx's views on "merchant's capital", which are an example of the impact of the average rate of profit on fractions of capital. The theory of the profits of accounting firms combines ideas drawn from the "costs of bookkeeping" with "merchant's capital".

I incorporate a dialectical element in Marxist theory of accounting firms by interpreting Bryer's work on Marxist theory of accounting. This involves tracing all the problems in accounting back to a fundamental contradiction, arising from the fact that accounting measures profit and simultaneously reveals capitalism as exploitative which creates the "labour danger" (Bryer, 1993a). Interpreting accounting as contradictory provides the basis for theorizing the accounting firm as combining the desire for profit with the need to disguise the exploitative nature of capitalist business. This dual character produces two behavioural predictions from Marx's theory, reflecting the fact that accounting firms have to adapt to these contradictions. We can then test these behavioural predictions against the evidence.

The first prediction is that accounting firms will pursue the maximum return on capital in a manner identical to other capitalist firms, for example, by pursuing mergers and acquisitions, diversification, and exploiting labour. The second prediction is that the accounting firms' response to investors' need of disguise is that they will make disputable claims of objectivity, the chief form of which is claims of auditor independence. In doing this, I argue that accounting firms perform a special function, different in nature to other capitalist firms.

The second prediction is that accounting firms are not capable of acting as independent auditors. A key feature of this approach is to argue that the original contradiction is in accounting, and that accounting firms are a particular expression of this, shaped by the need to make a profit. The problem of auditor independence is, in turn, a yet more specific form of expression, shaped by the particular and characteristic problems of stock markets. One of the strengths of this approach is therefore that we do not study accounting firms and auditing problems in isolation, but firmly place them in a wider framework, a necessary corrective to the approach adopted by Dirsmith *et al* (1997).

Because of this, I will argue that Marxist theory of the accounting firm resolves the Armstrong-Bryer-Hanlon debate by placing the relationship between capital markets and accounting firms in the context of the process of the average rate of profit, and the exploitative and dialectical nature of capitalist production. Having outlined the approach to theory, attention now turns to the data we need to test it.

**Sources of data on accounting firms**

The thesis uses three sources of data to test this theory of accounting firms. The first is the voluntary disclosures made by UK accounting firms of their fees and staff numbers in the period from 1986 to 1995, together with accounting salary survey data which can be combined to estimate accounting firm profit margins. The second source of evidence is the data revealing the SEC's increasing concern from 1996 to 2002 with the issue of auditor independence, culminating in the Enron and Sarbanes-Oxley episode and particularly the evidence generated by SEC Hearings of 1999 and the Independence Standards Board report of 1997. The third source of data is the additional accounting disclosures arising from the emergence of limited liability partnerships (LLPs) among UK accounting firms from 2002 to 2007. The data used in this study are therefore quantitative and qualitative and incorporate major events impacting accounting firms in recent times (mergers, the Enron episode and the emergence of LLPs).

I test the prediction that accounting firms will behave like capitalist firms using the first source of data by showing that mergers correlate with increases in profit margins. I test the prediction that accounting firms cannot act as independent auditors using the second source of data, which provides evidence of regulators and investor's concerns and attempts to strengthen audit independence. The emergence of limited liability partnership status tests both predictions by revealing the high level of profits earned by accounting firms and the impact of limited liability on auditor independence.

During the period 1986 to 1995 the top forty accounting firms (partnerships) voluntarily disclosed fees and staff numbers data in various accounting publication such as *Accountancy* magazine. These form a ten-year panel of data meaning a cross section of accounting firms over a number of years. This panel enables the calculation of fees per employee (FPE) for every accounting firm and average FPE for a ten-year period, identifying trends and tuning points in the data. FPE increased markedly in 1991, around the time of some big mergers.

The costs of accounting firms are mainly salary costs. During 2004 Price Waterhouse Cooper's (PWC) total costs, for example, were £1,178 millions of which staff costs were £680 millions (chapter nine). Expenses and disbursements were a further £207 millions. Several sources of information existed in 1986 to 1995 period relating to salary costs, including surveys carried out by recruitment companies and official sources of data (*New Earning Survey*). On this basis it is possible to estimate average salary per employee

(SPE) in the period 1986 to 1995. The profits of accounting firms derive from charging fees greater than the salaries paid to accountants. The available sources of secondary data in the period 1985 to 1995 allow the calculation of both average fees per employee (FPE) and average salary per employee (SPE) identifying trends and turning points in average accounting firms' profit margins.

A classic characteristic of a capitalist dominated market is the concentration of market share in the hands of a few large companies. The accounting firm disclosures can be used to measure concentration among accounting firms, using both the concentration ratio and Herfindahl index (Moizer and Turley, 1989) and this in turn can be used to measure the impact of mergers on profit margins. A simple linear regression measures the merger impact on profit margins, showing a close relationship.

The second type of data relates to debates and regulations regarding auditor independence, much of which is in the public domain. The SEC's concerns over auditor independence arose in 1995, from the perceived impact of mergers among accounting firms and the rapid diversification of the services provided, which is euphemistically termed "consulting". This led to the formation of the Independence Standard Board (ISB) that produced a detailed report on the issue in 1997 and commissioned other research. All of the documents produced by ISB are available on their website.

The SEC rejected the findings of this report and this led to a deeper debate on the nature of auditor independence. The public hearings held by SEC generated a wide range of expert opinions (from investment analysts, regulators, academics and accountants) which are available on the SEC website along with annual SEC reports. The SEC introduced new rules regarding auditor independence in 2000, but the events surrounding Enron gave new impetus to reform in the form of Sarbanes-Oxley Act (2002). During 2005 and 2006 it became apparent that the Sarbanes-Oxley Act (2002) had markedly increased financing costs in USA, a major beneficiary of which was the London Stock Exchange, and a process of reappraising SARBOX began, evidenced by increasing commentary in *Financial Times*. At the same time, new rules governing independence appeared in the UK showing that the re-evaluation of auditor independence was also an issue there.

This thesis brings together all of these sources to evidence the process of re-evaluation of audit independence that took place in the period 1995 to 2007, both the debates that took place and the regulations introduced. This evidence supports the prediction of Marxist theory of the accounting firm that audit independence is impossible as currently understood, and that stock market regulators will always struggle to find ways of dealing with the problem. A literature review of auditor independence in chapter eight reveals the limited amount of work that has been done, showing that some sociologically inspired approaches in the tradition of Dirsmith *et al* (1997, see chapter three) have been developed. These are subject to critique from a political economy perspective and integrated within the Marxist approach to auditing.

The Limited Liability Partnership Act (2000) introduced the first new commercial legal vehicle in UK for over 150 years. By imposing full financial disclosure on LLP accounting firms it made a detailed quantitative analysis of accounting firm profits possible. While the data in the period of voluntary disclosure (1986 to 1995) yield an estimate of average accounting firm profit margins, the more detailed data in the LLP era incorporates the total profits earned by each accounting firm as well as the assets and liabilities employed in achieving this profit. The audited LLP disclosures are subject to generally accepted accounting principles and incorporate profit and loss account and balance sheet as well as detailed notes. Consequently, this source of data is more reliable and easier to collate than the voluntary disclosures. There are, however, a number of obstacles to overcome before this data can be subject to analysis, in particular questions around pensions accounting and the introduction of IFRSs. Use of this source of data is therefore dependent upon a detailed understanding of LLP accounting. Chapter nine explores and explains LLP accounting issues, providing a basis for restating accounting firms' profits, allowing valid comparison between firms as well as comparison to stock market companies. These results reveal that large accounting firms enjoy an abnormally high return on capital employed.

The emergence of LLP status does not just create new sources of quantitative data. The lobby process leading to its introduction and the impact on auditor independence are also worthy of attention. All big accounting firms made the switch to LLP status (but some medium sized firms did not) and, as a result, no 'control group' exists to form the basis of the comparison of a big LLP firm to a big partnership firm. However, we can still examine the problem of auditor independence in the light of the detailed accounting firms' disclosures showing that LLP status exacerbates auditor independence problems by increasing the control investors have over auditors. I review the existing literature on limited liability status in accounting in chapter nine to provide a background for presenting the data.

The literature review exposed the limitations of developing a case study in PEA. Tinker (1980), in particular, exemplified the contrast between meta-theory and the narrow focus of a case study. Problems in accounting are world-wide and display a systemic character not found in the specificity of a case study. A case study of Price Waterhouse Coopers, for instance, would not provide the basis for a general theory of the accounting firm. Historical data of the type used by Bryer (1993a, 1994b, 2000b, 2005) and Armstrong (1987a) has been highly effective, but involved collecting large quantities of different types of data. In the final chapter I argue that a historical perspective on the accounting firm, developing the work of Walker (2004), Maltby (1999), and Mathews *et al* (1998), offers a route forward.

**Conclusions**

I conclude that the method set out in this chapter is empirically and philosophically robust. The sources of data represent a test of the theory as they reflect key events in the development of large accounting firms and events of an exceptional nature, not at all the "normal course of business". They also cover a long period of time, as well as being up to date. The scope of the data is appropriate to the scope of the topic and the empirics cover both quantitative and qualitative data. Fleetwood (2001) has shown that economists' methods are not philosophically robust because they do not explain behaviour, falling back on the weaker concept of correlation. In this thesis the behavioural predictions have strong links with theory, which in turn is developed from concepts such as value.

The aim is a detailed explanation of the levels of determination of the nature of accounting firms, not just "correlations" or "interpretations". There is a dialectical element to the theory, providing a disciplined structure for causation, and the domain of the real and nominal are combined using Bryer's capitalist mentalities within the accounting firm. In the following chapter, a Marxist theory of accounting firms and behavioural predictions are developed. Chapters seven, eight and nine then progressively test these predictions. Chapter ten suggests two ways in which the theoretical model can be further developed and tested.

# CHAPTER SIX

## A Marxist theory of the accounting firm

### Introduction

The aim of this chapter is to develop a Marxist theory of accounting firms to reveal the factors determining their profits, contradictions and characteristic patterns of behaviour. It combines Marxist theory of accounting, as presented by Bryer, with Marx's analysis (1954, 1956, 1959) of the "costs of circulation", "merchant's capital", and "commercial capital". To facilitate theoretical development, this chapter interprets Marxist theory of accounting as identifying a fundamental contradiction in the thinking and practice of accounting, the root of all its problems, particularly the debate around the conceptual framework (Bryer, 1999a). This contradiction stems from the tension between accurately measuring profits and, by doing this, revealing their exploitative nature, the "labour danger" (Bryer, 1993a). Interpreting accounting as contradictory allows us to recognise accounting's role in disguising the origin of profit and the rate of surplus value (Bryer, 2008a, 2008b).

Next, a theory of the origin and determination of accounting firm profits is developed by working through three key stages, reflecting the structure of Marx's *Capital* (1954, 1956, 1959), his analysis of the production and circulation of capital (1954, 1956), and his analysis of the process of the average rate of profit (1959).[22] I then combine the analysis of the contradictory nature of accounting with Marxist theory of the profits of accounting firms to produce a general theory of the accounting firm, integrating objectivity, disguise, and the process of the average rate of profit. I then use the theory to identify two characteristic forms of behaviour exhibited by accounting firms, including their pursuit of profits through mergers and their false claims of objectivity. Finally, I show that Marxist theory of accounting firms resolves the Armstrong-Bryer-Hanlon issue highlighted in chapters two and three regarding the relationship between accounting firms, capital markets and corporations.

A series of mergers between accounting firms, together with the bankruptcy of Arthur Andersen, has resulted in only four large accounting firms (Price Waterhouse Coopers, KPMG, Ernst and Young and Deloitte and Touche). These firms offer a range of different services, including auditing, taxation and consultancy.[23] A Marxist theory of accounting firms must encompass all of these services and not restrict itself to a theory of auditing. Some of the most important implications of the theory, however, relate to problems inherent in the role of auditor, and chapters seven, eight and nine explore these problems and test the behavioural predictions against data.

This chapter argues that Marxist theory of accounting firms identifies aspects of the character of accounting firms shared by all firms and companies (the process of the

[22] The literature review established the importance of working through these three stages, see chapter two.
[23] Although the Sarbanes-Oxley Act (2002) attempted to impose restrictions accounting firms they still pursue a broad range of activities, see chapter nine.

average rate of profit) as well as aspects that are unique to accounting firms (role of disguise). This suggests that the Marxist theory is, in this respect, superior to neoclassical theories of accounting firms which highlight only their prosaic, rather than their unique, aspects. The theory is also superior to sociologists' interpretive approaches because it links social action with profits and capital markets. This chapter shows that the private profit making character of the accounting firm is in active contradiction with the social and objective character of accounting, but the root of the problem is found in the nature of accounting and auditing itself, and not in the accounting firm, although they do amplify and exacerbate it. An implication of this analysis is the need to withdraw auditing from the private sector, to establish it within the regulatory regime such as the Securities and Exchange Commission (SEC) or appointed government auditors.

**Total social capital and modern capital markets**

We can construct a Marxist theory of accounting firms from Marx's analysis of the production of capital, its circulation, and the process of the average rate of profit. Bryer's interpretation of Marx emphasises the concept of "total social capital" and it is from this concept that theoretical development must commence. In Bryer's view:

> "Marx argues that individual enterprises must be conceptualised as part of a larger social totality. As capitalism develops production is increasingly socialized, complex and extended. Marx predicted that capital would also become

increasingly socialized around what he called 'the general rate of profit'" (1994a, p.314).

The process that results in capital having a "total" and "social" character is that of the equalization of the rate of return on capital, the tendency to move towards an average rate of profit. This process can be readily observed as capital is withdrawn from countries, industries and firms in which it is earning a low or negative rate of return and invested where it earns a higher rate of profit. The process of the average rate of profit is a disciplining force both in the nominal domain, the capitalists' "calculative mentality" (Bryer, 2000a), and in terms of real movements in jobs and investment. Threat of plant closure and redundancy due to inadequate profits become part of workers' thinking, resulting in a docile work force (Nichols and Beynon, 1977). The term "process" indicates that it is not the achievement of a particular average rate of profit that is important, but the tendency to move towards it. An equally important element of the capitalist mentality (Bryer, 2000a) is the desire to achieve *more* than the average rate of profit, which helps explain continuous labour saving innovations and the export of jobs to low labour cost countries such as China.

This chapter interprets modern capital markets as institutional forms of appearance of total social capital.[24] Marx's theory of capitalist production is not contradicted by the development of modern capital markets, as Engel's appendix to Marx (1959, p.908) illustrates. Stock markets impose an added dimension to the controls imposed on capitalist production, forming a critical element in a general system of economic and

[24] In contrast with interpretations such as Toms (2005) see chapter four.

social control that envelops individual firms. In this framework, the discipline imposed on firms is not merely transmitted though competitors, customers, suppliers, and banks, which Marx explored in terms of circuit of capital (Marx, 1956), but is also exerted from the stock market through a system of regular, formal and audited financial reports. Capital markets, in short, result in an increase in the level of control imposed on managers as well as a change in the nature of control towards indirect, economic and social control (Bryer, 2006a).

Viewed from a nominal perspective, capital markets encourage a particular calculative mentality which, following Bryer (2000a), I will term the investor capitalism mentality. Within this world-view, investors evaluate all countries, sectors and companies as potential investment opportunities. Businesses appear to investors simply as an array of opportunities to invest capital to earn a rate of return. The gaze of the modern investor, however, is broad but not detailed and does not encompass the day-to-day running of real business processes or technologies. Instead, investors adopt the portfolio approach to investment. The core proposition, popularised by Markowitz (1953) but also found in Marx (Bryer, 1994a), is that investors minimize risk by spreading investments over a wide range of sectors, industries and firms. This idea has gained widespread acceptance to such an extent that many investment institutions, acting on behalf of a wide range of investors, hold shares in every large listed company (the “market portfolio”). In effect every investor, through intermediaries like pension funds and products such as index funds, has holdings in every large company, tending to give capital the “total” and socially homogenous character theorised by Marx (1956, 1959). One aspect of the homogeneity of capital is the fact that every dollar or pound of capital is identical.

The investor capitalism mentality and the institutional structures of modern capital markets therefore create an informational distance or asymmetry between investors and managers. The systematic controls imposed on firms by capital markets are necessarily impersonal taking the form of results control (Bryer, 2006a). Because of its multilateral and systemic nature, the discipline imposed by the process of the average rate of profit is hegemonic and, consequently, managers submit to it and incorporate it in their thinking. Decisions made by individual managers, therefore, take on a social character, revealing the limitation in neo-classical economists' notions of individual decision making. This, in turn, holds the key to appreciating why we cannot theorise profit as changes in the present value of future cash flows because profit presents itself to managers as a target they must achieve, often in the form of earnings per share.[25] The submission of managers to the process of the average rate of profit also provides a basis for understanding why Armstrong's (1991) concept of "trust" is not the core concept in agency relations (Bryer, 2006a) because systematic controls reduce capital's need to rely on trust.

[25] Graham et al (2005) and Berenson (2003) provide evidence of the emphasis placed by mangers and investors on earnings and ratios such as Earning Per Share.

### Capital markets and the functions of accounting

The increasing level and changing nature of control occasioned by the emergence of capital markets has important implications for accounting. One is that the change in the character of accounting resulting from the emergence of modern capital markets stems from the changing nature of control to systemic 'results control' enveloping the firm. This changes the character of accounting because it now transcends the corporation. Systematic results control allows accounting to become free of the firm, which Bryer (2006a) identifies as the "objective" character of accounting. Freed of the ties to the corporation, accounting can provide an objective record of the performance of the company free from individual bias and firm based economic interest. Freedom from the firm leads accounting to adopt as its "metric" the idea of "socially necessary labour time" (Bryer, 2006a; 2007).

Reinforcing this modern focus on objectivity, another aspect of the change in the character of accounting, caused by the development of modern capital markets, is that interested parties include those who are *not* currently investors as well as to those who are. The audience accounting addresses includes potential investors as well as existing investors. In other words, the audience is capital "in general", or total social capital, rather than particular investors. Comments by the Investment Management Association and other users to the IASB on proposed changes to the conceptual framework, for example, are consistent with the idea of capital in general (Bryer 2006b). In this respect, accounting again becomes free of links with firms and corporations taking on a more objective “social” and generalized or “total” character. The well known “Caparo judgment” (Grey and Manson, 2008) also drew on the general character of accounting when ascribing the auditor’s duty of care to all the shareholders of a company collectively, and not to individual shareholders. In a diversified market, where many shareholders have interests in all firms, this would mean all shareholders, current and potential. Lord Denning concurred: “accountants owe a duty of care not only to their clients but also to all those who they know will rely on their accounts” (Crane and Christmas & Co. [1951] 1All ER 426).

The changing character of accounting is simultaneously an increase in the quantity, prevalence and level of accounting controls, although the increase in the quantity is more readily apparent than the changing character. The investor capitalism mentality places special emphasis on the rate of return on capital and provides a wide audience for accounting information. The cost effectiveness of results control and difficulty in imposing action control at a distance both contribute to the prevalence of accounting. The fact that management must pursue the rate of return on capital through the production process provides a spur to management accounting (Bryer, 2006a). The ubiquity of accounting based results control is reflected in an increased reliance on auditing which has been termed the “audit society” (Power, 1996, 2003).[26] In the context of modern capital markets, from Marx’s viewpoint accounting emerges at the centre of a hegemonic system of control allowing investors to monitor the performance of managers

[26] I discuss Maltby’s criticisms of this idea in chapter 8. Here I accept the implication that we now have a lot more accounting and auditing.

and enforce their right to an unearned share of profits, usually taking the form of dividends.

## Accounting contradictions

The argument that accounting is taking on an increasingly social, objective character is functionalist, and it is therefore only a partial analysis of the modern roles of accounting (Armstrong, 1985; 1991). Marx's political economy approach dictates that we take detailed account of capitalists' economic interests and the social and political process by which accounting achieves this objective status. Marx developed a critique of modern society as exploitative, profit being economically and ideologically enforced unpaid labour in the form of surplus value. Marx does not merely offer a conflict model but exposes systematic injustice (Meiksins Wood, 1981; Bryer 2006a).[27] Bryer argues that Marxist theory of accounting thereby reveals the relationship between accounting and exploitation. That profit and loss accounts provide the necessary data for Marx's measure of the rate of exploitation, gross profit divided by productive wages (Bryer, 1999a). Accounting in the form of regular reviews of performance (turnover, costs, profits etc) against budget is therefore a detailed process of systematic exploitation (Bryer, 2006a). From this perspective, the theory of surplus value (Marx, 1954) explains the practice of modern accounting, not just in general or through mediations, but at the level of the firm (Bryer, 2007).

[27] The distinction between conflict and exploitation usefully distinguishes Marx's political economy from other approaches such as 'financialisation'

If accounting serves investors by giving them objective measures of exploitation, it reveals that which is manifestly unjust. It is self evident that exploitation requires disguise and secrecy to conceal its unjust nature and, consequently, disguise is a necessary part of capitalist accounting. As Marx argued in relation to the rate of surplus value and its connection to the organic composition of capital:

> "… not only do the specific ratios of this excess of value to the particular components of his capital, and its inner connections with them, not interest him but it is actually in his interest to disguise these particular ratios and inner connections" (quoted in Bryer, 2008a, p.4).

Accounting combines objectivity and disguise, both aspects of its character are necessary and simultaneously in conflict with each other. The function of accounting as an objective measure of surplus value and tool of control stands in contradiction with the need for secrecy and disguise. By accurately measuring and controlling exploitation, accounting undermines the process by stirring discontent (Bryer, 2006a, p.8).

The basic contradiction in accounting has many consequences or "forms of appearance" in a continual state of negotiation and change. The weak conceptual framework of the economist's economic income perspective (Bryer, 1999a) can be interpreted as a method of disguise, an ideology, allowing real processes of exploitation to continue under a cloak of theoretical obfuscation and inversion (Bryer, 2006b). We can also interpret the distinction between management accounting and financial accounting as a form of disguise. Management accounting plays an important role in the process of exploitation (Bryer, 2006a), while financial accounting is a theatre of the absurd, of distraction and confusion (Bryer, 1999a; 2006b). Bryer (2009) argues that “unconditional conservatism” in accounting has been used as form of disguise in USA.

Total social capital’s need for objective measures of profit is constant, but the need for disguise has more the nature of a variable, albeit one that cannot take a negative value. When the rate of surplus value (s/v, surplus value divided by productive wages) is high, there is more need of disguise and less need when s/v is low. When the level of working class consciousness and militancy is high, the need for disguise is increased and vice versa. Under different economic and social conditions, therefore, the contradiction in accounting assumes different forms of appearance, which have important implications for accounting firms

Different aspects of the contradiction in accounting are apparent in the different themes and topics explored by Bryer. Inflation makes it more difficult for capitalist investors to monitor and control the process of exploitation. Bryer and Brignall (1986) showed that inflation accounting reasserted the functional aspects of accounting at a time, the 1970s and early 1980s, when the need for transparency was at a premium and the need for disguise met in other ways, mainly through the obfuscatory debate on inflation accounting. On the other hand, the need for disguise was dominant in the goodwill debate of the 1980s to disguise the payment of dividends from capital (Bryer, 1995).

From the perspective of measuring profit, the arguments in favour of amortization of goodwill are powerful. The need to disguise paying dividends from capital, however, necessitated goodwill write offs against reserves. Investors' need of disguise is not a modern phenomenon. Bryer (1991) showed that disguise triumphed over accuracy in the railway manias, showing capitalism to be a "rational and rapacious social hierarchy". Bryer (2008a, 2008b) argues that the trend in the rate of surplus value is the driving force behind US accounting theory debates and identifies three main methods of accounting disguise: secrecy; conservatism; ideological obfuscation (particularly economists' 'income' theories).

Tesco plc provides an up-to-date example of the contradictory nature of accounting and the link between accounting profits and social groups. The company has grown rapidly in terms of turnover and profits and this has had a negative impact on a range of social groups including farmers, small retailers and civic groups. Opposition to Tesco plc is organised through the 'Tescopoly' website (www.tescopoly.org) which draws together unions such as GMB, environmental groups such as Friends of the Earth and anti-globalisation campaigners such as War on Want. This is a diverse and potentially powerful coalition of social groups. The first paragraph on the website uses the fact that Tesco plc annual report shows profits in excess of £3 billion as evidence of the company's excessive power.

Understanding accounting as contradictory helps identify alternatives to Watts and Zimmerman's (1979) influential theory of the "demand and supply of accounting theories". They identify the fact that accounting theories develop in negotiations, but they restrict their view of negotiations to processes between individuals rather than powerful economic groups. Political economy conceptualises capital at a group level, exposing the group level processes (social, economic and political) that capitalist investors use to shape accounting. The idea of the contradictory nature of accounting suggests that the "demand and supply of accounting theories" is the result of investors' need to balance objectivity and disguise and the distinctive feature of this approach is that investors demand accounting theories, not managers. Watts and Zimmerman (1979) overestimate the power of managers, adopting the mainstream managerial position (Rowlinson, Toms and Wilson, 2006), and do not consider the possibility that accounting acts as a hegemonic system of control and, consequently, do not allow accounting any objective character.

Understanding accounting as contradictory also offers a possible explanation for the apparently puzzling phenomena of "conservatism", that share prices tend to move more quickly upwards than profits, but downward movements are more contemporaneous (Ball, Kothari and Robin, 2000; Holthausen and Watts, 2001; Watts, 2003). As Marx interprets profits as exploitation, the reluctance to show sharp increases in profits is understandable from the investor's perspective because it highlights the exploitative nature of capitalism, while no such qualms exist for falls in profits (Bryer, 2008a, 2008b).[28] The fact that disguise is part of the character of accounting helps explain why Foucauldian and other post-modern approaches have gained a foothold in accounting

[28] Arthur (1979a) shows that dialectical reasoning is particularly suited to explaining asymmetries.

research (Armstrong, 1994). Bryer (2008a, 2008b) has identified "ideological obfuscation" as an important aspect of accounting disguise and this idea has parallels with "power knowledge" in as much as the IASB's conceptual framework for accounting is designed to reinforce the power of capitalist investors. It is important to grasp that accounting has a dual and contradictory nature and, at different times, its functionalist nature prevails while at others disguise is dominant. For this reason both post-modernist and positivist approaches to accounting are necessarily partial and incomplete.

Understanding the role of disguise in accounting provides a basis for theorizing the role of managers in accounting and agency problems. We can readily appreciate why managers seek disguise because it serves their economic interests to present profits as high as possible either immediately or in the future, which may mean artificially reducing profits in the short term. The challenge is explaining and theorizing *how* managers exercise disguise in the face of the hegemonic power and wealth of capitalist investors and the institutions of modern capital markets, such as the Securities and Exchange Commission (SEC). The answer is that the contradictory nature of accounting results in a vague theory and, therefore, in periodically vague and inexact accounting practices. Managers capitalize on this vagueness by using it to further their interests, which may themselves take a range of different forms (Bryer, 2008, 2008b). This provides a basis for understanding why managerial machinations are sometimes tolerated, for example, the widespread use of goodwill accounting described by Smith (1992), while at other times, when the need for disguise is reduced, capital markets take action to eliminate it. Managers, steeped in the "capitalist mentality" (Bryer, 2000a), are not slow in exploiting this capability since they are aware of the exploitative nature of production, but simultaneously they understand the limits within which it will be tolerated (Bryer, 2006a). Armstrong (1991) has argued that the source of the contradiction in capitalist agency relations (the problem inherent in managerialism) is the high cost of generating trust. The argument developed here is that the source of the problem is capitalist investors balancing objectivity and disguise and in doing so creating opportunities for managers to exploit.

Disguise helps throw new light on the problem of "creative accounting" (Smith, 1992; McNicolls, 2000; Berenson, 2003). Interpreted from the perspective of Marxist theory of accounting, there are two distinct forces driving creative accounting, standing in contradiction. Capitalist investors seek to disguise the exploitative nature of profit while managers attempt to present a flattering view of their performance (or save an exceptional surplus for a rainy day). The present literature on creative accounting fails to make the distinction between these two divergent perspectives. McNicolls (2000, p.313) for example argues, "The earning management literature attempts to understand why managers manipulate earnings", but ignores the role of investors in manipulation. The concept of disguise also provides a new perspective on the expectations gap. Usually the causes of the expectations gap are understood to be society's "unreasonable expectations" combined with poor quality audit work and poor quality audit standards (Grey and Manson, 2008, p.518). The idea of the contradictory nature of accounting argues that the source of the expectations gap is investors need to balance objectivity and disguise sometimes resulting in vague and unsatisfactory accounting.

In summary, the idea of the contradictory nature of accounting has many applications across a range of important accounting issues including agency, creative accounting and the expectations gap. Another impact of the contradiction is that investors' need of disguise provides opportunities for accounting firms to increase profits and, consequently, the contradiction in accounting has implications for accounting firms. We must, therefore, develop a theory of the profits of accounting firms before we can understand the contradiction within the accounting firm.

## A Marxist theory of the profits of accounting firms

I have shown that Marx developed his approach to capitalist production through three levels of analysis, and the theory of the profits of accounting firms follows this procedure. Marx’s views on the “costs of circulation” are the basis of the theory of accounting firms’ profits and I therefore summarise Marx’s underlying theoretical arguments, which are necessary for understanding the “costs of circulation”, to provide a platform for more detailed investigations. The first section below summarizes Marx’s arguments in volume 1 and the first part of volume 2 up to “costs of circulation”. The second section analyses the “costs of circulation” (2a) and “bookkeeping” (2b), before moving on to integrate this with his analysis on the “competition between capitals” and “commercial capital” in particular, which is the third section. The fourth section derives a Marxist theory of the profits of accounting firms, analyses their contradictions, and deduces behavioural predictions that the following chapters test.

### 1. Marx on the “Commodity”

Marx's starting point is a philosophical consideration of the commodity:

> “The wealth of those societies in which the capitalist mode of production prevails, presents itself as an immense accumulation of commodities’ its unit being the

> single commodity. Our investigation must therefore begin with the analysis of a commodity" (1954, p.43).

Marx's definition of a commodity is anything satisfying a human need that is exchanged before it is consumed. This is a wide definition, including all the goods consumers buy in shops, all the materials and machines purchased by firms and consumed in production and all health, education, welfare and entertainment services that are paid for, but not those which are free. In the capitalist system, commodity production is general and, consequently, the human capacity for labour also takes on the appearance of a commodity.

Because they satisfy human needs from the market, every commodity has a use-value and an exchange value. Use-value originates in the physical characteristics of the commodity, reflecting the different ways it satisfies human need. Exchange value of a commodity is different. Exchange value is not a physical characteristic of the individual commodity, but is something distinguishable from it.

> "A given commodity, e.g., a quarter of wheat is exchanged for x blacking, y silk, or z gold etc. In short for other commodities in the most different proportions. Instead of one exchange value the wheat has, therefore, a great many. But, since x blacking, y silk, or z gold etc each represents the exchange value of one quarter of wheat, x blacking, y silk and z gold must be replaceable by each other or equal to each other. Therefore, first: the valid exchange values of a given commodity

> express something equal; secondly, exchange value generally is only the mode of expression, the phenomenal form of something contained in it yet distinguishable from it" (Marx, 1954, p.44).

Marx (1954) argues that social labour is the "something" contained in the commodity, but "distinguishable from it", that is, "socially necessary labour-time" (1954, p.47). Because exchange value is distinct from use value, the type of labour making up exchange value is distinct from any particular type of labour. The type of labour expressed in exchange value is abstract labour:

> "Along with the useful qualities of the products themselves, we put out of sight both the useful character of the various kinds of labour embodied in them, and the concrete forms of that labour; there is nothing left but what is common to them all; all are reduced to one and the same sort of labour, human labour in the abstract" (1954, p.46).

The quantity of abstract labour contained in a commodity is socially determined:

> "The socially necessary labour time is that required to produce the article under the normal conditions of production, and with the average degree of skill and intensity prevalent at the time" (1954, p.47).

Having established that commodities are values, Marx goes on to examine the form of value arguing that money, rather than being the source of value, is a form of value, a special commodity gold (1954, p.55).[29] Marx argues that money is a commodity that measures value, as well as being the medium for the circulation of commodities. Marx's analysis shows that buying and selling, the "circulation of commodities", is merely a change in the form of value, and that therefore no increase in value can arise in exchange.

Rather, surplus value emerges in production because the capitalist ensures the exchange value of a commodity produced is greater than the socially necessary exchange value of the commodities and labour consumed in its production. The value of commodities is socially determined, as are the value of labour power and the value of commodities consumed in production. The production of surplus value is, therefore, socially determined, meaning that both the nature and origin of surplus value, the quantitative amounts of surplus value and the particular forms of appearance of surplus value, are social. Surplus value does not originate in an individual firm, industry, country or capitalist. All surplus value must originate from labour in general since the commodities consumed in production yield up only their value (cost) (Marx, 1954, p.189):

> "Every condition of the problem is satisfied, while the laws that regulate the exchange of commodities have in no way been violated. Equivalent has been exchanged for equivalent. For the capitalist as buyer paid for each commodity and the labour power its full value. He then did what is done by every purchaser

[29] Paper currencies make no difference (Foley, 1986, p.25)

> of commodities he consumed their use value. The consumption of labour power… resulted in 20 lbs of yarn, having a value of 30 shillings. The capitalist, formally a buyer now returns to the market as a seller. He sells his yarn at eighteen pence a pound, which is its exact value. Yet for all that he withdraws 3 shillings more from circulation than he originally threw into it".

Marx's development of the concept of surplus value in volume one (1954) incorporates themes of evolution and change (the capitalist trajectory) including the emergence of relative surplus value from absolute (1954, p.296), the development of capitalist production on an increasing scale (1954, p.543), and the emergence of managerial work (1954, p.314). Many of the ideas needed to develop Marx's economics in the context of modern capital markets are, therefore, already present in the text. Further, all the ideas developed in volumes two and three appear in the analysis of volume one.

The firm must realise surplus value in the market place. If there is no buyer for a commodity there is no surplus value. Selling, although it creates no value, is essential to the realization of surplus value. Furthermore, buying commodities, such as machines, materials, labour etc., is also crucial to surplus value. Paying too much for these commodities means less or no surplus value. Although surplus value originates in production, the circulation of capital is just as important, even though it adds no value to the product. As capital circulates, it takes the following forms in turn: money capital, productive capital and commodity capital.

This brief introduction summarizes the aspects of Marx (1954, 1956) necessary for the development of the theory of accounting firms profits up to "costs of circulation" (1956, p.132).

**2a. The "Costs of Circulation"**

Marx's (1956, p.32) approach to "the costs of circulation" is essential to the development of the theory of the profits of accounting firms because accounting and auditing costs fit into this category. Arthur and Reuten (1998) highlight that the subject of Marx (1956) is the 'circulation of capital' not the circulation of commodities (see also, Bryer, 1999a). The costs of circulation are, therefore, the costs of circulation of capital, a broader category than costs of circulation of commodities that includes transactions costs, marketing costs, purchasing costs, etc. Marx's treatment of costs of circulation is re-organized here to give a more systematic and accessible presentation.[30]

Marx (1956) identifies three costs of circulation of capital: "the time of buying and selling" (p.133), "bookkeeping" (p.136), and "money" (p.138). In his treatment of the time of buying and selling, Marx mentions three different types of arrangement for this work in a capitalist organization.[31] A capitalist, an employee of a capitalist, or another specialist capitalist, can undertake the work of buying and selling:

[30] The order of presentation is changed because the relevant chapter in Marx (1956) contains an insertion (p.132) from a different manuscript (see Engel's preface on p.4) in addition to the need to reorganize the material to focus on accounting.
[31] In addition to pre-capitalist arrangements.

> "In order to simplify the matter (since we will not discuss the merchant as a capitalist and merchants' capital until later) we shall assume that this buying and selling agent is a man who sells his labour. He expends his labour power and labour time in the operations C-M and M-C" (Marx, 1956, p.134).

Because of the increasing scale of capitalist production, the capitalist cannot undertake the work of buying and selling, and the capitalist delegates this work to employees. These employees, sometimes called "commercial workers" or clerks, represent an identifiable class of worker who perform tasks previously performed by the capitalist. Specialist firms can more efficiently do this type of work and therefore these workers are distinct from productive industrial workers. Carchedi (1977) described this as a "contradictory class location" (see chapter two), but, as Foley (1986 p.6) has pointed out, Marx's distinction reflects the enrichment of a "fundamental determination by later ones", rather than a contradiction.

Because of the three stages in which Marx (1954, 1956, 1959) presents his ideas, wages of commercial workers have to be understood at three different levels of determination. First, we must understand their determination by the production of capital and surplus value. Second, we must understand this as part of the total circuit of capital and the changes in form of capital. Third, we must understand the determination of their wages by the "concrete forms" growing out of the circulation of capital, in particular competition between capitals and the consciousness of the capitalist and his agents (Marx, 1959, p. 25).

Marx's view was that the wages of commercial workers have no impact on the production of surplus value, the value of commodities or the rate of surplus value. The wages of commercial workers represent an unproductive cost and an increase in the wages of commercial workers has no impact on the value of commodities.[32] Because they are an unproductive cost, wages of commercial workers reduce the surplus value available to the capitalist. An increase in commercial workers' wage reduces the profit of the capitalist.[33] In fact, it may appear to the individual capitalist that wages of commercial workers are merely part of the variable capital because they both represent costs to the firm. However, from the perspective of total social capital wages of commercial workers cannot be part of variable capital because they are unproductive costs:

> "A certain amount of labour power and labour time must be expended in the process of circulation…. But this now appears as an additional investment of capital. A part of the variable capital must be laid out in the purchase of this labour power functioning only in circulation. This advance of capital creates neither product nor value" (Marx, 1956, p.135/6).

[32] This is the first level of determination
[33] This is the second level of determination

Marx argued only that wages of commercial workers ‘appear’ to be part of variable cost and does not argue that the wages of commercial workers are part of variable capital, which would contradict his view that value arises in production not circulation. “The labourer adds fresh value to the subject of his labour … the value of means of production used up in the process are preserved, and present themselves afresh as constituent parts of the value of the product” (Marx, 1954, p.193). The time of buying and selling plays no role in the determination of value, so we cannot describe it as a variable or a constant capital.[34] Rather, it is a non-productive use of capital, in other words a loss.

In one respect, we can say that the work of commercial workers has value, because we can measure the value of labour power simply by the goods consumed by particular workers:

> “The value of labour power is determined as in the case of every other commodity, by the labour time necessary for the production, and also consequently also the reproduction, of this special article ... the value of labour power is the value of the means of subsistence necessary for the maintenance of the labourer” (Marx, 1954, p.162).

Describing the wages of commercial workers as “value” however is potentially confusing because it could appear that this value becomes part of the value of a commodity, when it does not. The accounting concept of ‘unproductive costs’ serves as a reminder that the

[34] This argument, which is the third level of determination, can be found in earlier working papers (Marx, 1987 p.13).

wages of commercial workers are a deduction from surplus value. The mass of surplus value accruing to the capitalist class falls by the unproductive costs of circulation of capital whereas the capital advanced by the capitalist class increases because it includes productive and unproductive costs.

The basis of exploiting commercial workers, therefore, is not the value they add to commodities. Commercial workers increase their employer's profits by facilitating economy in necessary expenditure or by increasing the turnover of capital. Their exploitation arises, therefore, from the fact that their pay is, like productive workers, less than their contribution to profits. Because they do not directly add value to commodities, the exploitation of commercial workers is, however, different from the exploitation of industrial workers, confirming their distinct sub-class identity.

The third type of arrangement Marx identifies is subcontracting to another capitalist. At this stage of his argument, Marx has only developed three types or forms of capital: money, productive and commodity. Later in volume 3 (Marx, 1959) other types of capital will be developed including "commercial" capital. As a result, Marx is not ready in Volume 2 (Marx, 1956) to discuss fully the third arrangement, and I will return to this at the appropriate place (see below).

**2b. Marx on the cost of bookkeeping**

The second cost of circulation of capital Marx (1956, p.136) identifies is bookkeeping costs, which is similar to the cost of the time of buying and selling:

> "Apart from the actual buying and selling, labour time is expended in bookkeeping, which besides absorbs materialised labour such as pens, ink, paper, desks, office paraphernalia. This function, therefore, exacts the expenditure on the one hand of labour power and on the other of instruments of labour. It is the same condition of things as obtains in the case of the time of purchase and sale" (1956, p.136).

Because of the increasing scale of capitalist production, these general overheads may grow and become considerable.

As Bryer (2007) has noted, Marx's second point is more subtle, that accounting captures the changes in form within the circuit of capital and that accounting has an impact on the mind of the capitalist (Marx, 1956, p.136):

> "As unity within its circuits, as value in motion, whether in the sphere of production or in either phase of the sphere of circulation, capital exists ideally only in the form of money of account, primarily in the mind of the producer of commodities, the capitalist producer of commodities".

Marx paid close attention to changes in form within the circulation of capital. In volume 2 of *Capital* (Marx, 1956), he devotes one hundred pages (25 – 124) to its detailed examination.[35] Marx's linking of these changes in form with accounting is significant. Marx suggests here that accounting is the key to the capitalist understanding of the circuit of capital and key to his control of the valorisation process. The mental image the capitalist has of the changing form of capital is the entries in the ledger rather than the physical assets such as factories, etc. In short, Marx suggests accounting is the form of appearance of the changing form of capital in the mind of the capitalist. Viewed in this light, wages of commercial workers can appear to the individual capitalist, in idealistic moments, as part of variable capital and that capital not labour produces value. Capitalists may even consider accountants to be productive workers.

The capitalist's mental image of production appears in the specific form of capitalist bookkeeping, double entry bookkeeping (DEB). Marx (1954, p147) argued a characteristic of capitalism, the "general formula for capital", is that "the money is not spent it is merely advanced". DEB deals with this double character of money-capital and, equally, records further changes in form through raw materials, finished good, debtors and back to cash (money-capital). In short, we can operationalize Marx's general formula for capital by using DEB (Bryer, 2005). Another link between DEB and the capitalist's mentality is through its connection to calculating the return on capital employed, or the processes of the average rate of profit, stemming from the nature of

[35] Bryer has called Marx (1956) the "technical" volume of capital (Bryer, 1994a)

total social capital.  DEB allows for continual calculation of the return on capital.  Bryer (1993b) has shown that the emergence of DEB is linked to the socialization of merchant's capital.  DEB works for detailed accounting and summary accounting and as financial accounting and management accounting.  I conclude therefore that when we examine Marx's views on the double character of money capital in the light of his views on the costs of bookkeeping, it becomes clear that he firmly links DEB and capitalism.

The time of buying, selling, and bookkeeping have the same nature in capitalist production, as they are both general overheads.  While the first two costs of circulation are similar in this regard, Marx identifies a difference between expenditures on buying and selling and bookkeeping.  He suggests that buying and selling is specific to commodity production, but that bookkeeping is something that grows in significance as production becomes more social and, therefore, more generalized (1956, p.137):

> "The latter (time of buying and selling) arise only from the definite social form of the process of production, from the fact that it is the process of production of commodities.  Bookkeeping, as the control and ideal synthesis of the process, becomes the more necessary the more the process assumes a social scale and loses its purely individual character.  It is therefore more necessary in capitalist production than in the scattered production of handicraft and peasant economy, more necessary in collective production than in capitalist production.  But the costs of bookkeeping drop as production becomes more concentrated and bookkeeping becomes social".

Marx suggests here that bookkeeping is a form of expression of the social and large-scale character of capitalist production.

Marx's third type of arrangement for dealing with time of buying and selling was to use other capitalists. This is also applicable to bookkeeping, but for the same reasons given earlier, he leaves this to volume 3 (Marx, 1959). Marx's development of commercial capital in volume 3 will be the basis for developing his ideas about bookkeeping into a theory of the accounting firm.

The third type of cost of circulation is money and interest, which is not relevant to the purpose of this thesis.

**3a. From the turnover of capital to the average rate of profit**

After examining the cost of circulation, Marx (1956 p.156) examines in detail the turnover of capital which determines the mass of surplus value that can be generated at a given rate of surplus value, and illustrates the types of forces and disciplines acting on the capitalist firm. The analysis is then extended to a two-department model (1956, p.356) representing the start of the examination of the relationship between capitals, built up on a framework of DEB (Bryer, 2005).

Marx (1959, p.25) examines:

> "….the concrete forms which grow out of the movement of capital as a whole. In their actual movement capitals confront each other in such concrete shape, for which the form of capital in the immediate process of production, just as its form in the process of circulation, appear only as special instances. The various forms of capital, as evolved in this book, thus approach step by step the form which they assume on the surface of society, in the action of different capitals upon one another, in competition and in the ordinary consciousness of the agents of production themselves".

Here Marx creates space for the key function that Bryer (2007) says accounting performs for the capitalist when surplus value transforms into profit and the rate of surplus value into the rate of profit. More important for the purpose of this study is the derivation of an average rate of profit. Competition between capitals forces the rate of profit towards equality. For a given rate of surplus value, this follows from forcing prices to diverge from values. In sectors where large amounts of fixed capital are required, prices rise above their value to equalize the rate of profit. Where less constant capital was required, prices fall to below their values to equalize the rate of profit. The amount of profit earned on every pound or dollar of capital will tend to be the same when adjusted for the risks involved (Marx, 1959, p.157; Bryer, 1994a). The theory of the accounting firm therefore starts with his analysis of "commercial capital".

### 3b. "Commercial Capital"

The first type of capital Marx examines in volume 3 (Marx, 1959) is the time of buying and selling. Marx now argues that what was previously determined as "commodity capital", part of the circuit of industrial capital, can emerge as a distinct specialist form of capital, separate from industrial capital:

> "In as much as this function of capital in the process of circulation is at all set apart as a special function of a special capital, as a function established by virtue of the division of labour to a special group of capitalists, commodity capital becomes commercial capital" (1959, p.267).

Marx develops his argument about commercial capital in two sections. The first deals with "the form of the movements of his capital" (Marx, 1959, p.269), and the second deals with the profit earned by commercial capital. In term of the forms of movement of commercial capital, Marx (1959) argues that commercial capital is merely a different form and a specialized form of the commodity capital. Because commercial capital exists, a smaller part of the total social capital exists in the form of commodity capital and one turnover of commercial capital can represent the turnover of many industrial capitals. Marx (1959, p.275) concludes:

> "If merchants' capital does not overstep the necessary proportions, it is to be inferred

1. That as a result of the division of labour the capital devoted exclusively to buying and selling … is smaller than it would be if the industrial capitalist were constrained to carry on the entire commercial part of his business on his own.

2. That because the merchant devotes his time exclusively to this business, the producer is able to convert his commodities more rapidly into money….

3. That in viewing the aggregate merchant capital in its relation to industrial capital, one turnover of merchants capital may represent not only the turnovers of many capitals in one sphere of production, but the turnovers of a number of capitalist in different spheres of production".

The continuing existence of merchants' capital as a specialist form of commodity capital is dependent upon economy in the use of capital. Economy in the use of capital is a particular example of the disciplining force of the average rate of profit. In short, merchants' capital only exists if it results in a higher rate of profit. If this is the case, merchants' capital tends towards the same average rate of profit as industrial capital.

> "Nevertheless, since the circulation phase of industrial capital is just as much a phase of the reproduction process as production is, the capital operating independently in the process of circulation must yield the average annual profit just as well as the capital operating in the various branches of production" (Marx, 1959, p.282).

The fact that industrial capital creates surplus value tends to suggest, at least at first sight, that bargaining power lies with industrial capital. The fact that surplus value is logically prior to its distribution is, however, irrelevant to the continual bargaining process underpinning the average rate of profit. We can best view competition between industrial and commercial capital as a contest for a share in surplus value, a process of negotiation and change. There is no presumption that power lies with the industrial capitalist. The importance of commercial capital in this thesis lies in fact that it provides the basis for the development of the theory of the profits of the accounting firm, which is the subject to which we now turn.

### 4.1 A Marxist theory of the profits of accounting firms

All the elements needed to develop a theory of the profits of accounting firms are now in place. Marx does not give the same systematic and detailed treatment to bookkeeping as given to the time of buying and selling. Bookkeeping is not a phase in the circuit of capital and bookkeepers hardly represented, at that time, a powerful sub-division of capital. It is clear, however, we can give a similar treatment to the costs of bookkeeping. Such an extension of Marx's analysis is necessary as bookkeeping now has the form of a specialist type of capital separate from industrial capital. The emergence of large accounting firms suggests that the development of Marx's idea in this direction is timely and relevant.

I have already shown that Marx argued that as production takes on an increasingly social character, accounting becomes more necessary. Marx also argued, as Bryer (1994a, p.316) has pointed out, capital was becoming more social:

> "Formation of Stock Companies … The capital, which in itself rests on a social mode of production and presupposes a social concentration of means of production and labour power, is here directly endowed with the form of social capital (capital of directly associated individuals) as distinct from private capital, and its undertakings assume the form of social undertakings as distinct from private undertakings. It is the abolition of capital as private property within the framework of capitalist production itself" (Marx, 1959, p.436).

An implication of these two aspects of Marx's thought is that accounting was destined to become more important.

In the same way that the industrial capitalist firm can use specialised agents to minimize the costs of buying and selling, the costs of obtaining and controlling capital (accounting and auditing) can be minimised by using specialist accounting capitals, which we call accounting firms, a service required by law for limited liability companies. Accounting firms lower the costs of capital including the costs of auditing. The source of the profits of accounting and auditing firms in relation to surplus value is identical to those of commercial capital. Industrial capital cedes surplus value to accounting firms in return for higher rates of profit and lower costs of capital. Accounting firms do not produce surplus value. The amount of profit earned by an accounting firm is determined in the light of the process of the average rate of profit. There is pressure from industrial capital to minimise the costs of accounting and auditing as well as competition between accounting firms.

There is nothing deterministic in the relationship between accounting firms and industrial capital, which is simply a continual struggle for a share of surplus value.[36] At different times and in different countries, the specific character of accounting and auditing may change depending on the negotiating power of industrial capital and competition between accounting firms. The system of accountability imposed by social capital exerts continual pressure on the accounting and auditing firm.

Although partnership status does accord certain special rights and duties, the general character of a partnership is a capitalist one. Partners in accounting firms are perfectly at liberty to sell their stake, to leave the accounting firm (partnership) and seek employment as a manager or invest funds in industrial capital. If partners in accounting firms are enjoying increasing profits, they may inject more capital into the partnership and expand the firm, for example, by taking over another accounting firm. Equally, any investor or manager may train as an accountant and seek partnership in an accounting firm, start a new accounting firm or acquire an existing firm. Partnership status does not provide a 'closure' from the process of the average rate of profit. It is merely a particular and dwindling institutional form of social capital. Although the reservoir of funds that

[36] We will see that this negotiating process is the root of the Hanlon Armstrong Bryer contradiction.

industrial capital draws on is vast while accounting partnerships draw on comparatively narrow funding, this does not alter their underlying capitalist character and does not make them immune from the process of the average rate of profit.[37]

In summary, the process of the average rate of profit in the sphere of competition between capitals governs the relationship between private sector accounting firms and industrial capital. Accounting firms share in surplus value in return for lowering the cost of capital and maximising the profits earned by client companies (industrial capital). As part of the private sector, the extent of surplus value that is ceded to accounting firms, and the extent to which particular firms benefit, is determined by the process of the average rate of profit including competition between accounting firms. Should accounting firm charges become excessive, services can be bought elsewhere. If accounting firms' audit fees become excessive capitalist investors can seek cheaper suppliers such as SEC based auditors or inspectors. Similarly, should the profits of accounting firms become too low, firms can leave the sector and reduce competition. Profits of accounting firms, therefore, should tend towards the average rate of profit.

Given this theoretical foundation, we can now explore the contradictions in accounting firms and then deduce predictions of their behaviour.

[37] Chapter nine shows how the accounting partnerships have changed into limited liability partnerships and also briefly examines other legal vehicles such as stock market listed accounting firms.

## 4.2 Contradictions in accounting firms

Having understood the contradictory nature of accounting, the origins of the profits of accounting firms, and the process of negotiating those profits (the process of the average rate of profit), what follows combines these elements to identify contradictions in, and characteristic behaviours exhibited by, accounting firms. The puzzle presented by accounting firms is that the objective and social character of accounting, particularly the legal requirement for independent auditing, stands in stark contrast with the private and profit making character of accounting firms. The process of the average rate of profit heightens this contradiction by making it clear that accounting firms compete for a share of surplus value whilst performing an essential function for capitalism.

The accounting firm is a capitalist firm and partners in accounting firms seek to maximise profits. Marx's (1954) views on the intensity of work and the "length of the working day" fit easily into the context of modern accounting firms. Braverman (1974) would have no difficulty identifying instances of deskilling, for example, the 'tick-box' approaches to auditing. The process of negotiating fees with companies and providing a broad range of services reflects all the hallmarks of a capitalist service industry ("commercial capital"). These commercial considerations are, however, in dialectical contradiction to the objective social character of accounting. Commercial considerations undermine objectivity and usually tend to drive it out. Seen in this light the accounting firm is, therefore, unlikely to be able to supply the objectivity capitalists demand and it seems, at least at first sight, it should not exist in its current manifestation as just another capitalist industry.

If total social capital wants accounting firms for disguise as much as objectivity this would explain why capital markets sometimes tolerate the accounting firms' lack of objectivity. Although not perhaps consciously, the unique bargaining tool held by accounting firms is the ability to assist in disguise and this, therefore, in some circumstances could be a key to their existence and profits. The challenge for the accounting firms is judging the balance of disguise in the context. They have to supply what is needed to achieve an objective measure of profit whilst not exposing the exploitative nature of capitalist production, employing the full range of tools of disguise mentioned earlier, for example, economists' economic income theory (Bryer, 1999a, 2008a). They have to strike a changing balance of disguise, in reaction to the needs of capitalists and the changing political and social environment.

Capitalists' need of disguise has a variable quality dependent on the level of profits and the level of working class organization and consciousness. When the need of disguise is greater, there is more opportunity for accounting firms to display the full range of their skills and earn higher profits that way, using the discretion allowed by requiring the auditor to make a judgement of truth and fairness. When the need of disguise is reduced the accounting firms' auditing role is reduced to that of accounting technician (Bryer, 2008a, 2008b). Fortunately for accounting firms, the need of disguise in a capitalist system can never fall to zero since it stems from exploitation. It is in the interest of accounting firms to ensure that capitalists' demand for disguise remains at high levels and, consequently, accounting firms have a contradictory economic interest in subjective, judgmental accounting. Subjective accounting allows the accounting firm greater scope for disguise, but it has the disadvantage of increasing legal exposure. It is no coincidence that accounting firms officially adopt a neutral position on the present conceptual framework of accounting while often fiercely criticising its economic income approach (see, for example, KPMG's comment letter to the IASB, 2006).

Because accounting firms have to manage, and possibly exploit, the problems and possible opportunities presented by the contradictory nature of accounting, the determination of accounting firm profits has two elements: the normal process of the average rate of profit and the special opportunities provided by investors' need of disguise. The factors affecting accounting firm profit include all the tactics, strategies, trends and risk factors affecting capitalist profit. The opportunities provided by disguise depend on investors' demand for disguise, which in turn depends on the level of profits and the level of working class militancy and organisations as well as periodic tightening and loosening of the regulatory regime.

**4.3 Behavioural predictions drawn from the Marxist theory of accounting firms**

A Marxist theory of accounting firms suggests that the relationship between accounting firms and capitalist investors is in a constant state of negotiation and can take many different forms especially in the short term. The behavioural predictions drawn from the theory come from the fundamental and long-term aspects of the relationship. The key behaviour exhibited by accounting firms is not the continual offer and promotion of possibilities for disguise because this process of has to remain clandestine and can never be an overt behavioural characteristic of an accounting firm. Partners in accounting firms, imbued with the capitalist mentality, must (whether consciously or not) balance their profit making zeal with total social capital's need to keep disguise clandestine. Under a regime of "conservative accounting" for example, as Bryer (2008a, 2008b) has defined it, the accounting firm cannot reduce capitalists profits to absurdly low levels because this would makes disguise transparent. Equally, they cannot take secrecy to its ultimate level and make no accounting disclosures. Disguise is a feature of accounting that accounting firms have to carefully judge and balance against profits.

Accounting firms manage the contradictory nature of accounting by creating and sustaining the appearance of accounting firm objectivity. Marx's theory suggests that the creation of objectivity hides the accounting firms' role in disguise and legitimises their profits. Accounting institutes play an important role in bolstering the accounting firms' image of objectivity by providing regulations, training and ethical standards and sustaining the symbols of professions. The vast apparatus of accounting standards and auditing standards as well as the underlying conceptual framework drawn from economists' theories (Bryer, 1999a) are all part of the appearance of objectivity. Despite the size of accounting firms they are still reliant on accounting institutes and the legitimising influence of 'professional status' to help create a sense of objectivity and in this respect political economy relies on the sociological concept of “legitimation” (Ricoeur, 1986).

On this basis accounting firms should exhibit two different types of behaviour. The first encompasses the normal business tactics and strategies that all capitalist firms pursue, including expansion, diversification and cost reduction. These are important but not characteristic behaviours in as much as we can observe them in many types of firms. In short, the accounting firms will copy the tactics and strategies seen as successful in other capitalist firms such as takeover and merger or diversification.

The second behavioural prediction is that accounting firms will create the impression of objectivity to ensure their role in disguise remains clandestine. The creation of an impression of objectivity reveals the contradictory nature of the accounting firm which, in turn, reflects the contradictory nature of accounting. The predicted behavioural characteristic is not the work of disguise but the consequences of disguise, the need to make false claims of objectivity.

The literature review (chapter three) revealed that the mainstream literature on accounting firms treats accounting firms as simply another variety of capitalist firm, which provides a basis for exploding the myth of professionalism. Economists’ functionalist approach, however, prevents them developing the economic interests approach to accounting, rendering their approach partial and preventing them developing a theory of the accounting firm. A Marxist theory of the accounting firm is by contrast a theory of both the uniqueness and normality of the accounting firm as well as a theory of the relationship between accounting firms and corporations and, as such, is more comprehensive than economists' theories.

Marxist theory of accounting firms is a constructive critique of the interpretive approach developed by Dirsmith *et al* (1997). It shows that the accounting firms compete for surplus value and as such have a close relationship with other capitalist firms and capital markets, while the interpretive approach was limited to inside the accounting firm. The interpretive approach does not place accounting firms in a financial context and Marxist theory corrects this gap. Marxist theory also provides perspectives inside the accounting firms by revealing partners in accounting firms as capitalists and exploiters of their employees. Dirsmith *et al* (1997) addressed only the relationship between partners in accounting firms and not the issue of the relationship between employees and partners. The Marxist theory of the accounting firm articulates the concepts of dialectic, power, and control, while interpretive approaches are poorly theorised relying on notions such as "MBO". Having developed Marxist theory of the accounting firm and behavioural predictions, we can now return to the resolution of the Hanlon-Bryer-Armstrong debate.

**Armstrong, Bryer and Hanlon**

When we examine Hanlon's (1994) work in the light of the Marxist theory of accounting firms a problem becomes apparent. Hanlon (1994) suggests the accounting profession is "commercialising" and moving away from "social service professionalism" to pursue profits. Marxist theory of accounting firms, however, argues that accounting firms are part of "commercial capital" and have always pursued profit, an argument confirmed by historians of accounting (Mathews *et al*, 1998). Hanlon (1994) is therefore clearly wrong to suggest the profit motive is a new phenomenon, since accounting has always been a business pursued for profit. According to Marx's theory what has changed is the increasing social and objective character of accounting occasioned by the development of modern capital markets and contradicted by the private and profit making nature of accounting firms.

Willmott and Sikka (1997) accuse Hanlon (1994) of confusing the relationship between accounting and capital. Marxist theory of accounting firms suggests that we should understand the relationship between accounting, capital markets and corporations within the process of the average rate of profit. Consequently, the relationship is in a continual state of renegotiation and change and, as such, it is possible that the balance of power between accounting and capital markets, measured by the share of surplus value captured by either party, is constantly shifting in response to changes in investors' need of disguise. In this sense the criticism of Hanlon (1994) made by Willmott and Sikka (1997) is not significant, since changes in the balance of power and direction of causation are characteristic of the relationship between accounting and capital markets.

The literature review highlighted Armstrong's (1985, 1987a) notion of the domain of "professional practice", derived from the sociology of the professions. I argued that Armstrong (1987a) treats the domain of the professional practice of accounting as distinct from that of business, which, to the extent that accounting firms pursue profit, is incorrect. We can now sharpen this criticism in the light of Marxist theory of accounting firms and, at the same time, reconcile Armstrong's IDC model with Bryer's AIC.

We can interpret the historical process that Armstrong (1987a) describes, as the competition between capitalist firms, prior to interpreting it as occupationally or professionally based. This has the advantage of maintaining Marx's levels of analysis and avoiding Braverman's (1974) errors. Taking this approach, the process of IDC is a particular form of appearance of competition between commercial capitals, logically combining Armstrong's "professional competition" and the social construction of the professions with the core propositions of the theory of surplus value and process of the average rate of profit, integrating sociology and political economy.

A Marxist theory of accounting firms therefore suggests we can better understand the historical development of accounting and auditing by theorising it as the competition between commercial capitals before interpreting it as competition between professions. Evidence supporting this approach is the success of the big accounting firms, which are a form of commercial capital. It is significant that other managerial disciplines (engineering, marketing, HRM, etc) have similar professional institutions as accounting and specialist firms of practitioners, but have never matched the international accounting firm in terms of size and brand name. A reinterpretation of Armstrong (1987a) as competition between commercial capitals allows us to theorize the relationship between accounting firms and the professional bodies in accounting, and the diversity of accounting roles (Mathews et al, 1998). A Marxist theory of the accounting firm also allows for intra-professional competition, the conflict between partners in accounting firms and managers of industrial capital (see comments on Dirsmith *et al* 1997 above). Finally, this reinterpretation of Armstrong (1987a) provides a theory that can incorporate Maltby's (1999) argument that the 'fractions of capital' are important in explaining auditing history.

In the literature review, I compared Armstrong's (1985, 1987a) ideas on the relationship between accounting and capital to Bryer's (1993a) and argued that they are contradictory. Bryer viewed accounting as in the service of capital, and Armstrong viewed accounting as manipulating capital. I argued above that the needs of capital markets are not straightforward and involve disguise, provided by accounting firms. The need for disguise is a bargaining tool that accounting firms use to manipulate capital markets, within the limits set by the process of the average rate of profit and the need for disguise to remain clandestine. As a result, a Marxist theory of the accounting firm combines both Bryer's and Armstrong's perspective thereby resolving the contradiction. The greater investors' need of disguise, the more the balance shifts to Armstrong's view of the power of accounting within the limits mentioned. The less need investors have of disguise, or the less they have to rely on accounting firms to carry out the work of disguise, the more the balance shifts towards Bryer's notion of objective accounting.

A secondary impact of the dialectical emphasis given to Bryer's ideas above is the fact that disguise may open the possibility for managerial self-interest. The vague quality that disguise imposes on accounting may lessen the effectiveness of accountability and increase managerial power. The relationship between accounting firms and capital markets is in a constant state of renegotiation and it is possible that a secondary impact of vague accounting is an increasingly close relationship between accounting firms and senior managers. Armstrong (1991) explored the "contradiction in capitalist agency relations", and Bryer's secondary impacts provide an alternative approach, driven by the rate of surplus value and level of militancy.

**Conclusions**

I conclude that the accounting firm is a form of commercial capital competing for a share of surplus value. The special character of the accounting firm lies in its role in disguising and legitimating the exploitative nature of capitalist production. In addition to competing for surplus value, accounting firms must balance investors' need of objective accounting information with the need to disguise exploitation. Capitalist need of disguise is a variable dependent on the level of profits and working class consciousness and organization. As a result, the balance struck by accounting firms has to be responsive, and may at times present opportunities for super profits. The types of behaviours exhibited by accounting firms fall into two categories: capitalist behaviour and falsely claiming objectivity. The next three chapters test the behavioural predictions against recent events, developments, and problems in accounting and auditing. This leads the discussion into an examination of auditor independence, my conclusions and reflections on further research.

# CHAPTER SEVEN

## Capitalist accounting firms: profit margins and concentration ratios

### Introduction

This chapter tests the prediction that accounting firms exhibit types of behaviour common to all capitalist firms. Marx described a number of characteristic trends of capitalist production, including the mass production of low cost standard commodities (1954. p.43), and production on an increasing scale (1954, p.543). A related long-term trend in capitalist production is the growth of large corporations through mergers and acquisitions. This chapter reveals a close relationship between large accounting firms average profit margins and merger activity, measured using regression analysis. It argues that this supports the hypothesis that accounting firms used mergers to increase profits, just like other capitalist firms. The data needed to demonstrate this is available from the secondary sources described in chapter five.

Chapter nine examines the emergence of limited liability partnerships after 2002, bringing their full reports and accounts into focus. By contrast, this chapter considers the period of voluntary disclosure 1985 to 1995 and, although the disclosures are far more limited, the level of merger activity was much higher. The first section measures the level of concentration over the period 1986 to 1995 using standard measures of concentration. It examines the impact of increases in concentration on the structure of the industry using grouped data and the merger impact on concentration is measured using Martin's (1988) method. The second section measures fees per member of staff, as well as its rate of increase, over the ten year period. The third section measures increases in accounting salaries and this data is combined with fees data to achieve, in section four, an estimate of increases in average large accounting firm profit margins over the period. It tests the behavioural prediction by estimating the parameters of a linear relationship between increases in average accounting firm profit margins and concentration measures, using simple regression. The results reveal a strong statistical relationship, supporting the hypothesis and a Marxist theory of the accounting firm.

Let $M_t$ be the average profit margin per employee in the accounting industry in time t. This is given by the difference between the average cost of employing a member of staff and the average fees charged per employee. Let F represent the average fees charged per employee (FPE). Let S represent the average salary cost per employee (SPE). The industry average profit margin per employee is, therefore:

$$M_t = F_t - S_t$$

Let $\Delta M$ represent the rate of change of industry profit margin per employee.

$$\Delta M = M_t - M_{t-1} = \Delta F - \Delta S$$

We can use the accounting firm fees data to calculate an index of FPE and *New Earnings Survey* and accounting salary survey data can be used to calculate an index of SPE. The difference between the two indexes yields an estimator of the increase in industry profit margins. Inflation does not affect this method of calculating industry profit margins as it impacts both the fees charged and the salaries paid to employees and, therefore, cancels out. It is then a simple matter to estimate an equation of the form:

$\Delta$M = a + b (Concentration Measure)

The statistical significance of the estimated b parameter, its sign and size, together with the total explanatory power of the estimates, measure the strength of the relationship between accounting firms mergers and average profit margins. This chapter estimates accounting firms' profit margins rather than the rate of return on capital. Wages and related labour power costs are the chief costs of an accounting firm. Fixed capital investment, on the other hand, is a relatively small component and, as a result, profit margins have a close relation to return on capital. Chapter nine explores the relationship between profit margins and return on capital in more detail using LLP accounting disclosures.

**1a. Concentration measures**

Chapter three noted that concentration ratio and Herfindahl index were the main methods economists use to measure concentration. In this section, three types of concentration measure are employed: the five firm concentration ratio (CR5), the ten firm concentration ratio (CR10) and the Herfindahl index (H). The CR5 results are as follows:

**Table 1**

**Five firm concentration ratio**

| Year | Fees Basis | Staff Basis |
|---|---|---|
| 1986 | 0.428 | 0.394 |
| 1987 | 0.474 | 0.447 |
| 1988 | 0.483 | 0.464 |
| 1989 | 0.486 | 0.466 |
| 1990 | 0.625 | 0.571 |
| 1991 | 0.644 | 0.618 |
| 1992 | 0.647 | 0.608 |
| 1993 | 0.639 | 0.589 |
| 1994 | 0.649 | 0.595 |
| 1995 | 0.675 | 0.608 |

This represents an increase in concentration of 58% over the period, on the fees basis (54% on the staff basis). The CR10 results are as follows:

**Table 2**

**Ten firm concentration ratio**

| Year | Fees Basis | Staff Basis |
|---|---|---|
| 1986 | 0.697 | 0.653 |
| 1987 | 0.744 | 0.709 |
| 1988 | 0.747 | 0.707 |
| 1989 | 0.751 | 0.720 |
| 1990 | 0.819 | 0.785 |
| 1991 | 0.846 | 0.818 |
| 1992 | 0.856 | 0.822 |
| 1993 | 0.850 | 0.814 |
| 1994 | 0.854 | 0.817 |
| 1995 | 0.865 | 0.838 |

This represents an increase of 24% over the period, on the fees basis (28% on the staff basis). The results, so far, on the fees basis are similar to those on a staff basis. For H, results are on the fees basis only because those on a staff basis are similar.

The H results are as follows:

**Table 3**

**Herfindahl measure of concentration**

| Year | Herfindahl | Index 1986 = 100 |
|---|---|---|
| 1986 | 0.0573 | 100.00 |
| 1987 | 0.0668 | 116.57 |
| 1988 | 0.0686 | 119.72 |
| 1989 | 0.0691 | 120.59 |
| 1990 | 0.0961 | 167.71 |
| 1991 | 0.0999 | 174.34 |
| 1992 | 0.1005 | 175.39 |
| 1993 | 0.0982 | 171.37 |
| 1994 | 0.1000 | 174.52 |
| 1995 | 0.1056 | 184.29 |

This represents an increase of 84% over the period.

In summary, the tendency towards higher levels of concentration, identified in the existing literature, continued up to 1995. Between 1986 and 1992 there was an uninterrupted trend towards concentration, temporarily halted in 1993, an important turning point in the data.[38] In 1990, a significant jump occurred in all concentration measures, with H showing the biggest percentage increase. Of the concentration ratios, the CR5 shows a bigger increase than the CR10 tending to confirm the wide spread view

[38] McMeeking et al (2007) use plc disclosures to show that concentration increases up to 2002.

in the accounting industry about the importance of the Big five or six firms. In comparison to the results obtained elsewhere, the CR's are broadly consistent with those calculated by Beattie and Fearnley (1994) and Moizer and Turley (1989). The H results, however, are greater than those previously obtained and the rate of increase in H is particularly high: 84% over ten years compared to Moizer and Turley's (1989) 32%. The persistence of the increase in concentration and its reflection across a wide range of concentration measures illustrates that it is an established phenomenon as predicted by Marxist theory.

### 1b. Merger impact on concentration

The greatest increase in concentration took place in 1990 when some large mergers took place. This section calculates the merger impact on H over the ten year period. If two firms merge, we can calculate the effect of the merger on H by a shortcut method (Martin, 1988, p.282) which may be adapted to the accounting firm data. In order to calculate the merger impact on H, first consider a statistic $\Delta H$ which is given by the increase in H in any year t.

$$\Delta H = H_t - H_{t+1}$$

Existing literature shows that mergers play a role in increases in H. We can think of $\Delta H$ as comprising two components, the part caused by merger activity $\Delta Hm$ and the part caused by other more competitive activity $\Delta Hc$. Consequently, $\Delta H$ can be presented as

$\Delta H = \Delta Hm + \Delta Hc$

We know $\Delta H$ and the next step, therefore, is to calculate the extent to which $\Delta H$ is caused by merger activity, the $\Delta Hm$ variable. H in any year is given by

$$H = \Sigma(Fi)^2 / (\Sigma Fi)^2$$

Let us write Z to shorten the denominator. Consider two accounting firms x and y merging to form a larger firm. Before the merger, H could be written as follows:

$$H = (\Sigma(F_{i\text{-}x\text{-}y})^2 + F^2_y + F^2_x)/Z,$$

where the $F_{i\text{-}x\text{-}y}$ term separates out the firms which are not merged, from the firms which are merged. After the merger,

$$H = ( \Sigma(F_{i\text{-}x\text{-}y})^2 + (F_y + F_x)^2 )/Z$$

The merger affects H in two ways. Firstly, and mainly, through the conversion of $F_x$ and $F_y$ into $(F_x + F_y)$. Secondly through the change in Z, as what was previously the 41st firm now becomes the 40th. However, the change in Z is very small because, in a forty firm array of data, the fortieth firm is very small if we compare it to the total fees. To illustrate, in 1995, the fortieth firm had fees of £5.2 millions. The total fees for the top forty firms were £3,596 millions. On that basis let us assume that Z is the same before and after the merger.

The $\Delta$Hm statistic is the difference between the pre and post merger H described above. However, the pre and post merger H have a term in common, the $\Sigma(F_{i-x-y})^2$ term, which drops out when the change in H is calculated. The impact of the merger is, therefore:

$$\Delta Hm = F^2{}_y + F^2{}_x - (F_y + F_x)^2 \; /Z$$

This, in turn, reconciles to

$$\Delta Hm = 2(F_x * F_y)/Z$$

This is the short cut method for calculating the merger impact on H, $\Delta$Hm. To illustrate this method, consider the following example. Peat Marwick merged with KPMG during 1987. The final fees figures disclosed by these two firms were £114.4 millions and £52.5 millions. The effect on H is given by:

$$2(114.4 * 52.5)/(1224.5)(1224.5) = 12{,}012/1{,}499{,}400 = 0.0080112.$$

One characteristic of the merger impact measure is that it can be greater than the ΔH statistic itself when competitive behaviour counteracts the mergers. During the period in question the following mergers took place:

**Table 4**

**Merger activity top 40 firms**

| **Year** | **Firms** | **Fees (£ m)** |
|---|---|---|
| 1986 | None | 0 |
| 1987 | Peat Marwick with KPMG | 166.9 |
| | Binder Hamlyn with Dearden Farrow | 55.9 |
| | ***Total*** | **222.8** |
| 1988 | Baker Rook with Howard Tilley | 13.4 |
| 1989 | Pannell Kerr Forster with Ball Baker Leake | 52.1 |
| | Chantry Wood King with Hill Vellacot | 10.0 |
| | ***Total*** | **62.10** |
| 1990 | Coopers with Deloitte | 413.8 |
| | Ernst and Whinney with Arthur Young | 283.9 |
| | Kidsons with Hodgson Impey | 49.4 |
| | ***Total*** | **747.1** |
| 1991 | None | 0 |
| 1992 | None | 0 |
| 1993 | Baker Tilley with Milne Ross | 33.7 |
| | Stoy Hayward with Finnies | 82.5 |
| | ***Total*** | **116.2** |
| 1994 | Grant Thornton and Cape Dalgleish | 122.8 |
| 1995 | Halpern Woolf and Casson Beckman | 20.13 |
| | Binder Hamlyn and Andersen | 539.8 |
| | ***Total*** | **559.93** |

This indicates the levels of merger activity in each of the years under review. Table 5 presents the results of calculating the merger impact on H.

**Table 5**

**Merger impact on Herfindahl**

| Year | ΔH | ΔHm | ΔHc |
|---|---|---|---|
| 1986 | 0 | 0 | 0 |
| 1987 | 0.0095 | 0.008962 | 0.000538 |
| 1988 | 0.0018 | 3.99E-05 | 0.001760 |
| 1989 | 0.0005 | 0.000158 | 0.000342 |
| 1990 | 0.0270 | 0.024779 | 0.002221 |
| 1991 | 0.0038 | 0 | 0.003800 |
| 1992 | 0.0006 | 0 | 0.000600 |
| 1993 | -0.0023 | 0.000200 | -0.002500 |
| 1994 | 0.0018 | 9.55E-05 | 0.001705 |
| 1995 | 0.0056 | 0.007616 | -0.002020 |
| Total | 0.0483 | 0.041851 | 0.006449 |

Of the 0.0483 increase in H, 0.041851 comes from merger activity. This is 86% of the increase in H. Beattie and Fearnley (1994) found a much lower merger impact on concentration. Of the 23% increase in concentration they observed, 14% was attributable to merger. This represents 60% of the increase in concentration compared to 86% found here. Therefore, not only is the increase in concentration well established, that mergers have caused this increase is also established.

**1c. Impact of concentration on industry structure**

This section examines the impact of mergers on the structure of the accounting industry. Naturally, an increase in concentration will be associated with fewer but larger firms. Grouping the accounting firm data reveals a slightly different aspect of the concentration process. I use the staff numbers data here because, unlike the fees data, it does not reflect the impact of inflation. In addition, the number of firms is restricted to twenty-five, because the smallest fifteen firms all fall into the smallest group.

**Table 6**

**Accounting firm staff numbers: grouped data**

| Staff Numbers | 1995 | 1986 |
|---|---|---|
| 0 – 999 | 15 | 11 |
| 1000 - 1999 | 4 | 6 |
| 2000 – 2999 | 0 | 5 |
| 3000 – 3999 | 1 | 3 |
| 4000 – 4999 | 3 | 0 |
| 5000 – 5999 | 1 | 0 |
| 6000 – 6999 | 1 | 0 |

These figures show that by 1995, the concentration of the market had produced some very large accounting firms, compared to those that existed in 1986. In addition, within the top forty firms, the smallest firms had become more numerous.

Significantly, the firm size profile was continuous in 1986. By 1995, a discontinuity had emerged, a distinct gap between the larger firms and the rest. The capacity of medium sized firms in 1986 was comparable to that of the larger firms.[39] By 1995, however, the capacity of medium sized firms was no longer comparable. This gap in the profile suggests that the market segmented and that a "barrier to entry" developed (Porter, 1990). If this barrier were effective, it would allow the larger accounting firms to charge a premium for their work and earn higher profits.

[39] The Lorenz Curve (Yamane, 1973 p. 29) can be adapted to measure this form of industry structure.

**2. Big firm fees per employee 1986 to 1995**

We saw above that a small group of larger accounting firms is increasingly dominant and, as a result, this chapter concentrates on calculating the profit margins of the largest accounting firms. This means the top eight firms up to and including 1989, and the top six firms thereafter.[40] Table 7 gives the full forty firms data:

**Table 7**

**Top forty accounting firms data**

| | Total Fees £m | Total Staff | FPE £ 000's |
|---|---|---|---|
| 1986 | 1,224.5 | 41,237 | 29,694 |
| 1987 | 1,499.0 | 39,610 | 37,844 |
| 1988 | 1,831.3 | 41,819 | 43,791 |
| 1989 | 2,258.5 | 45,658 | 49,465 |
| 1990 | 2,811.5 | 49,879 | 56,366 |
| 1991 | 3,237.5 | 49,728 | 65,104 |
| 1992 | 3,429.8 | 46,099 | 74,401 |
| 1993 | 3,452.0 | 43,583 | 79,205 |
| 1994 | 3,485.3 | 41,607 | 83,767 |
| 1995 | 3,596.0 | 41,715 | 86,204 |

Table 8 gives the data relating to the big firms below. Recall that the approach in this chapter it to calculate the increase in fees per employee (FPE), rather than the absolute value. To capture the increase in FPE an index (1986 =100) has been calculated (see the right hand column).

[40] In chapter nine the number of firms is reduced to four due to mergers and the demise of Andersen.

**Table 8**

**Big firm data**

| | Big Firm Fees £m | Big Firm Staff | Big Firm FPE £m | Index Big Firm FPE |
|---|---|---|---|---|
| 1986 | 743.5 | 22,610 | 32,884 | 100.00 |
| 1987 | 986.5 | 24,106 | 40,923 | 124.45 |
| 1988 | 1,223.0 | 26,346 | 46,421 | 141.17 |
| 1989 | 1,521.2 | 28,972 | 52,506 | 159.68 |
| 1990 | 1,927.4 | 31,336 | 61,508 | 187.04 |
| 1991 | 2,354.5 | 33,668 | 69,933 | 212.67 |
| 1992 | 2,551.6 | 31,626 | 80,680 | 245.35 |
| 1993 | 2,554.1 | 29,601 | 86,284 | 262.39 |
| 1994 | 2,606.4 | 28,616 | 91,082 | 276.98 |
| 1995 | 2,764.1 | 29,667 | 93,171 | 283.33 |

This data shows that the big firm FPE increased by 183% in the period, increasing from about £33,000 to £93,000 per member of staff, giving the first indication of the extent of the increases in accounting firms' profits.

### 3. Accounting salaries per employee 1986 to 1995

As described in chapter five, two sources of salary data are available, *Accountancy Personnel* salary survey data and *New Earnings Survey.* In their spring 1986 report, *Accountancy Personnel* reported that newly qualified accountants with the larger firms in London earned between £13,000 and £14,000 (p.18, right hand column). They commented:

"... Demand high, supply poor.  Firms are still paying the penalty of under recruitment of trainees in previous years …." (p.18).

By early 1991, newly qualified accountants in central London working for a top 20 firm were quoted in the range £20,000 to £25,000, typically £22,000 (p.10).  This represents an increase of 63% over 5 years.  However, by 1991 the balance of supply and demand had moved decisively against accountants.  *Accountancy Personnel* commented:

"… Much lower demand from top practices.  Salaries static" (p.10).

By 1994 the worst of the recession was over.  *Accountancy* magazine (p.54) commented:

"Prospects in Practice improve … redundancies have dwindled virtually to zero …."

During 1995, *Accountancy* magazine reported two sets of figures for newly qualified accountants in London.  The first was in the range £20,000 to £30,000 (June p.60) and the second in the range £20,000 to £29,000 (December p.62).  Therefore, £25,000 would represent a midpoint.  In summary, the salaries paid to newly qualified accountants in London rose from £13,500 to £25,000.  This represents an increase of 85% over the whole period, most of which took place before 1991.

This gives a view of the direct cost base of large accounting firms.  A more systematic source of data is the *New Earnings Survey*, Part D providing a useful comparison.  The data relating to qualified accountants is set out in Table 9 below along with a salary per employee (SPE) index:

**Table 9**

**Accountants' earnings**

| Year | Weekly Earnings £ | Index SPE |
|---|---|---|
| 1986 | 268.7 | 100 |
| 1987 | 294.4 | 109.56 |
| 1988 | 323.6 | 120.43 |
| 1989 | 368.9 | 137.29 |
| 1990 | 402.7 | 149.86 |
| 1991 | 445.5 | 165.79 |
| 1992 | 469.4 | 174.69 |
| 1993 | 489.3 | 182.10 |
| 1994 | 505.4 | 188.09 |
| 1995 | 506.3 | 188.43 |

These figures show an increase in accountants' earnings of 88% in the period. This is slightly more than the accounting salary survey data, which shows 85%. Like the salary survey data, the largest increases took place before 1991. The fact that both sources of data give similar results suggests that the index calculated above is a robust reflection of accounting firms' salary costs. The increase in salary costs is substantial, but not as large as the increase in FPE.

## 4. Increases in profit margin 1986 to 1995

The accounting firm data provides the basis for estimating increases in fees and the *New Earnings Survey* for estimating increases in salaries. It is now possible, therefore, to estimate the change in industry profit margins. Table 10, below, presents the results:

**Table 10**

**Increase in average profit margin per employee**

| | Index FPE | Index SPE | Index Margin |
|---|---|---|---|
| 1986 | 100.00 | 100.00 | 0 |
| 1987 | 124.45 | 109.56 | 14.89 |
| 1988 | 141.17 | 120.43 | 20.74 |
| 1989 | 159.68 | 137.29 | 22.39 |
| 1990 | 187.04 | 149.86 | 37.18 |
| 1991 | 212.67 | 165.79 | 46.88 |
| 1992 | 245.35 | 174.69 | 70.66 |
| 1993 | 262.39 | 182.10 | 80.29 |
| 1994 | 276.98 | 188.09 | 88.89 |
| 1995 | 283.33 | 188.43 | 94.90 |

The average profit margin per employee increased by 95% during the period. The FPE index increases by much more than the SPE index. Therefore, the result obtained is not sensitive to the slight difference in salary increases between the 'New Earning Survey' and the accounting salary surveys.

## 5. Concentration and profit margins

Having calculated an indicator of concentration and profit margins, attention can now turn to the link between profits and mergers using ordinary least squares to estimate the parameters of a model of the form:

Profit Margins Indicator = a + b (Concentration Indicator)

As both indicators are indexes, the value of the parameters estimated does not have a straightforward economic interpretation.  Table 11 below gives the values of the two indicators, the parameters, with their t statistics in parenthesis, and the R Squared:

**Table 11**

**Concentration and profit margins**

| **Year** | **Profit Margin Index** $\Delta M$ | **Herfindahl Index** |
|---|---|---|
| 1986 | 0 | 100.00 |
| 1987 | 14.89 | 116.57 |
| 1988 | 20.74 | 119.72 |
| 1989 | 22.39 | 120.59 |
| 1990 | 37.18 | 167.71 |
| 1991 | 46.88 | 174.34 |
| 1992 | 70.66 | 175.39 |
| 1993 | 80.29 | 171.37 |
| 1994 | 88.89 | 174.52 |
| 1995 | 94.91 | 184.29 |
| | | |
| | Intercept | **-95.6 (-3.758)** |
| | | |
| | Gradient | **+0.95 (5.746)** |
| | | |
| | R Squared | **0.80** |

The explanatory power of this simple model, captured by the R Squared statistic, is high and the value of the gradient is positive and statistically significant suggesting a strong relationship between mergers and increases in profit margins.  The change in H explains 80% of the increase in average industry profit margins.  This suggests that 80% of the increase in profit margins is caused by increases in H, which themselves are overwhelmingly caused by merger activity. Based on this evidence the hypothesis that mergers are a key component increasing accounting firms' profits is accepted.

**Possible limitations**

The 80% R-squared between the big firm margins indicator and the concentration indicator suggests that mergers increase profits. However, because accounting firms provide a range of services (including consulting) it is possible that the increase in profit margins could be caused by diversification. The core services of audit, taxation and insolvency, however, dominate throughout the period. In 1986 the top eight firms derived an average 15.3% of their fees from consulting. Arthur Andersen had the largest share of consulting work with 28%. By 1995, consulting accounted for 27.6 % of the top six firms' fees and Arthur Andersen had risen to 52.6%. This represents a considerable increase, but not so large that it could explain the 95% increase in industry profit margins revealed in this paper

It is possible to argue that because the larger accounting firms do different types of work, their cost base is different. For example, the larger firms may pay higher salaries, or they employ more non-accountants on higher salaries. If this were the case, the salaries index might underestimate the costs of the larger firms. In reply to that, the large firms are cost conscious. There is no reason why they would pay above the market rate for labour. Further, the accounting salary survey data was London based. As Hanlon (1994) has pointed out, London is weighted towards the larger accounting firms. As a result, the large firms' cost-base is in the data. Because audit, tax and insolvency still dominate, the salaries of non-accountants cannot greatly affect the salary index.

## Conclusions

A key aspect of the accounting firm is that is competes for a share of surplus value with all other capitalist firms, the sphere of "competition among capitals", and this chapter provides evidence consistent with the view that accounting firms compete just like a capitalist firm. The evidence suggests that mergers have been used to substantially increase concentration in the market for accounting services and that mergers have been closely associated with increases in the profit margins of large accounting firms. The evidence of profit-seeking merger tactics employed by large accounting firms suggests that the shift to a "commercialized profession" may be more pronounced than Hanlon (1994) thought. The capitalist nature of accounting firms has long hidden behind the facade of "professionalism" and public service, but the evidence presented here suggests this is a myth. The next chapter questions another apparently unique aspect of accounting firms, the claim of "independence" and the appearance of "objectivity".

# CHAPTER EIGHT

## Capitalist accounting firms and audit independence

### Introduction

The aim of this chapter is to test the prediction, developed in chapter six, that accounting firms falsely claim objectivity. In Bryer's work, the objective character of accounting is reflected in accounting's stewardship conceptual framework (Bryer, 1999a) and managerial control systems (Bryer, 2006a), but the implications of objectivity in the field of auditing have not yet been fully explored (Bryer, 1993a gives a historical perspective, see also Maltby, 1999). This chapter tests the hypothesis that claims of auditor independence are false against key events in the development of auditor independence, particularly changes in SEC regulations and the Sarbanes-Oxley Act (2002). These events were an unprecedented critical examination of the concept and practice of auditor independence, exposing its shortcomings, which I argue supports the hypothesis that accounting firms' claims of auditor independence are false.

Development of Marxist theory of accounting into the field of auditor independence represents a move from general theory to a more specific institutional framework, namely modern stock markets. The meaning of the term "capitalist" in the context of modern capital markets has become clouded by the development of the financial services industry (Boyer, 2000; Langley, 2004) and managers' aspirations for social mobility (Armstrong, 1993; 1986). The range of services provided by the financial services industry results in a situation in which all working people are, indirectly, shareholders through insurance, mortgage and pension products. Managerial social mobility projects promote the idea that managers are at the pinnacle of organizational hierarchies, distinguished by their "strategic decisions" (Armstrong, 1986). These two developments make capitalist investors (shareholders) less visible as they no longer appear at the pinnacle of capitalist corporations and they blend in with the average shareholder, potentially helping disguise the exploitative nature of capitalist production.

Capitalist investors nevertheless still represent a distinct and powerful group. The distinctiveness of capitalist investors stems from the fact that they invest to live from a return on capital. Capitalist investors diversify their investments by working through intermediaries such as merchant banks, and they invest directly. In contrast, workers invest with intermediaries such as pension funds and insurance companies to achieve a degree of financial security. Workers are distinct from capitalist investors because they purchase a service (a "commodity") from earned income. Even if a worker invests directly in shares, the investment is to get financial security from earned income and not to live from the labour of others. Therefore, not all shareholders are capitalists. Equally not all capitalists are shareholders. There are still partnerships, family businesses, and those wholly owned by individuals. Many of these businesses are small scale, but one individual, such as Richard Branson or Alan Sugar can wholly or substantially own a large businesses if they can raise debt. These individual capitalists have a much higher public profile than shareholder capitalists even though their economic significance is small in Anglo-Saxon shareholder capitalism (La Porta, *et al*, 2000). Armstrong (2005) argues that entrepreneurship enjoys a high profile because free market ideologies have taken over government policy, for example, education policy. The ‘entrepreneurship industry’ therefore plays a part in clouding the continued existence of the capitalist.

The source of capitalist investors’ power is monitoring the performance of senior managers, rewarding increases in profits and punishing falls. Accounting is the universal monitoring tool used to enforce the power of capitalist investors, a process often termed “accountability”. In this chapter, the term “capitalist” and “capitalist investor” will be used interchangeably to refer to a group of wealthy, powerful and diversified shareholders investing the proceeds of capitalist business directly or through an intermediary.

The first part of this chapter reviews the sparse literature on auditor independence, exposing its limitations. Next, it develops the Marxist theory of auditor independence from the interpretation of Bryer’s accounting theory set out in chapter six. This sees auditor independence as a variable, resulting from capitalists’ need to trade off auditor independence against the need for disguise as well as the capitalist tactics adopted by accounting firms. The chapter tests this hypothesis against key events in the period 1997 to 2007 during which several changes to audit independence regulations took place against the background of a wide-ranging debate about its nature.[41] The changes in regulations and the nature of the debate are consistent with the predictions of my Marxist theory of auditing as they show that in a context of high profits and low labour militancy

[41] The beginning of this period coincides with the end of the period covered by the data in chapter seven.

regulators have refocused accounting firms on the key task of monitoring managers to reduce earnings management.

**The literature on auditor independence**

Otley (2002, p.398) observed that auditing research plays a relatively small part in accounting research and, perhaps as a result, the specific topic of audit independence is not yet fully explored or understood. Beattie *et al* (1999, p.72) noted, “No formal theory of auditor independence exists and thus, to date, analytical models concerning independence are very limited”. It is understood, for example, that “auditing has always been a business” (Power, 2003, p.382), but the implications of this for auditor independence have not been theorized. Changes in the meaning of the term “independence”, from moral ideas of professional detachment towards a more technical meaning linked to accounting and auditing standards, have been noted (Gray and Manson, 2008, p.749), and Reiter and Williams (2007) explore this as a “shifting narrative”. These fragments, however, do not amount to a theory of audit independence.

Auditing research has grown from four different foundations: the postulates and principles approach favoured by practitioners (Gray and Manson, 2008); the economists “agency” approach and the theory of the firm, such as the audit fee determination literature reviewed in chapter three; sociological interpretations of audit such as Power’s “audit society” (1996); and auditing history (Maltby, 2009). The postulates approach is not a good basis for developing theory because it is a pragmatically based practitioners’ view (Maltby, 2001). The economists' approach carries all the weaknesses of neoclassical economics (Keen, 2001; Tinker, 1988; Neimark *et al*, 1986). The sociologists' interpretive approach shifts emphasis away from real audit practices and problems. Maltby (2008, p.389), for example, shows that Power (1996, 2003) does not define audit, does not explain the history of auditing, does not collect detailed evidence of audit work, and does not examine audit in the light of accountability. Debates in auditing history have centred around the adequacy of Watts and Zimmerman's (1983) functionalist and agency based explanation for the rise of auditing (Maltby, 2009, p.224). These four approaches to audit have remained isolated from one another (Maltby, 2008 is an exception), giving us four broad approaches to audit independence.

The pragmatic postulates approach states the underlying principles and examines practical problems and regulatory issues surrounding audit independence, such as auditor rotation (Gietzman and Pradyot, 2002) and ethics (Citron, 2003). There are some studies of comparative regulatory frameworks such as Stevenson (2002), Van Der Plaats, (2000) and Yang *et al* (2001). Economists emphasise the costs of loss of independence, such as litigation, insurance and reputation (Moizer, 1991: ISB, 1997).[42] They develop models of independence (Gray and Manson, 2008, p.67), and measure independence objectively, using some form of surrogate such as the propensity to issue negative audit opinion (Firth, 2002; Craswell, Stokes and Laughton, 2002; Holland and Lane, 2008), or scale of perceived independence (Bartlett, 1993; Beattie *et al*, 1999). Interpretive papers seek to understand, in different ways, the social construction of "independence" (Sikka and

[42] Simunic (1980) treated litigation costs as a surrogate for all accounting firm costs, see chapter three. Chapter nine shows they are only a small component of total costs.

Willmott, 1995). Maltby's (1999) auditing history shows that independence was compromised by the fact that auditors forged close links with inside shareholders and managers at the expense of small investors, who were labelled "speculators". None of these approaches delivers a comprehensive theory of audit independence.

Fearnley *et al* (2005) represented a breakthrough in the level of access to the usually confidential processes of carrying out an audit, moving beyond the normal practice of measuring audit independence using proxies that did not reflect the reality of the auditing process. Fearnley *et al* (2005) interviewed audit partners and finance directors about the substantive issues of disagreement that had emerged during specific audits. In addition to revealing both sides of the argument on key issues that arose, Fearnley *et al* (2005) observed how these issues were resolved. Their study (supported by ICAEW) revealed detailed evidence about the audit process, in particular the types of factors and circumstances linked to a lack of auditor independence, and showed that the threats to audit independence recognized in ICAEW rules were not sufficiently comprehensive. They concluded that the general "audit risk" model, which classifies all audit risks as inherent risk, control risk, or detection risk (Gray and Manson, 2008), fails to include the possibility that audit risk can arise from within the audit firm. Fearnley *et al* (2005) uncovered the range and intensity of pressures that managers placed on auditors and highlighted the fact that auditors do not always resist this pressure.

Sociological and interpretive approaches dominate critical thinking about the nature and meaning of auditor independence. The sociology of the professions involves a number of useful concepts and tools such as “social mobility project” and “knowledge base” (Armstrong, 1993; Roslender, 1992), but ideas about audit independence have tended to make use of concepts such as “legitimation” and “jurisdiction” (Preston *et al*, 1995).[43] Audit independence is understood as a characteristic that the accounting profession promotes as part of a social mobility project to justify or legitimize its special status, jurisdiction and remuneration. Sikka and Willmott (1995), for example, used evidence from three accounting episodes to interpret “independence” critically as a social construction or image used by accountants to expand their jurisdiction and guard against incursions from hostile groups. Sikka and Willmott (1995) employed the idea of competition between professions, but they did not take full account of Armstrong’s (1985) critique of functionalism. Sikka and Willmott (1995) carefully eschewed simplistic functionalist formulations, but we have seen that Armstrong's (1985) critique of functionalist explanations is their general incompleteness rather than their erroneous nature (see chapter two). Following Armstrong, chapter five argued that the best methodological approach is not to abandon functionalist thinking, but to combine it with conflicting factors – chapter six, for example, argued that accounting combined an objective and functionalist character with subjective disguise of the exploitative nature of production. Sikka and Willmott’s (1995) abandonment of functionalism means their theory of independence lacks any function. Their notion of independence has no real dimension and, as a result, there is no explicit dialectic between the real aspects of independence and the ideal. Consequently, they interpret the widespread perception of a lack of auditor independence as a “crisis of credibility” (1995, p.574).

[43] These concepts have also played a major role in auditing history (Maltby, 1999)

The title “Weberian” is not one that Sikka and Willmott (1995) claim, but their treatment of the concept of independence has parallels with Weber’s (1968) concept of “social action”. Weber (1968, p.4) argued that “Action is ‘social’ in so far as its subjective meaning takes account of the behaviour of others and is thereby oriented in its course”. The use of the image of independence to bolster the accounting jurisdiction is an example of “social action”. One of the weaknesses of the idea is that it does not easily incorporate the real aspects of the ontological spectrum. The relationship between the real and the ideal is not formally recognized or adequately theorized. The idea that capitalist investors use accounting and auditing as tools to impose accountability, an important element in a real process of exploitation, power and control, cannot be incorporated into “social action”. Despite the fact that it can incorporate historical, political and sociological dimensions, the concept does not provide a broad enough foundation for theorizing modern finance, accounting and auditing. Additional evidence of the partial character of Weber’s thinking is provided by Tawney (1938, p.320) who showed that Weber had not fully theorized the rise of capitalism, placing too much emphasis on religion. The comparison of Marx’s work to Weber plays a key role in the relationship between sociology and political economy (Bryer, 2000a; Ricoeur, 1986).

Power (1996, 2003) also focuses on the social construction of the meaning of ‘audit’, in particular the ways it is now widely employed in the public sector. In comparison with Sikka and Willmott (1995) and Dirsmith *et al* (1997), Power’s (1996, 2003) philosophical position is more idealist, less empirical (Maltby, 2008), and less inclined to a ‘sociology of radical change' (Burrell and Morgan, 1979). As Maltby (2008) has shown, by failing to develop concepts of power and control, Power (1996, 2003) lacks organizational context, historical perspective, and excludes any political dimensions. Consequently, Power (1996, 2003) lacks the tools for understanding how power and control are transferred from private to public sectors and how the business aspects of auditing are combined with the professional (Napier, 1998). Maltby's (2008) criticisms of Power reinforce the need to theorise auditing with a keen sense of the real material life of auditing, evolving historically and incorporating social capital (Maltby, 2000, 1999; Bryer, 2006a).

The development of the financial services industry opens up an important real dimension to auditor independence. The SEC reports that more than half the families in USA own some shares (SEC Annual Report, 2000) and, as a result, lack of auditor independence affects the financial security of ordinary working people: in the domain of the real, not just in the domain of images and symbols. The failings of Arthur Andersen as auditors of Enron corporation contributed directly to the collapse of the firm and many redundancies (Berenson, 2003; Bryer, working paper a: Froud *et al*, 2004), illustrating powerfully that auditor independence exists in the domain of the real. Any critical understanding of auditor independence clearly needs both real and ideal domains, integrating function and conflict, and I argue below that a political economy of audit independence achieves this and, in this respect, is superior to the analyses of Power (1996, 2003) and of Sikka and Willmott (1995). Developing the political economy of audit independence in the real domain incorporates Fearnley *et al*'s (2005) insight that audit independence problems stem from managerial motivations and from real 'issues' within accounting firms.

Working in the same tradition as Sikka and Willmott (1995) and Preston *et al* (1995), Everett, Green and Neu (2005) examine independence and objectivity as an "ethical discourse". Reviewing publications in the Canadian context (1911–2000), they present a genealogy of the two terms, tracing the gradual development of the ideas over a century. They suggest that the emphasis placed on independence has contributed to the expectations gap. Like Sikka and Willmott (1995), it is the notion of independence they examine, not the real function of auditing. Citron's (2003) conclusions provide further evidence of the need to break from idealist conceptions of audit independence. In a detailed study of the process of updating UK ethical regulations, Citron (2003) found that the factors driving change in ethical rules were firmly in the domain of the real, including accounting firms desire to broaden their product range. In terms of method, an important lesson to be drawn from Citron (2003) is that the process of debate leading up to changes in regulations is as insightful as the actual changes introduced. Citron (2003) emphasizes the importance of unifying a functionalist view of audit independence with its ideological and cultural character, an idea further developed below.

The limited liability partnership status of accounting firms is examined in chapter nine, but the question of auditors' liability needs brief examination here since litigation and the costs of settling claims have played a significant role in economists' ideas about auditing and auditor independence. Napier (1998) examined the legal history of auditor liability using Watts and Zimmerman's (1983) distinction between "collective" and "business" models of governance. Watts and Zimmerman (1983) argued that conflict between investors and managers grew as corporate governance moved from the "collectivities" model, for example, the English East India Company, towards the "business model", for example, stock exchange companies, that is, from socialised to total social capital. Napier (1998) argued that the accounting profession originally lobbied in favour of liability as part of the "professionalisation project", but later changed its mind because it became more concerned with taking more risk as the route to more profits.[44] This initially seems a vindication of Hanlon's "commercialisation" hypothesis, but I will argue below that the Marxist approach suggests a different interpretation of the balance between profits and professionalism, placing more emphasis on the power of investors.

In summary, the audit independence literature lacks a philosophically robust concept of independence and a theory of audit independence. Sociologists' approaches have been characteristically broad and interpretive, while economists are narrowly focused and positivist. An advantage of economists' approach is its view that audit is a low cost solution to the problem of agency (Watts and Zimmerman, 1983). This "value for money" perspective places a limit on sociologists' ideas of the social construction of audit by emphasizing cost monitoring. Maltby's (1999) historical evidence, however, consistent with Antle's (1984) application of game theory to auditing, shows that auditors have incentives to collude with managers, revealing the limits of Watts and Zimmerman's (1983) functionalist explanation.

[44] Napier (1998) also argued that the law of negligence plays a role in the determination of auditors' liability, a view supported by Freedman and Finch (2002) in relation to LLP (see chapter nine).

It is evident that auditing research has become detached from accounting research, reflecting an untheorised distinction between financial accounting and management accounting (see chapter one). The next section pulls these strands together to develop a Marxist approach to auditing independence in the context of modern capital markets, integrating real and ideal dimensions, as well as function and conflict.

**The Marxist theory of audit and audit independence**

This section develops a Marxist approach to auditing and audit independence, building on the foundation laid in chapter six. It uses this to develop the claims of objectivity hypothesis into a more detailed hypothesis about false claims of audit independence. I then compare my Marxist theory of audit and auditor independence with economists and sociologists' theories. The starting point is the parallels between the basic 'postulates' of auditing and political economy.

Viewing auditing from a political economy perspective, striking parallels emerge between the basic "postulates" of auditing such as "verification" and "accountability" (Gray and Manson, 2008, p.23), and concepts such as "value" (Bryer, 2007) and "control" (Bryer, 2006a). A distinguishing feature of a Marxist theory of accounting is the recognition of its objective character, and this concept provides the basis for Marxist theory of auditing. Accounting is objective because values exist independently of firm specific culture and firm based technology processes or knowledge (Bryer, 2006a; 2007).

The auditing postulate of "verifiability" means that audit work is concerned with questions answerable by collecting audit evidence. If accounting has an objective character, and is not dependent on subjective judgment, evidence can prove the accuracy of accounts.

Chapter one argued that political economy is a useful approach to the agency debate, providing an alternative to Jensen and Meckling's (1976) neoclassical economics approach. The political economy of agency suggests group level control of managers by shareholders, which Bryer (1993a, 2006a) argues is the traditional meaning of "accountability". Although authors invariably fail to define it precisely, the existence of a relationship of accountability is a fundamental 'postulate' of auditing (Gray and Manson, 2008, p.23), which is consistent with a political economy of auditing.

The real need for audit stems from the control managers have over accounting within the corporation, combined with the incentive they have to overstate profits Managerial motives for creative accounting are very real, linked directly, for example, to remuneration and job security (Berenson, 2003; Levitt, 1998; Smith, 1992). A basic postulate of auditing (Gray and Manson, 2008, p.33) is that auditors must be completely independent and the political economy perspective says this means independent of managers (Napier, 1998 provides a legal history of this idea), and of typical managerial incentives.

The role of disguise in accounting, however, has consequences for auditors, and this is the decisive contribution of political economy. If auditors are independent of managers, they are independent of capitalists, preventing capitalists disguising profits. Capitalists need auditors to be independent of managers while remaining under capitalist influence in case of need of disguise. The contradiction at the heart of audit, stemming directly from the contradiction in accounting, is that capitalist investors cannot allow auditors to be fully independent. A consequence of not allowing auditors full independence from investors is that this opens a space for managers to influence auditors, an unintended and secondary affect of the capitalist need to control auditors, as we shall see.

Take the example of "conservative" accounting, which Bryer (2008, 2008b) argues is a key to USA accounting history. If auditors are completely independent of investors and managers it will be more difficult for investors to insist on "conservative" accounting, but they will achieve a better insight into managerial performance. If investors retain some influence over auditors, it is easier for investors to achieve the right level of conservativeness. Capitalist investors have to find a way of reconciling their need for disguise with their need for an objective review of managerial performance.

Chapter six argued that capitalists' need of disguise is determined both by the level of profits and the level of working class organization and militancy. Consequently, capitalists' trade off between auditor independence and control is driven by these factors. In one dimension, if profits fall to zero, capitalists want auditors to work fully independently to find out what managers are doing wrong: it needs no limits on auditor independence, at least temporarily. When profits are high, capitalists need auditors to help in the work of disguise so auditors cannot have full independence. Underpinning the level of profits is the rate of surplus value (s/v) which increased sharply in the 1980's (Shaikh and Tonak, 1994). In the other dimension, if the level of working class militancy and organization is low, capitalists will grant auditors a higher level of independence. However, increases in the level of working class militancy force capitalists to increase control of auditors.

Thus, rather than being a "state of mind", a contractual term or a "principle", audit independence becomes a characteristic of auditors that varies in intensity over time, increasing and decreasing in response to capitalists' need of disguise and all the many factors that, in turn, influence it. Auditor independence is therefore a historical question and historical evidence, such as Bryer (2008a, 2008b in the USA) and Maltby (2000, 1999 in UK), is necessary to reveal its true nature.

Large accounting firms are typically the appointed auditors. The level of control that capitalists retain over auditors means, in practice, retaining some control over large accounting firms through ideology, state regulation, stock market regulation and fees, which opens the possibility for a wide range of influences. As well as being the instruments of capitalist disguise, accounting firms also compete for a share of surplus value and, as a result, there are two reasons why their claims of auditor independence are false. This double impact has important implications for reform and regulation of audits since there is little point addressing one of the problems while ignoring the other.

Capitalists understand that big accounting firms are not independent, but can be influenced in matters of disguise, for example, by city inspired debates on the need for goodwill write offs (Bryer, 1995). Accounting firms' lack of full independence suits capitalists if they can choose the balance between independence and disguise. However, accounting firms will attempt to negotiate the trade off between independence and disguise to their maximum advantage, and chapter seven has already provided evidence consistent with the aggressive pursuit of profit, in addition to Hanlon's (1994) evidence.

Accounting firms are constrained because disguise must remain clandestine and, as a result, they face a trade off between their immediate profits, which may depend on acquiescing with needs for disguise, and retaining their independence and "professionalism". If they allow excessive disguise they increase the chance of exposing the disguise, which threatens long-run earnings, for example, the risks Andersen took in auditing Enron's accounts. Both the capitalists' need for disguise and accounting firms' need to maintain an image of professionalism enter into the determination of the level of auditor independence. Although they need to strike a balance between profits and "professionalism", accounting firms gain considerable encouragement and opportunity from the lax, flexible, and vague IASB/FASB accounting regime that maximize their discretion, and from the ideology that supports it (Bryer, 2008a, 2008b).

The balance between auditor independence and disguise results from negotiations (a "discourse") in a particular institutional and regulatory framework varying between countries, the product of history. This framework incorporates general law (Ball, Kothari and Robin, 2000 distinguish code law and common law), company law (La Porta *et al*, 2000), stock market regulations and laws (Bush, 2005), bank and financial services regulation, accounting principles (or the lack of), accounting standards or policies, and labour history (Bryer, 2008a, 2008b). In mainstream auditing research the regulatory framework is a major factor in shaping audits and auditor independence, while in the Marxist approach it primarily serves the need of capitalists and is not an independent force. The Marxist approach hypothesizes that the power of capitalist investors enables them to shape the regulatory framework collectively to achieve the appropriate balance between auditor independence and auditor control, and thereby influence accounting firms balance between profits and professionalism.[45] Another tactic by capitalist investors could be to engineer a relaxation of enforcement of regulations, when necessary, reducing their impact. The cost of regulatory enforcement (salaries, training etc) is often cited as a key factor in lack of enforcement, for example, Berenson (2003, p.138) argues that reductions in SEC budgets have reduced the effectiveness of its monitoring of stock markets.

Chapter six hypothesized that accounting firms make claims of objectivity they cannot sustain. The Marxist approach to audit and audit independence set out above suggests that claims of objectivity take a more specific form, that of claims of auditor

[45] I will argue later that the Sarbanes Oxley Act (2002) is an example.

independence, suitable for testing against evidence. The Marxist theory says that the level of independence enjoyed by auditors is a variable evolving historically in response to capitalists' trading off independence and disguise and accounting firms' trading off profits against objectivity. The model suggests that capitalists' need of disguise is driven by the rate of surplus value and militancy while accounting firm tactics include expansion, mergers, diversification and cost cutting to maximise return on capital. Other factors in the model include the level of flexibility in the accounting regime and the extent to which managers attempt to increase their remuneration and discretion. This is the model I test against the recent history (1997 to 2006) of audit independence.

**The recent history of auditor independence: debates, regulations, and laws**

During the last ten years auditors have come under intense regulatory scrutiny, resulting in important changes that can be used to test the Marxist theory of auditing. In order to place these changes in a proper context, I summarize below the key events in recent history of capital markets:

- 1999 NASDAQ grows rapidly as result of the e-business boom.
- 2000 peak in the NYSE, NASDAQ & e-business collapse.
- 2001 Enron bankruptcy.
- 2002 Sarbanes-Oxley Act.
- 2003 Second Gulf War, bottom of the New York Stock Exchange.
- 2006 NYSE reaches new high.

- 2007-8 Credit Crunch & Oil price instability.

The last ten years have been a period of great stock market volatility, testing the robustness of capitalist institutions as well as accounting and auditing concepts. A low level of working class militancy and organization, but a high rate of surplus value, characterised the period (Bryer, 2008a, 2008b). Because of the relative weakness in the working class during the period, capitalist investors have focused more on controlling managers by imposing accountability and, consequently, audit independence has enjoyed a higher profile than "labour danger". In these circumstances, the Marxist model predicts a real tightening of "independence", a move or tendency towards objective stewardship accounting caused by managers exploiting the discretion given in earlier recessionary and militant contexts (the 1970s-1980s) to earn undue rewards and commit frauds (from the 1990's). Bryer (2006b, 2008a and 2009) provides evidence of a conceptual shift to stewardship accounting by shareholders and their representatives and advisors.

The key events relevant to auditing and auditor independence in this period are as follows:

- 1997 Independence Standards Board (ISB) formed by SEC and American Institute of Certified Public Accountants (AICPA) and Conceptual Framework 'white paper' submitted to ISB by AICPA.
- 2000 SEC Hearings on Auditor Independence.
- 2001 SEC auditor independence rules introduced and ISB formally disbanded.

- 2002 Sarbanes-Oxley Act (Sarbox).
- 2003 SEC Adopts tighter auditor independence rules specified in Sarbanes-Oxley Act.
- 2004 UK guidelines on independence updated.
- 2005 Beginning of the re-evaluation of Sarbox.

The creation of the Independence Standards Board (ISB) was the joint effort of the SEC and AICPA and grew out of SEC concerns regarding the diversification of accounting firms (*Accountancy*, July 1997 p.7).[46] The SEC saw that non-audit services posed a threat to the independence of audits, and was alarmed at the increase in the level of these services. Results presented in chapter seven illustrate the aggressive growth of UK accounting firms through merger, and the same happened in the US, but it was the diversification of accounting firms not the growth that drew the attention of the SEC.

Up to this time, with its roots in the 1970s, the maintenance of the appearance of independence in the UK and US had been through professional bodies (ICAEW & AICPA) and their "ethical" rules (Citron, 2003). This tactic deflected independence problems away from accounting firms, reflecting them through the prism of codes of conduct and ethics, leaving it to "self-control". The growth of accounting firms, however, increased their profile, and the issue of independence became linked in the minds of regulators with accounting firms directly. The voluntary disclosure of

[46] The Securities Exchange Commission has regulated stock markets and accounts oversight in USA since 1934.

accounting firm fees focused SEC attention on the issue and it is understandable why, as capitalist enterprises focused on profit, they should cease to make these voluntary disclosures around this time.[47]

The aims of ISB established at its commencement were clear:

> "The mission of the ISB is to establish independence standards applicable to audits of public entities in order to serve the public interest and to protect and promote investors' confidence in securities markets. To achieve this, the Board will at its inception adopt as its standard the existing independence guidance of the SEC. Develop a conceptual framework for independence applicable to audits of public entities which will serve as the foundation for development of principle based independence standards. Promulgate standards as appropriate and review and ratify if appropriate consensus of the Independence Issues Committee and interpretations of the ISB staff that address matters involving auditor objectivity and independence. Develop a process, including utilizing the IIC, for referring emerging issues affecting independence for guidance and resolution. Provide a consultative function for practitioners and registrants who have questions about independence standards" (www.cpaindependence.org).

[47] This is why the data in chapter seven goes no further than 1995.

The use of the term ‘conceptual framework for independence’ mirrors FASB’s search for a conceptual framework for accounting.

In October 1997, ISB issued a draft or ‘white paper’ entitled ‘Serving the Public Interest: A New Conceptual Framework for Auditor Independence’ (Independence Standards Board, 1997). As the ISB only formed in July 1997, these cannot have been new ideas, and not surprisingly, the SEC reacted by pointing out that the suggested approach was the same as the ideas that had previously been rejected (*Accountancy*, March, 1998 p.9)! ISB considered independence from a historical as well as an economic perspective. The board’s main argument was that there was too much reliance on rigid rules and that a more “flexible regime” and “paradigm” was required.

Weaknesses in the arguments presented in the white paper, however, were easy to identify. From the outset of their investigation, ISB assumed that "independence is one of the most ingrained ethics in the accounting profession" (Independence Standards Board, 1997, p.1). This assumes away the very problem under consideration, displaying what Tinker (1988) has termed a “Panglossian” mentality. The ISB paper did not take seriously the argument that diversification undermined independence, setting the big five accounting firms and AICPA on a collision course with SEC.

The ISB attempted to deflect attention away from the problem of auditor independence by pointing to external factors rather than issues in accounting and accounting firms.

> “Dramatic changes in the world economy, in combination with astonishing breakthroughs in information technology, are redefining the audit function, placing new demands on auditors and permanently altering the relationship between accounting firms and their clients” (ISB, 1997, p.1).

Chapter six argued that the process of investing capital to earn a profit is not altered by the development of modern capital markets and the circuit of capital model is still relevant to modern corporations (Bryer, 1999a; 2006a). Equally, managers’ incentives to exaggerate profit have not reduced (see above). This undermines the argument that external changes have revolutionized auditing.

The “dramatic changes” argument was used by ISB to justify what they termed a “principles based model of self regulation” (p.2):

> “In place of the current system of one size fits all rules and micro management, the new model would have the ISB establish core principles, identify safeguards and challenge firms to establish independence codes. To ensure transparency and foster conformity with core principles the codes would be filed with ISB ….”

In proposing a more flexible regime, the ISB was moving against the SEC, towards looser controls rather than stronger. Rather than developing a new conceptual framework, they in fact produced ideas for a new system of regulation, something quite different and less radical.

The white paper adopts a view directly contrary to SEC's regarding the impact of accounting firm diversification. "Efforts to impede the establishment of multidisciplinary service firms, based on the conjecture that a broad range of services impairs independence, thus are detrimental to the goal of achieving the highest quality audits" (ISB, 1997, p.3). We can understand this aggressive stance as a genuine belief in the existence of audit independence, or as a negotiating stance, hoping to test the resolve of SEC to force change. This tactic nearly paid off as initial SEC reforms (discussed below) were quite weak, but the Enron case and the resulting Sarbanes Oxley Act (2002) imposed severe restrictions on the big five (now four) accounting firms.

The white paper floated a neoclassical economic analysis of auditor independence using the concept of "reputational capital", the present value of the future income for a reputation of independence. It argued that legal liability imposes an additional, unnecessary high cost on lack of independence, because the potential loss of 'reputational capital' gave accounting firms sufficient incentive to ensure auditor independence.[48] The white paper emphasized the importance of developing codes of practice within accounting firms, which was quite a radical departure from previous practice. Consistent with its economic theory, it defined auditor independence as an "absence of interests that create an unacceptable risk of bias with respect to the quality or context of information

[48] Chapter nine reviews this argument ('positive auditing theory') in the light of LLPs.

that is the subject of an audit engagement" (ISB, 1997, p.7). The ISB also clearly set out the core principles including:

> "Auditors and firms should not be financially dependent upon an audit client, auditors and firms should not have conflicting interests that would impair their objectivity with regard to matters affecting financial statements, auditors and firms should not have relationship with, or engaged in activities for, clients that would entail making managerial decisions or otherwise serve to impair an auditors objectivity".

However, as the Marxist theory predicts in a context of high s/v and low militancy, the SEC rejected the ISB white paper because it could not trust accounting firms to develop their own rules, and such rules would be difficult to implement and monitor. They were "unhappy that competition could arise between audit firms on the basis of their independence rules" (*Accountancy*, March 1998, p.9).

SEC's Policy Statement FRR 50 (Improvement of Standards Relating to Auditor Independence) represented a new phase in the debate, now focusing on accounting firm mergers, not just the diversification of services.

> "Since the formation of ISB there have been public announcements of mergers of several of the big 6 accounting firms. The impact of these mergers and the

accelerating trend towards consolidation of accounting firms generally on foreign and domestic self-regulatory programs is being discussed within USA, other countries and international organizations. These events will be monitored closely and may prompt the Commission to reconsider certain of the profession's self-regulatory programs, including ISB".

This was a thinly veiled threat because by 2001 the SEC was evincing a total lack of confidence in ISB, announcing that the:

"SEC will no long look to ISB for leadership in establishing and improving auditor independence standards applicable to audit of the financial statements presented by SEC registrants" (SEC, 2001, Annual Report, p.84).

During 2000, the SEC began collecting evidence of its own on the issue of auditor independence by inviting written submissions and through formal hearings. The formal hearings took place on Wednesday 26th July 2000 and generated an important body of evidence and opinion for auditing researchers drawn from financial services practitioners, financial services regulators, accounting practitioners and accounting academics.[49] Although the SEC did not invite any critical accounting scholars, the opportunity for academics to speak freely[50] and face follow up questions brought to light hidden aspects

[49] Many accounting practitioners simply restated the arguments made in the ISB white paper, so I do not examine them in detail.
[50] I mean free of the formal constraints of an academic paper.

of auditing. During Professor Rick Antle's testimony, the problem of grasping the concept of independence quickly emerged (SEC hearings, p.25):

> "Having done my dissertation on auditor independence I think I have been confused by this issue for more the twenty years now, ever since I first looked at it, things seem to swirl around. I think it is a very confusing set of issues. I think I am beginning to figure out why and that is one reason I wanted to talk to you today".

His testimony continues:

> "When I think about the integrity of the USA financial reporting system to me it comes down to this: We want auditors to have good incentives. And we can talk about what those incentives are" (SEC hearings, p.25).

Understanding the way people react in term of economic incentives seems logical at first sight, and has a pedigree stretching back to Adam Smith. This thesis, however, argues that the basis of auditing is objectivity and, therefore, incentives do not provide the foundation for understanding auditing. The first principle of auditing is freedom from the types of bias and incentives managers face: the absence of incentives. Chapter five argued that 'finance' research was restricted to a narrow neoclassical economics framework based on individual economic decision making. Antle's testimony on audit independence repeats the error by starting from the perspective of individual incentives. Capitalist investors have powerful common interests that auditors represent and to which managers submit. Antle's incentives approach ignores investors' common interests and power.

Evidence above showed that the SEC saw the sources of problems of auditor independence as the non-audit services provided by accounting firms, and mergers. The Marxist approach agrees, but suggests the issue is much broader, a view supported by Fearnley *et al*'s (2005) evidence, and by the testimony of Professor Miller, who argued, "no-one is asking the question whether audit fees might compromise independence. That's quite provocative and I will let that be discussed elsewhere" (SEC hearings p.33). Because the SEC had framed the issue as being about non-audit services, the general point made by Professor Miller was not explored in more detail. Testimony from Mr. Biggs (a pension fund manager) also unwittingly revealed the scope of the problem (p.50):

> "My own suggestion to allow firms to do what they want and let them pursue their self interest as long as they abide by one simple rule: Independent public audit firms should not be the auditors of any company for which they simultaneously provide other services. It would be that simple, simpler even than the proposed commission rules" (SEC hearings, p.50).

Mr. Biggs was giving evidence about problems encountered with auditors and, as it happened, the auditor was not involved in providing any other services. The SEC had already framed the problem as one closely linked with non-audit services and, therefore, problems arising when non-audit services were absent did not fit the SEC's view, possibly taking them by surprise. In discussing the case, Commissioner Carey sought clarification "that was not an instance where audit and non-audit services were being provided to the client, right?" Mr. Biggs "That's right." Like Professor Miller's, Mr. Biggs' testimony suggest that the problems are not limited to the question of non-audit services or mergers.

Rules introduced by SEC in 2001 were termed a "final ruling", but as it turned out it was not the final word. In these new rules, the SEC tried to balance all the views they heard, leading them to ban some non-audit services, but not others. They attempted a definition of auditor independence that hints at the need for a realist or materialist understanding:

> "Independence is generally understood to refer to a mental state of objectivity and lack of bias. The first prong is direct evidence of the auditors' mental state: independence 'in fact.' The second prong recognizes that mental state can be assessed only through observable 'external facts'…"

Then Enron Corporation collapsed. This was a large-scale bankruptcy as the company employed around 20,000 people and was one of the top ten corporations measured by stock market value. Like the Titanic, Enron had been lauded as a model and the psychological impact of its collapse was therefore considerable, contributing to a sharp, general, but temporary, fall in share prices and business confidence (Berenson, 2003; Froud *et al*, 2004, see also other contributions to a special issue of *Critical Perspectives on Accounting*). The Enron case included a criminal fraud, but one that made extensive use of the lax accounting regime that had grown up in Anglo-Saxon economies in the 1990's (Bryer working paper a; 2008a; 2008b). Enron particularly exploited laxity in the rules regarding consolidated accounting and financial instruments. From the perspective of accounting the most damaging aspect of the affair was not the fact that accounting standard were exposed as weak, but the close involvement of a big five accounting firm, Andersen, in the scandal. The US authorities charged the firm with obstruction and its license to practice was with drawn resulting in the worldwide collapsed of the firm. The ruling was later overturned (*Houston Chronicle* 1st June 2005).

The scale of the Enron collapse coupled with the general market downturn legitimated a general strengthening of capitalists' controls and regulations as well as a political response (Froud *et al*, 2004), even though the Enron problem was not general. Quickly, a compromise bill between a republican senator Oxley and a democratic senator Sarbanes was agreed. The Sarbanes Oxley Act was wide ranging, including the creation of a new Public Company Accounting Oversight Board (PCAOB), strengthening audit committees, regulation of audits, restriction on non-audit services, CEO and CFO certification of financial statements, payback of bonuses in cases of non-compliance, expansion of company disclosures and criminalization of misconduct (*Accountancy*, October 2002, p.110). It prohibited auditors from the following area of business:

- Bookkeeping
- Financial systems design
- Appraisal and Valuation
- Actuarial
- Internal audit
- Management functions
- Human resources
- Investment banking
- Legal services
- Audit committee must pre-approve non-audit service including taxation work.

Non-audit service comprised more than half of the fees of big accounting firms at this time, so the message was clear: concentrate on auditing and do not stray from that specialism. These reforms to auditing were in the spirit of Mr. Biggs testimony to SEC (see above), but they did not change the fact that accounting firms competed for a share of surplus value, they did not strengthen the lax accounting regime, nor did they address the issue of investors' current and future need of accounting disguise. The authorities ignored Professor Miller's controversial point about audit fee being part of the problem.

Changes in the regulation of USA capital markets have worldwide impact, for example, many firms listed on the London Stock Exchange list in New York. Another aspect of the impact of these developments in the UK was the updating of ICAEW guidance on independence. The importance of this guidance is that it provides the basis for accounting firms' claims of independence. The accounting profession has often said that independence is a "state of mind" (see literature above) and the most recent guidance provided by the Institute of Chartered Accountings in England and Wales in December 2004 defines "independence of mind" as (p.3):

> "A state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity and exercise objectivity and professional scepticism".

Characterizing independence as a "state of mind" cloaks the concept in ambiguity because the domain of the nominal is impossible to measure and control. This in turn makes it much easier to accommodate the demands of capitalists for disguise while keeping pretence of independence. Defining independence ambiguously avoids overt conflict between auditors and capitalists. The guidance issued by ICAEW in 2004 goes on to define "independence of appearance" (p.3):

"The avoidance of fact and circumstances that are so significant that a reasonable and informed third party, having knowledge of all the relevant information, including safeguard applied, would reasonably conclude a firm's or a member of the assurance team's integrity, objectivity or professional scepticism had been compromised".

Shortly after, there is a partial admission of the impossibility of independence (p.4):

> "Standing alone the word may lead observers to suppose that a person exercising professional judgment ought to be free from all economic financial and other relationships with others. This is impossible as every member of society has relationships with others".

During 2005 and 2006 stock markets began to recover, regaining the losses of 2001 and 2002 and 2003. IPO activity began to increase but London was far more active than New York. It became understood that Sarbox had increased costs and made the process of floating a new company in USA much slower. During the e-business boom of 1999 and 2000 NASDAQ was synonymous with the successful IPO, but during 2005 and 2006 London's Alternative Investment Market (AIM) was far more active than the NASDAQ. In response, NASDAQ began to look at the possibility of buying the London Stock Exchange (*Financial Times*, 16th December, 2006, p.16). In addition, regulators in the USA began to describe the regulatory regime in UK as "lax". Some commentators and regulators began to talk of the benefits of a "principles based" (*Financial Times*, 20th November 2006 p.15) regime of regulation, which was exactly the type of regime that the ISB had originally suggested and SEC had rejected. In this way, the debate appears to return to its initial starting point reflecting the same oscillating pattern that Bryer (2008a) has uncovered in the USA conceptual framework for accounting debate.

## Conclusions

It is not difficult to point to evidence that accounting firms' claims of auditor independence have been false in the period under review. The SEC, politicians, investment managers, academics and financial commentators such as Berenson (2003), all took this view. The events surrounding the collapse of Enron corporation provide detailed evidence and the ICAEW updated guidance show the accounting profession beginning to accept the limitations of the notion. The hypothesis tested in this chapter, however, is more specific than showing the lack of auditor independence. The hypothesis tested is that independence is a variable, rather than a principle, reacting to changes in capitalists' need of disguise and accounting firms' behaviour.

The evidence that auditor independence is a variable is the fact that in the period under review, despite the efforts of accounting firms to maintain the status quo, it has been strengthened in two distinct stages in 2001 by SEC and again in 2002 in the Sarbanes-Oxley Act. In addition, the changes have not resulted in full independence (independence in principle), but still a compromised level of independence because audits are still performed by profit seeking accounting firms and the general accounting framework is still lax. In other words, auditor independence retains its character as a variable. Consistent with this hypothesis, auditor independence has been a subject of debate throughout the period under review. In the period 2004 to 2008, the *Financial Times* carried more than 40 articles or letters on the topic. These examined the issue from a broad range of perspectives including agency aspects (2nd November, 2006, p.1), aggressive expansion of consulting (23rd January, 2006, p.22), private equity involvement (31st October, 2005, p16), links to limited liability (14th April, 2005, p.14) and audit independence (13th May, 2008).

The main factor driving change has been the behaviour of accounting firms rather than capitalists adjusting the trade off between auditor independence and disguise. The aggressive expansion, merger and diversification of accounting firms led the SEC to believe they were not carrying out independent monitoring of managers and they reacted by imposing restrictions on accounting firms. The behaviour of Andersen in the Enron case brought political intervention and further restriction on accounting firms. The SEC reasserted auditor independence, which is consistent with acting in the interests of capitalists, because of the aggressive tactics employed by accounting firms and growing evidence of managerial "greed" (Buck and Shahrim, 2005).

In the period under review, capitalists acted to foil the tactics used by large accounting firms and refocus them on monitoring managers in a period of boom and low labour militancy. Capitalist institutions firmly jerked accounting firms back to their function as independent auditors, reasserting the essential function of the audit. Clearly, the discipline of the average rate of profit was not sufficient to exert capitalist control on accounting firms as capitalists had to use changes in the regulatory framework and company law to achieve their aims. The importance capitalists placed on controlling the accounting firms illustrates the special character of the accounting firm and their key role in accountability and the power of the stock market.

Maltby (2008) argued that Power (1994, 2003) lacked empirical evidence, a political dimension (power and control), and was isolated from the real life of auditing. This chapter shows that the Marxist model of auditing captures all of these features. It was argued that Sikka and Willmott (1995) lacked a real and functionalist dimension and Marxist political economy fills the gap by showing that "legitimation" and "jurisdiction" have a real dimension that complements the idealist interpretation. Rather than refuting these Weberian type concepts, political economy strengthens them by locating them in the context of capital markets and corporations, thereby linking them with profits, accountability and agency.

Antle (1984) and Maltby (1999) argue that collusion with managers is part of the audit independence problem. The Marxist model agrees, but argues that collusion is a result of the lax accounting and auditing framework, reflecting the fact that disguise plays an important role in both. In addition, we can trace the audit expectation gap back to investors' need of disguise, rather than understanding it as unrealistic public expectations (Gray and Manson, 2008, p.681).

Comparing the results in this chapter to those of chapter seven, brings the dual character of the accounting firms more sharply into focus. In chapter seven, the accounting firms appeared as any other capitalist firm, while this chapter has highlighted the special character of accounting firms. Both chapters have evidenced the aggressive commercial nature of the accounting firm, illustrating that accounting firm partners have the "capitalist mentality". Chapter nine provides further evidence of this by showing how large accounting firms have lobbied for and achieved limited liability and a high rate of return on capital, but at the expense of being subject to closer monitoring by capitalists.

# CHAPTER NINE

## Capitalist accounting firms and limited liability partnerships

### Introduction

An important development among large accounting firms in the UK has been the transformation of their business from general to limited liability partnership (LLP) status. This legal change, resulting from Limited Liability Partnership Act (2000), has important implications both in terms of the risks faced by partners in accounting firms (their “liability”) and disclosure of accounting firm profits. These changes act as a test of both hypotheses developed from my Marxist theory of accounting firms, that they will behave like capitalist firms and that their independence is a negotiated variable. A paradox of LLP status is that unlimited liability provides a powerful incentive for the performance of good quality audits and auditor independence.[51] Restricting auditors’ liability eliminates this incentive, and it is difficult, *prima facie*, to understand why the state has sanctioned this legal vehicle. A second paradox, discussed in section two of this chapter, is that LLP status involves accounting firms making detailed accounting disclosures when previously they had been loath to disclose (see chapter seven). This chapter uses the Marxist theory of accounting firms, coupled with relevant evidence, to resolve both these apparent paradoxes.

[51] Note that the ‘incentive’ here is not Antle’s marginal utility theory, but the need to avoid catastrophically costly mistakes.

The emergence of LLP status is a historical development, and the first part of this chapter explores the origins and nature of LLPs, as well as the literature on the issue and the distinction between LLP and plc status. The second part examines in detail the accounting disclosures made by UK accounting LLPs. Because of the complexity of LLP accounting, the different accounting treatments adopted by different firms and the adjustments caused by the introduction of IFRS in 2005, the analysis of accounting firm disclosures is not a simple matter. In order to achieve comparability between accounting firms, as well as some comparability between LLP and plc disclosures, a number of adjustments are required. The *Financial Times* noted the lack of comparability (10th August, 2006, p.16), and it raises some questions about the nature of accounting, explored below. Although this chapter identifies weaknesses in the LLP disclosures, the emphasis here is on making the necessary adjustments.

I examine the disclosures of the largest firm, PwC, first, as an introduction and benchmark. Next, a comparison between all four LLP firms using 2005 data, the first time this has been possible. Then, I present a comparative analysis using the 2006 disclosures, which were the first to be prepared using IFRS and, finally, a comparative analysis of the 2007 results. Once the nature of the accounting firm LLP has been understood and the comparative analysis of the results of the big four accounting firms has been carried out, it is a relatively simple matter to test the behavioural predictions set out in chapters six and eight.

**The nature of limited liability partnerships**

The limited liability accounting partnership originates in the state of Delaware in USA, which has close connections with lightly regulated company registration (Bush, 2005, p.2). Acceptance by New York State was the key to establishing the principle (*Accountancy*, 1994, p.11) as this is where most accounting partnerships had their largest offices. In UK, Jersey introduced legislation in 1997, prompting the introduction of a similar UK bill in 2000. In due course, many other countries brought forward similar legislation making the availability of LLP status a global phenomenon (Cousins *et al*, 1999, p.284).

The emergence of LLP status has generated little academic literature. Brock and Powell (2005), for example, do not mention it despite claiming to theorize 'radical changes' in 'global professional networks'. The Jersey LLP legislation, a forerunner of the UK legislation, attracted some academic attention both in terms of the content of the Act and the events leading up to it. Morris and Stevenson (1997) pointed out an anomaly in the Jersey legislation that LLPs were not required to publish accounts, and argued that the fact that large negligence claims would still bankrupt partnerships would limit the impact of the legislation. The UK legislation, however, did contain a stipulation regarding accounting disclosures, explored in section two below. Individual partners' risk is limited by the legislation, not the business risk of the firm as a whole.

Mitchell and Sikka (1999) viewed the Jersey LLP Act in its social context, arguing that it was detrimental to individual rights and the rule of law. Their evidence supports the view of the aggressive commercial behaviour of large accounting firms that emerged from the evidence presented in chapter seven and eight. Cousins *et al* argued that there was no need to limit the liability of audit firms because they had a "monopoly" (1999, p.284) of the audit business and the costs of insuring against legal action were relatively small, some 3% of total income (1999, p.292). They pointed out that most legal action against accounting firms came from other accounting firms (1999, p.293). They suggested that the issue did not impact the wider public interest, that the Caparo judgment had already diluted the rights of individual shareholders (1999, p.288), and that accounting firms already had the right to limited liability, for example, KPMG plc (1999, p.289). Further evidence that LLP status was unnecessary came from Freedman and Finch (2002), who approached LLP from a legal perspective, rather than from an accounting perspective, and pointed out that the House of Commons Trade and Industry Committee were not convinced of the need for such legislation (2002, p.2). In short, the emergence of LLP status was an unusual and striking event in UK legal, business and political history, as well as in global terms.

Before the Limited Liability Partnership Act (2000), the Partnership Act of 1890 governed partnerships in the UK under which all partners were liable for all their personal wealth (Deards, 2003). The liability of partners was both joint and several and, consequently, creditors could make up a shortfall in the assets of one partner by taking more from other partners. The practical impact of this was that one wealthy partner might have to bear all the liabilities of the partnership even if that partner was not personally at fault, for example, in the event of a negligence claim. In contrast, the limited liability company provides stock market investors with a limit to the amount they lose in the event of bankruptcy. This advantage explains the widespread adoption of limited liability company status, even by sole traders, and clearly large accounting firms desired this favourable treatment.

The UK LLP is a "hybrid entity" (Freedman and Finch, 2002, p.2). There are no shareholders, but partners in the company. In the event of bankruptcy, the partnership as a whole is liable for all debts, but the personal assets of individual partners are not at risk. Partners' liability is limited to the capital they have contributed or formally agreed to contribute to the partnership, displaying the characteristics of a limited company or a company limited by guarantee. In the event of a negligent audit, and the resulting damages, partners' personal assets are not at risk. Consequently, the investment made by partners in accounting firms takes on a character more like that of a shareholder in a corporation. The difference between the two is that partners always work within the partnership firm, while shareholders are passive investors in a corporation.

The advantage of LLP status of a reduction in the risks faced by individual partners clearly exceeded the disadvantage of accounting disclosures, as the transfer to LLP status was swift. Ernst and Young were the first UK firm to adopt it in 2001, and all the big four firms, as well as some medium sized ones, had transferred to LLP status by 2004. This episode in the development of accounting firms therefore reconfirms the hypothesis that these firms exhibit the types of commercial behaviours expected of capitalist firms. The adoption of LLP status confirms this hypothesis in two ways. Firstly, by providing protection to partners in accounting firms similar to the protection enjoyed by shareholders in corporations. Second, by accepting obligations to disclose profits similar to those imposed on other capitalist companies.

The stipulation that partners in LLPs must work in the partnership has important implications for the extent to which liability is limited in practice. Plc companies do not require shareholders to work in the company. Plc companies have many millions of shareholders and, as a result, they can spread risk widely so that the amount of risk borne by an individual shareholder is very small. LLPs cannot draw on such as wide pool of capital because they are restricted to partners working in the company. As a result, new partners have to contribute to partnership capital on admission. In the event of bankruptcy of the partnership, the whole of this capital will be lost. Therefore, the amount that a partner in a LLP loses in the event of bankruptcy is far greater than the average shareholder who enjoys the benefits of a wide spread portfolio. Because an LLP cannot spread the risk as widely as a plc, this reduces the extent to which it is limited in reality for individual partners.

Another factor influencing the extent to which LLPs achieve real limited liability is the role of regulators. Financial services regulators increasingly take the view that large audit firms must not become bankrupt. An EU Internal Market Commissioner, for example, said "I think we should have a cap on auditors' liability" (*Financial Times* 27th October, 2006, p.7 also 23rd January, 2006, p.28 in relation to USA). Regulators take this stance because they worry that bankruptcy would lead to only three audit firms (and ultimately none might remain) because this could lead to a loss in confidence by financial markets. They have discussed a number of methods of preventing this, including liability capping and additional insurance. At present, there is no legislation or regulation, but it does seem likely that in the event of a possible bankruptcy of a large audit firm, regulators would step in to save it. When we examine LLPs in a regulatory and institutional context, they enjoy greater security than plc companies do.

In summary, the distinction between a LLP and plc is not at all a simple legal technicality, but has dimensions in the political, regulatory and business realms. However, despite the complexities explored above, the LLP is closer to a plc company than an old style accounting partnerships because it enjoys limits to its liability (Freedman and Finch, 2002, p.4). The emergence of LLP status, therefore, dilutes the special character of accounting firms bringing them closer in nature to all other capitalist firms. In this respect, the emergence of LLP status appears as a move in the opposite direction to the Sarbanes-Oxley Act (2002), which imposed a special character on accounting firms by restricting their sphere of influence and imposing added regulation. However, the price of limited liability is disclosure, and this may ultimately give more control by the capital markets over accounting firms.

Another development relevant to the understanding LLP's is the fact that Companies Act 2006 allows 'limited liability agreements' (LLA) which provide a way of ensuring that auditors are not pursued for excessive losses, just a reasonable proportion based on their responsibilities (the legislation came into affect in April 2008). While LLP limits an individual partner's liability, not the liability of an audit firm as a whole, LLA provides a vehicle for placing a cap on an audit firm's liability in relation to a specific audit client. A limitation of LLP is that it does nothing to prevent a negligence claim bankrupting an audit firm, but in principle, an LLA could provide auditors with additional protection. In practice, there are two issues preventing the widespread adoption of LLA. Firstly, there is no reason why shareholders would enter into such an agreement, as it weakens their legal position, without any reciprocal benefit. Secondly, although the EU has adopted LLA, the USA has not and LLA do not therefore provide effective protection for global audit firms. In the future the LLA may become more widely adopted but it can never be a substitute for LLP as it does not limit the liability of the individual partners in audit firms.

**LLP and accounting firm profits disclosure**

The disadvantage of LLP status to capitalist accounting firms is financial disclosure. *Accountancy* set out the issue as follows:

> "There is a price to pay for limited liability protection in the form of greater regulation and accountability. Under Limited Liability Partnership Regulations (2001) LLP are required to prepare and file financial statements in accordance with UK GAAP under the accounts and audit requirements of the companies act 1985 (modified as appropriate). For many high profile partnerships this will lead

to public scrutiny of their financial performance and position for the first time" (July, 2002, p.102).

Although the accounts of LLPs are prepared on the same principles as all other firms, in practice a number of adjustments are required to make them comparable, especially to calculate the rate of return on capital employed (ROCE). The approach adopted in this section is to examine the disclosures made by one firm as an exemplar before moving to examine all the big four firms. Price Waterhouse is the biggest UK firm with the simplest partners' pension arrangements and, as such, provides a useful starting point.

### 2.1 Price Waterhouse Coopers' 2004 Disclosures

Price Waterhouse Cooper's (PwC) early accounting disclosures took the following form.

**Price Waterhouse Coopers UK**

**Consolidated Profit and Loss Account Year Ended 30th June 2004**

| | **2004 £ Million** | **2003 £ Million** |
|---|---|---|
| Turnover | 1,568 | 1,604 |
| Less: Operating Costs | | |
| Expense and Disbursements | 207 | 194 |
| Staff Costs | 680 | 749 |
| Depreciation | 47 | 35 |
| Other operating charges | 244 | 266 |
| Operating Profit | 390 | 360 |
| Add: Interest Received | 1 | 3 |
| Add: Profit on disposal of PwC Consulting | 0 | 223 |
| Profit Before Taxation | 391 | 586 |
| Less: Subsidiary's Taxes | 7 | 7 |
| Profit for the Year Before Members Remuneration | 384 | 579 |

**Price Waterhouse Coopers UK**

**Consolidated Balance Sheet As At 30th June 2004**

| | 2004<br>£ Million | 2003<br>£ Million |
|---|---|---|
| Fixed Assets | 140 | 152 |
| Current Assets | | |
| Stock | 24 | 18 |
| Debtors | 555 | 497 |
| Cash | 65 | 129 |
| | 644 | 644 |
| Creditors due in less than one year | 316 | 316 |
| Net Current Assets | 328 | 328 |
| | | |
| Provision | 99 | 107 |
| Loans due to members | 1 | 1 |
| Net Assets | 368 | 372 |

| | | |
|---|---|---|
| Number of partners | 752 | 779 |
| Number of Staff | 12,767 | 13,322 |
| Average Profit Share | 511,000 | 429,000 |
| Average Salary | 53,262 | 56,223 |

These figures show turnover and profit per partner falling compared to 2003, reflecting the timetable of financial events presented in chapter eight. The Marxist theory of accounting applied to accounting firms themselves suggests that its contradictory nature stems from the fact that presenting an objective measure of profit reveals exploitation. This feature of accounting is readily apparent in the figures above as the "remuneration" of partners (including profit) is large compared to the salaries paid to staff. The average profit share per partner is £511,000 while the average staff salary is £53,262. The 'remuneration' of partners including profits is, on average, ten times that of staff. This difference initially seems anomalous for partners and their staff with the same or equivalent qualifications and similar commercial and technical experience, but arises because partners are the capitalist component of the accounting firm as well as playing a managerial and operational role. Before these accounting disclosures, staff had no information on partners' remuneration.

Accounting firm disclosures also make partners' remuneration visible to stock market investors. The figures above report a profit of £384 millions on total net assets of £368 millions, suggesting a rate of return on capital greater than 100%. The average dividend yield on all shares is around 3% and PE ratios are frequently around between 15 and 20, giving equivalent returns of between 5% and 7% (Arnold, 2002, p.772). *Prima facie*, investors in stock market companies would envy the apparently very high return on capital earned by partners in accounting firms. However, profits of accounting firms are before the remuneration of partners ("Profit for the year before members' remuneration"). Consequently, accounting firm costs do not include the cost of partners' productive work and to this extent reported profits appear artificially high when compared to stock market companies.

Members' profit shares comprise a payment for their work, a salary, plus a share of profits. It is possible to allow for these lower costs and higher profits by estimating the market, or "socially necessary", value of partners' work and allow for partners salaries. To do this we can utilise a recent development in accounting, the emergence of specialist stock market quoted accounting firms such as Vantis plc and Tenon plc. These make full disclosure of directors' remuneration providing a useful benchmark for the remuneration of partners in large accounting firms. A review of the annual report and accounts of these two stock market specialist accounting companies reveals directors' remuneration as follows:

| VANTIS plc | 2004 | 2005 | 2006 |
|---|---|---|---|
| Directors Remuneration | 816,949 | 1,133,439 | 1,522,627 |
| No. of Directors | 5 | 5 | 5 |
| Average Directors remuneration | 163,389 | 226,687 | 304,525 |

| TENON plc | 2004 | 2005 | 2006 |
|---|---|---|---|
| Directors Remuneration | 1,108,666 | 1,223,000 | 1,497,000 |
| No. of Directors | 9 | 8 | 8 |
| Average Directors remuneration | 123,185 | 152,875 | 187,125 |

Using this benchmark, the salary element of partners profit shares would be in the region £150,000 to £300,000. Placing the issue of the value of partners' work in a wider perspective, many directors of stock market companies earn more than £300,000, sometimes more than £1 million every year, but this covers all types of directors not restricted to the finance and accounting specialty. On the other hand, survey evidence suggests many finance directors earn around £100,000, for example the 2006 survey in *Accountancy Age* (see accountancyage.com/salary survey). A figure of £250,000 represents a mid-point between the higher remuneration enjoyed by main board directors of stock market companies and finance directors of smaller and subsidiary companies. Put another way, if the role of partner in a large accounting firm advertised a salary of £250,000, there are good reasons to believe that there would be many suitably qualified applicants. In terms of PwC's stated average profit share of £511,000, the first £250,000 represents salary and the true profit element is £261,000 on average. Clearly, a substantial premium is paid for the capitalist element of the work of partners in large accounting firms.

The cornerstone of the power of the stock market is monitoring and performance data such as earnings per share (Graham *et al*, 2005), allowing the organisation of punishment, rewards, investment and divestment. The accounting firm disclosures allow investors to monitor accounting firms' profit performance, bringing them more clearly on to the 'radar' of the capital markets in the same way that the voluntary disclosures during the 1990's brought the audit firms to the attention of the SEC. In addition to coming to the attention of investors, the partners' premium is also visible to senior managers who will be able to compare partners' profit shares with their own salaries. The disclosure of accounting firm profits and partners' profit share is of interest to shareholders, senior managers, accounting staff and regulators.

The PwC disclosures also provide evidence of the movement of capital out of accounting firms, the process of formation of the average rate of profit. During 2003, a portion of the business dealing with what they describe as "big ticket I.T. consulting business" (Annual report 2004 p.20) and other I.T. related services were sold to IBM. The total profit generated was £223 millions. In order to give a fair comparison, the 2003 figures exclude the parts of the businesses sold. Similarly, in 2000, E&Y disposed of their consulting business to Cap Gemini for £369 millions making a profit of £340 millions (Annual report, p. 29). This provides evidence supporting the point developed in chapter six that capital invested in accounting firms is not quarantined, but fully subject to the process of the average rate of profit.

## 2.2 Comparative analysis of 2005 data

By 2004, all the big four UK accounting firms had adopted LLP status. Their 2005 disclosures allow a comparative analysis for the first time. The figures are presented below (all in £ millions):

| | **Deloitte** | **KPMG** | **E&Y** | **PwC** |
|---|---|---|---|---|
| Turnover | 1,355.5 | 1,281 | 945 | 1,780 |
| Less: Operating Cost | | | | |
| Staff Costs | 490.1 | 558 | 392 | 769 |
| Other Costs | 432.8 | 418 | 328 | 542 |
| Operating Profit | 432.6 | 305 | 225 | 469 |
| Less: Interest Paid | 14.1 | (3) | 5 | (3) |
| Profit Before Tax. | 418.5 | 308 | 220 | 472 |
| Less: Tax & Minority | 3.2 | 1 | 0 | 4 |
| Profit After Taxation | 415.3 | 307 | 220 | 468 |

It is evident that all the big four firms are very profitable, with PwC, the largest firm in terms of turnover, the most profitable, and EY which is the smallest in terms of turnover, the least profitable. The operating costs to turnover ratios are as follows:

| | **Deloitte** | **KPMG** | **E&Y** | **PwC** |
|---|---|---|---|---|
| Staff costs to turnover | 36% | 44% | 41% | 43% |
| Other costs to turnover | 32% | 33% | 35% | 30% |
| Operating costs to turnover. | 68% | 77% | 76% | 73% |

The low operating cost ratio achieved by Deloitte is linked to the low staff to partner ratio presented below. Staff costs include the following components:

| | Deloitte | KPMG | E&Y | PwC |
|---|---|---|---|---|
| Salaries | 412.2 | 490 | 339 | 658 |
| Social Security | 43.6 | 48 | 31 | 71 |
| Pensions. | 34.3 | 20 | 22 | 40 |
| | 490.1 | 558 | 392 | 769 |

This shows that pension costs are a significant part of staff costs.

The summarised balance sheets for 2005 (all in £ millions):

| | Deloitte | KPMG | E&Y | PwC |
|---|---|---|---|---|
| Fixed Assets | 206.8 | 48 | 124 | 120 |
| | | | | |
| Current Assets | | | | |
| Debtors | 483.9 | 519 | 343 | 611 |
| Cash & Deposits | 26.4 | 145 | 120 | 227 |
| | 510.3 | 664 | 463 | 838 |
| Current Liabilities | 186.1 | 283 | 133 | 306 |
| Net Current Assets | 324.2 | 381 | 330 | 532 |
| Creditors: more than one year | 0 | 2 | 35 | 0 |
| Provisions for liabilities & charges | 250.3 | 71 | 334 | 95 |
| Loans due to members | 0 | 23 | 0 | 1 |
| | | | | |
| Total Net Assets | 280.7 | 333 | 85 | 556 |

As might be anticipated in an accounting firm, current assets are much greater than fixed assets and debtors are greater than cash. The current ratio of all the firms is in a healthy state, summarised below:

| | Deloitte | KPMG | E&Y | PwC |
|---|---|---|---|---|
| Current ratio | 2.7 | 2.3 | 3.5 | 2.7 |

One unusual feature of the balance sheets presented above is the size of some of the provisions. This emerges when we compare the provisions to the total assets of the firms, suggesting the possibility of unconditional conservatism (Bryer, 2009):

| | Deloitte | KPMG | E&Y | PwC |
|---|---|---|---|---|
| Provisions to total assets | 35% | 10% | 57% | 10% |

I consider the causes of this divergence in more detail below. The balance between numbers of staff and numbers of partners is:

| | Deloitte | KPMG | E&Y | PwC |
|---|---|---|---|---|
| Number of partners | 592 | 560 | 392 | 755 |
| Number of staff (average) | 6,740 | 7,876 | 6,000 | 11,689 |
| Support Staff | 1,827 | 1,060 | 1,294 | 2,065 |
| Total staff | 8,567 | 8,936 | 7,294 | 13754 |
| Staff per partner | 11 | 14 | 15 | 15 |

Deloitte has more partners per member of staff resulting, all other things remaining equal, in a lower wages bill and higher profit which explains the lower operating costs percentages presented above. The relative importance of audit work compared to consulting is:

| | Deloitte | KPMG | E&Y | PwC |
|---|---|---|---|---|
| | | | | |
| Fees Analysis (£M): | | | | |
| Audit | 415.7 | 357 | 476 | 861 |
| Tax | 386.4 | 317 | 272 | 514 |
| Consulting | 312.4 | 607 | 197 | 405 |
| Corp Finance | 241.0 | 0 | 0 | 0 |
| Total | 1,355.5 | 1,281 | 945 | 1,780 |
| Audit dominance | 30% | 28% | 50% | 48% |
| | | | | |
| Fees per staff | 201,112 | 162,646 | 157,500 | 152,279 |
| Profit share per partner | £701,520 | 548.214 | 561,224 | 620,000 |

The disposal of the consulting business in 2000 mentioned above partly explains the high audit dominance in EY. This evidence shows that accounting firms were not limiting themselves to auditing but, on the contrary, still pursuing a diverse product base. This trend continued and on 19th November 2007 the *Financial Times* observed that "all four are back in the top ten consulting fee earners".

To gain a deeper understanding of these disclosures and to ensure comparison is valid, it is necessary to examine more closely the provisions, which seem abnormally large in Ernst and Young. The big four accounting firms are labour intensive and labour cost, especially the pensions element (see figures above), is key to understanding the comparative disclosures. PwC partners make their own pension arrangements, separate from the partnership, and, as a result, have a low level of pension provisions. The other three firms, in contrast, operate both staff and partners' pensions and one peculiarity of the latter is that some former and retired partners receive pensions paid from future profits. The Statement of Recommended Practice (SORP) 'Accounting for Limited Liability Partnerships' dictates that full provision for former partners pensions is made in the balance sheet (*Accountancy* July 2002 p.102). This amounts to £201 millions in the Deloitte balance sheet, explaining the substantial provision (£250.3 millions) disclosed above. KPMG offered to buy out these future pensions for a fixed sum in 2004. The annual report for 2005 (p.59) says that "Annuitants covering provision of £47 millions at 30th September 2003 accepted this offer". This had the impact of reducing their provision for former partners' pensions to £65 millions. Ernst and Young have a provision for former members' pensions of £63 millions, but there is a further reason for their substantial provision, examined below. In summary, the position regarding former partners' pension liability is as follows

**Provisions for Former Members Annuities 2005 £ Million**

| | |
|---|---|
| Deloitte | 201.4 |
| KPMG | 65 |
| EY | 63 |
| PwC | 0 |
| Total | 329.4 |

Many joint stock company pension schemes are presently showing a deficient (Langley, 2004), and accounting firms are no exception. There are detailed disclosures in the notes to the accounts regarding these deficits, but one firm elects for a different treatment. E&Y discloses the deficit on staff pensions on the balance sheet and, consequently, the company has the largest provisions figure.

**Staff Pension Deficit 2005 £Millions**

| | | |
|---|---|---|
| Deloitte | £182 | Disclosed in notes |
| KPMG | £15 | Disclosed in notes |
| EY | £238 | Balance sheet |
| PwC | £298 | Disclosed in notes |
| Total | £733 | |

The total number of staff employed by the four accounting firms is 38,551 and on this basis, the total deficit represents an average £19,000 per employee.

The different treatments given to both pensions and provisions hamper comparison of the ROCE earned by the four firms. ROCE can however be calculated excluding provisions by simply dividing profits by total assets less current liabilities, rather than subtracting total liabilities.[52] When we combine this approach with allowing for partners salaries of £250,000, we achieve a fairer comparison of ROCE. The necessary calculations are set out below:

[52] This is facilitated by the fact that none of the firms is highly geared, nearly all the capital is partners'.

| | | | | |
|---|---|---|---|---|
| Unadjusted ROCE | 78% | 71% | 48% | 72% |
| Total assets less current liabilities | 531. | 429 | 454 | 652 |
| Profit after tax[53] | 415.3 | 307 | 220 | 468 |
| Number of partners | 592 | 560 | 392 | 755 |
| Partners Salaries Adjustment (£250k ) | £148 | £140 | £98 | £189 |
| Adjusted Profits | £267 | £167 | £122 | £279 |
| Adjusted ROCE | 50% | 39% | 27% | 43% |

The adjusted ROCE are lower than the unadjusted, but still far higher than enjoyed by stock market investors.

The adjusted ROCE provide a basis for direct and objective comparison between the big four accounting firms. It is immediately apparent that E&Y is performing poorly and two factors stand out as contributing to this, the high current ratio (3.5) and the higher level of audit dominance (50%). The fact that we can explain the differences in the rates of return by pointing to features of the individual firms helps to confirm the validity of the data, and shows the level of outside scrutiny and pressure for commercial performance that publication of accounts allows.

## 2.3 Comparative analysis of 2006 disclosures (IFRS basis)

The introduction of IFRS had some important implications for LLP accounting. The basis of many aspects of IFRS is the ‘economic income’ hypothesis where assets are the present value of future cash flows, and liabilities are the present value of future payments. A feature of an LLP is that partners must work in the partnership and a consequence of

[53] In this context profit after tax means after subsidiary taxes, not after the tax payable by partners

this is that retirement means leaving the partnerships and repayment of capital contributions. As a result, members' capital is a liability under IAS 32, a treatment that was widely queried in the accounting circles (Bryer, 2009) and beyond, since it fails to recognise the distinction between equity and debt.

The income statements prepared under IFRS took the following form:

| | **Deloitte** | **KPMG** | **E&Y** | **PwC** |
|---|---|---|---|---|
| Turnover | 1,559.4 | 1,454 | 1,130 | 1,980 |
| Less: Operating Cost | | | | |
| Staff Costs | 553.4 | 635 | 445 | 719 |
| Other Costs | 529.9 | 446 | 379 | 562 |
| Operating Profit | 476.1 | 373 | 306 | 699 |
| Add: Interest Received | 4.9 | 30 | 8 | 68 |
| Less: Interest Paid | 20.1 | -29 | 16 | 67 |
| Profit Before Tax. | 460.9 | 374 | 298 | 700 |
| Less: Tax & Minority | 2.7 | 0 | 0 | 10 |
| Profit After Taxation | 458.2 | 374 | 298 | 690 |

PwC remains the largest firm in turnover and profits and E&Y the smallest. The profit of every company is higher in 2006 compared to 2005. The 'operating costs to turnover' ratios are as follows:

| | **Deloitte** | **KPMG** | **E&Y** | **PwC** |
|---|---|---|---|---|
| Staff costs to turnover | 35.5 | 43.7 | 39.4 | 36.3 |
| Other costs to turnover | 33.9 | 30.7 | 33.3 | 28.4 |
| Operating costs to sales | 69.4 | 74.4 | 72.7 | 64.7 |

Further analysis of staff costs reveals the following:

| | **Deloitte** | **KPMG** | **E&Y** | **PwC** |
|---|---|---|---|---|
| Salaries | 475.5 | 556 | 388 | 722 |
| Social Security | 51.1 | 57 | 35 | 74 |
| Pensions. | 26.8 | 22 | 22 | (77) |
| | 553.4 | 635 | 445 | 719 |

PwC's operating costs ratio appears to have fallen considerably compared to 2005 (73%). This is "benefit changes agreed with the defined benefit pension scheme trustees regarding cash commutation arrangements and the capping of pension increases" (Annual Report 2006). As the benefits were reduced the pension liability reduced and this resulted in a one off credit of £122 millions. In comparison, KPMG did not deal with this through profit and loss account but instead disclosed it on the statement of recognised gains and losses (£14 millions). The low operating cost ratio achieved by Deloitte continued from 2005 is linked to the low staff to partner ratio.

Taking the technique from the 2005 disclosures above (with some reorganisation to increase comparability) and with the added point that members' capital and amounts due to and from members are excluded, the ROCE is:

| | **Deloitte** | **KPMG** | **E&Y** | **PwC** |
|---|---|---|---|---|
| Total assets less current liabilities | 461.1 | 416 | 509 | 585 |
| Add Back: Members' Capital | 114.2 | 40 | 0 | 5 |
| Less: Due from members | 14.6 | 101 | 77 | 17 |
| Add: Due to members | 0 | 35 | 0 | 0 |
| Adjusted Net Assets | 560.7 | 390 | 432 | 573 |
| Profit after tax | 458.2 | 374 | 298 | 690 |
| Number of partners | 599 | 556 | 435 | 793 |
| Partners' Salary Adjustment £250k | 149.75 | 139 | 108.75 | 198.25 |
| Adjusted Profits | 308.45 | 235 | 189.25 | 491.75 |
| Adjusted ROCE | 55% | 60% | 44% | 86% |

All of the rates of return are very high and represent increases on the 2005 figures. The exceptionally high PwC ROCE reflects the impact of the pension adjustment of £122 millions explained above. Adjusted for this the ROCE would be 64%. Viewed in the light of the average returns earned by shareholders, the return earned by accounting firms continues to appear as exceptionally high.

Using the same method, the 2007 return on capital is:

| | Deloitte | KPMG | E&Y | PwC |
|---|---|---|---|---|
| Total assets less current liabilities | 528 | 500 | 504 | 676 |
| Add Back: Members Capital | 123 | 41 | | 5 |
| Less: Due from Members | 26 | 114 | 59 | 19 |
| Add: Due to members | 0 | 31 | 0 | 0 |
| Adjusted Net Assets | 625 | 458 | 445 | 662 |
| Profit after tax | 562 | 447 | 326 | 702 |
| Number of partners | 641 | 559 | 473 | 822 |
| Partners Salaries Adjustment (£250k ) | 160.25 | 139.75 | 118.25 | *205.5* |
| Adjusted Profits | 401.75 | 307.25 | | *496.5* |
| Adjusted ROCE | 64% | 67% | 47% | *75%* |

The PwC return on capital falls because of the exceptional item in 2006. All the other firms experienced an increase in return on capital. EY did not disclose audit fees separately and KPMG did not disclosure the numbers of staff and, as a result, the usefulness of the disclosures is already starting to be eroded, for example, audit dependence and partners to staff ratio cannot be calculated.

**3. Testing the Marxist theory of accounting firms against LLP evidence**

The two hypotheses developed from Marxist theory of accounting firms are that they will behave like other capitalist firms, and that the level of independence is negotiated in the light of investors' need of disguise as well as accounting firm tactics.

With respect to the first hypothesis, the quantitative (accounting disclosures) and qualitative (nature of a UK limited liability partnership) evidence regarding accounting LLPs laid out above shows their capitalist nature. LLP status moves accounting firms closer to a plc type company and, as such, is an attempt to emulate the capitalist public limited company (plc). Although the extent of the limit on liability is not as great as a plc company, the LLP is much closer to a plc than the former accounting partnerships. Accounting disclosures made by accounting firms now use the same principles as stock market companies and use similar formats and levels of detail. The analysis carried out above shows that accounting firms' disclosures are broadly comparable with plc disclosures.

The disclosures reveal that partners' profit shares are high if we compare them with salaries in LLP accounting firms, salaries in plc accounting firms, and average salaries in the finance sector as a whole. The extent to which partners pay outstrips others provides evidence of capitalist exploitation but the work of partners also includes managerial and operational elements. When translated into the ROCE, the levels of return achieved by LLP accounting firms are high if we compare them to stock market companies as a whole and plc accounting firms. Evidence suggests that since 2003 partners' profits and profit shares have increased every year in line with the recovery in stock markets. There has also been a continuous expansion of the product range and reduction in reliance on auditing, reflecting a capitalist strategy. In short, there is evidence, both quantitative and qualitative, that accounting LLPs behave as capitalist firms.

The second hypothesis of Marxist theory of accounting firms predicted that driving the level of auditor independence was investors balancing the need for disguise against the need for objective data to monitor managers, while accounting firms balance the desire for profit against the need to maintain an image of professionalism and independence.

The evidence in chapter eight suggested an important theme was the pressure exerted by investors on accounting firms to retain an audit focus rather than pursue diversification. It also emerged that the voluntary disclosures made by accounting firms in 1990's focused SEC attention on audit independence and, in addition, accounting firms ceased making voluntary disclosures when their independence came under scrutiny. The present day LLP disclosures are far more detailed than the voluntary ones and the precise issue is what difference these detailed disclosures make to the process of negotiating audit independence. There are only three complete sets of disclosures published so a rigorous test of the audit independence hypothesis against a rich data set of LLP accounting disclosures is not yet possible. It is possible, however, to explore the narrower question of the extent to which the detailed accounting firm disclosures are consistent with the negotiated character of audit independence.

Effective monitoring (results control) is the key to the power of stock market investors and LLP disclosures provide investors with the ability to monitor the results of the large accounting firms. By accepting LLP status, accounting firms accept monitoring by investors and, therefore, accept a greater degree of results control. *Accountancy* described accounting disclosure as the "price" that has to be paid for LLP status, explicitly recognizing that the accounting firms trade off the safety of partners' capital against accounting disclosure and pressure to cut costs. The "price" paid for LLP is not merely the inconvenience and expense of disclosures, but the whole apparatus of stock market monitoring as well as the need to answer questions posed by regulators and financial journalists.

In exactly the same way therefore that investors use bonuses to reward managers for increases in profits and withhold bonuses to punish managers for corresponding reductions, the accounting disclosures facilitate investors rewarding and punishing accounting firms, making it easier for investors to achieve the right balance between audit independence and auditor control. Investors are still dependent on accounting firms for the technical aspects of disguise and monitoring managers, but the accounting disclosures deliver a bargaining chip to investors and deprive accounting firms the cloak of secrecy. Data on the extent of accounting firms' diversification and profits will make it easier for investors and regulators to focus accounting firms on audit rather than consulting by, for example, organising a discourse around auditor's excessive profits. In summary, the LLP disclosures are perfectly consistent with the power that investors retain over auditors.

An appreciation of the power that investors have over accounting firms is an important dimension of the political economy approach to accounting LLP's. Cousins *et al* (1999) and Mitchell and Sikka (1999) emphasized the power that accounting firms wielded when they successfully lobbied for the creation of LLP. Marxist theory of the accounting firm, on the other hand, shows that investors benefit from greater control over LLP in return for granting limited liability, identifying the limits of the power of accounting firms. Napier (1998, p.126) argued that the development of auditors' liability depended on the law of negligence as much as "fundamental matters of corporate governance". The Marxist approach suggests that the power of investors lies behind many apparent legal niceties such as LLP.

## Conclusion

The development of LLP status supports the two hypotheses drawn from the Marxist theory of accounting firms by revealing the capitalist nature of the accounting firms and the negotiated nature of audit independence. The introduction described the development of LLP as paradoxical because unlimited liability is an incentive to audit quality. However, once we understand that investors cannot allow, and have ways of preventing, auditors being completely independent, the paradox disappears. Investors face a trade off between auditor independence and auditor control. Thus, the increase in control investors enjoy compensates for harm that may come from a reduction in partners' incentive for independence. Because of LLP, investors have obtained a greater degree of results control over auditors in return for reduced partners' liability.

We can also understand the dramatic reversal in accounting firms' views of publishing their own profit and loss accounts when viewed in terms of this trade off. When the accounting disclosures are viewed as a trade off we need not assume that accounting firms have changed their view of the disadvantages of accounting disclosures, but may conclude they have accepted those disadvantages as the necessary "price" for safeguarding their capital. We can infer that the desire to safeguard capital outweighs the desire to keep profits secret in the minds of partners in accounting firms, despite the fact that this trade off increases investor's economic and ideological control over auditors. In this instance, the commercial imperative triumphs over professional ethics, illustrating partners' capitalist mentality (Bryer, 2000a). Viewing LLP as an explicit trade off also helps explain why some medium sized accounting firms retain partnership status.

# CHAPTER TEN

## Conclusions and further research

### Introduction

It would be futile to attempt to close this thesis by suggesting practical policies for solving the problems of auditing and accounting. The aim of the thesis is the development of a theoretical model which has revealed the irreconcilable contradictions in the accounting firm. A different type of study is required to develop policies for improving accounting and auditing. Consequently, this chapter briefly summarises the contribution to knowledge and explores two main ways of refining and strengthening the theoretical model: formalising the model, and historical research into the accounting firm.

A theme that runs through the different types of evidence presented here is the aggressive nature of the tactics employed by accounting firms, evidenced in mergers, diversification, expansion, creative accounting, partner's remuneration, profit margins, return on capital, relations with regulators (SEC) and connections with politicians (LLP). The further work suggested below is designed to gain a deeper understanding of this behaviour.

**The contributions to knowledge**

The distinctive contribution of this thesis stems from the fact that it combines Marxist political economy with dialectics. The theory of surplus value highlights the fact that accounting firms are in competition with all capitalist firms for a share of surplus value. I interpreted Bryer's "labour danger" (1993a) as the central contradiction in accounting and argued that disguise and objectivity, contradictorily, both play a part in accounting. The resulting theory of the accounting firm argues that they assist investors in disguising the rate of surplus value. The theory places accounting firms firmly in the financial context of capital markets, corporations and regulators. I showed that economists' and sociologists' theories of accounting firms tend to be incomplete, economists usually applying the "theory of the firm" (Yardley *et al*, 1992 survey paper), which allows accounting firms no exceptional and little social character, while sociologists' interpretive approaches (Dirsmith *et al*, 1997) have not theorized accounting firms in the context of capital markets nor articulated the role of their profits. A further strength of the Marxist theory is that it is a general theory of *all* accounting firms, not just large or medium sized firms, and a theory of the full range of services offered by accounting firms, not just a theory of auditing.

Marxist theory of the accounting firm shows that auditor independence is a variable driven by investors demand for disguise and accounting firm behaviour, combining the real and objective character of audit independence with its "legitimation" aspects. Sociologists have tended to limit their attention to legitimation and have not integrated the real or objective dimensions (e.g., Sikka and Willmott, 1995). Economists on the other hand have restricted their theories of audit independence to the need to limit the costs of litigation (Independence Standard Board, 1997), which is only one of a whole range of aspects of the issue. Most audit researchers, for example, Fearnley *et al* (2005), focus their attention on the role of senior managers in auditing problems, neglecting the role of investors.

PEA has made an important contribution to critical accounting research, but the two main models (Armstrong's, 1987a; Bryer's, 1993a) stand in contradiction regarding the influence of accounting over capital markets and corporations. The theory of the accounting firm developed here reconciles these two by showing that accounting firms compete with all other capitalist firms for surplus value while at the same time imposing accountability on managers and helping disguise the origins of profits. Increases in the general rate of profit bring out the manipulating character of accounting (Armstrong) while falls in profits reinforce its functionalist character (Bryer). A deeper understanding of the relationship between these two models has been achieved, showing that we can combine them by reworking Armstrong's theory at the level of "competition between capitals". The benefit of this reworking is that we can theorize "professionalisation" as a capitalist tactic before theorising it as a managerial one. This is important because the sociology of the professions has focused much more on the managerial aspects of professions (implicitly adopting a managerialist perspective) than their capitalist aspects. The reconciliation of Bryer's and Armstrong's work strengthens PEA and clarifies its links with the sociology of the professions, combining the two.

The agency theory developed in the thesis argues that managers' reactions to investors' controls and accountability represent secondary impacts. This is not to say that manager's strategies and tactics are not important or not effective, but we must understand them as a reaction to investor's use of accounting as a control system. Managerial power is not a trend nor a spontaneous reaction nor an emerging knowledge base, but a response by managers to the opportunities created by investors' need to spread risk and disguise the rate of surplus value, for example, by vague accounting. In Marx's model managers are, after all, workers specializing in the exploitation of others, and we must expect them to exploit investors when they can. The full richness and diversity of managerial work (and accounting) is best explored by allowing investors a range of tactics, methods of dealing with contradictions, driven by the rate of surplus value and social movements, which managers (and accounting firms) respond to in a range of different ways.

Bryer's (2006a) work represents a departure within political economy and in addition to strengthening PEA the thesis contributes to this in other ways. The idea of the ontology of connectivity provides a robust philosophical basis for political economy. Rubin's (1972, 1994) two-part interpretation of Marx's method shows how dialectics sit comfortably with empirical and historical methods. The apparent shift back to value theory is an important aspect of the resurgence of political economy, but many contributors have argued in favour of "qualitative" value theory and against quantitative. The thesis has criticized qualitative value theory (Sweezy, 1942; Elson, 1979), tracing the error back to neglect of Marx's distinction between capitalist development and capitalist production.

The thesis demonstrates that accounting firm mergers correlate with increases in profit margins, and demonstrates statistically that mergers are the main cause of the increase in concentration in accounting. It theorizes limited liability partnership status, demonstrating the limits of LLP status and arguing that it contradictorily exacerbates problems in auditor independence, facilitating investors' monitoring and control of accounting firms. When expressed as a rate of return on capital the profits of large accounting firms are high compared to other firms, consistent with their capitalist nature, perhaps reflecting a capitalist trust bonus.

**Formalising, refining and further testing the model**

The thesis does not present a formal mathematical model of accounting firms' profits because there is insufficient data to test such a model. However, if LLP disclosures continue there will soon be sufficient data. The thesis reveals many of the variables (average rate of profit, etc.) within the model and these can be presented in functional form with predicted sign and size of coefficients. The accounting firms' rate of return is positively correlated with the rate of surplus value, level of union militancy and the complexity of the accounting regime. The two main strategies used by accounting firms identified in this thesis are diversification of the product range into 'consulting' and increasing market share through mergers.

Stated in functional form the Marxist model of accounting firms' rate of return on capital employed (ROCE) is as follows:

Accounting firm ROCE = f (rate of surplus value, level of militancy, laxity in the accounting regime, level of consulting, market share)

All the independent variables are predicted to be positive and the largest coefficient is predicted, in the long run, to be the first.

More sophisticated models (for example, non-linear models), can be developed from this functional form and the audit fee determination literature, for example, Pong and Whittington (1994) highlights the types of models that are already available. Suitable proxies for the independent variables have already been identified in the thesis. Shaikh and Tonak (1994) have estimated the rate of surplus value, and Bryer (2008a) has pointed out that we can estimate it as gross profit divided by productive wages. Statistics are widely available on the number of strikes and level of union membership. Bryer's papers on the history of USA accounting debates show that accounting conservatism is a key aspect of a lax accounting regime. There are several ways this can be measured including profits compared to taxation, profits compared to cash flow and profits compared to share prices. The accounting firm variables can be measured directly from LLP disclosures.

As UK LLP accounting firms are now committed to regular accounting disclosures, a set of more than twenty-five observations of large accounting firms' profits will build up over the next five years. This data set will take the form of panel data which can be explored as a time series or a cross section. The success of this approach is dependent on variability in the data and the recent global downturn in economic activity will have the impact of providing the needed variability and turning points. Over the next ten years an even richer data set will become available and the best results will be obtained by waiting and accumulating more data before estimating a model.

There are several other ways of using the LLP disclosures without waiting so long. It would be possible to combine LLP disclosures with data from plc firm disclosures (i.e., stock market companies) providing commercial and financial services. If a dummy variable were used to differentiate the two, it would be possible to test the hypothesis that LLP accounting firms earn a premium. Another possible use of the data is the comparison of UK LLP data to other countries to identify international differences in accounting firms profits (there are presently no disclosures in USA and some limited disclosure in Australia).

Another future application of the UK LLP disclosures should be the examination of the relationship between large and medium sized accounting firms. The main debate in this area is the growing gap between the two and the extent to which this acts as a barrier to entry (Porter, 1990; *Accountancy*, October, 2007, p.5). Not all medium sized accounting firms have made the transition to LLP status so less data is available, however, some voluntary disclosures are made by old-fashioned partnerships and it may be possible to calculate concentration ratios and reveal long-term trends in concentration. It may also be possible to adapt the Lorenz Curve (Yamane, 1973) to the accounting context, helping reveal the trend in concentration. It is also possible to examine this question by using the techniques used in the audit fee determination literature. If a dummy variable is used in an audit fee determination model to represent the difference between a large and a medium sized firm, the size, sign and significance of the estimated parameter measures the power of the large firms over the medium sized. McMeeking et al (2006) have carried out some studies of this type on plc firm disclosures.

The thesis has argued that investors and regulators will make use of LLP accounting firm disclosures to monitor and control accounting. In the future it will be possible to test this prediction by examining regulators reports and the financial press, searching for evidence that the disclosures are used for monitoring and control. These searches can also be used to find other types of evidence about the negotiated and variable nature of audit independence, for example, changes in SEC audit regulations.

**History of the accounting firm**

The variables that underpin auditor independence are long run and historical evidence is therefore well suited to testing the model, building on the work of Bryer (2008a, 2008b) and Maltby (1999, 2009). On the other hand, historical work on accounting firms has so far been of little theoretical value, characterised by self promotion, ‘celebration’ and descriptive analysis (Cooper and Robson, 2009). A historical approach to accounting firms has potential, but must break decisively with the bulk of the existing auditing and accounting firm literature. The Marxist approach developed here provides a basis for making this decisive break. Cooper and Robson (2009, p.289) have called for accounting firm histories that focus on these firms as 'political and cultural actors'. The political economy perspective is capable of revealing the economic, social and political role of accounting firms and the debate about the relationship between Marx and Weber (Bryer, 2000a) provides a foundation for linking the economic and social (Marx and political economy) with the political and cultural (Weber and interpretive sociology). In this way accounting firm history can be made relevant to major theoretical debate.

Mathews *et al* (1998) started to explore the history of accounting firms and they found that an early accounting firm, Harmood Banner, was based in Liverpool, having close connections with shipping and banking.[54] The firm was involved in a major legal case (Astrachan Steam Ship Company and Harmood Banner, Accountant Law Reports, 17 March 1900, p.49). It would be possible to examine the records of this case and supplement them with comment from the Liverpool business press of the day, which is available in Liverpool Central Library, as well as comments in the newly emerging financial and accounting press of the time, to assess whether this firm indulged in disguise.[55] The major benefit of this line of enquiry, however, relates to sociological

[54] The earliest accounting firm was based in Bristol, Tribe Clarke and Co., traced back to 1790 (1998, p. 17). Harmood Banner began trading in 1805 and the name continued until 1974 (1998, p. 294).

[55] The Maritime Museum in Liverpool has an archive of letters, minutes and other records on Harmood Banner and its clients, including the Astrachan Steam Ship Company (Milne, 2000). The maritime trade was at the heart of the emergence of capitalist relations and time spent in this archive could uncover many other interesting sources and themes, for example, the development of double entry bookkeeping in Liverpool (Arnold and McCartney, 2008) or evidence of Bryer's (2000a) "capitalistic" accounting (consumable surplus).

theories of the accounting profession (e.g., Walker, 2004; Sikka and Willmott, 1995) explored below.

Walker (2004) investigated the emergence of the Incorporated Society of Liverpool Accountants (ISLA, 1870) using archive records. He concluded that relations with the legal profession in response to changes in bankruptcy legislation provided the main impetus for the development of the ISLA. Bryer (1997), in contrast, argued that in general limited liability had a close relationship with the development of accounting. Walker's scholarship is in the sociological and interpretive tradition of Sikka and Willmott (1995) and Dirsmith *et al* (1997), which benefits from being incorporated into a political economy perspective. This thesis has argued that professionalisation must be viewed as a capitalist tactic before it can be understood as a managerial one. The role of capitalist firms in using professionalisation as a legitimizing tactic is historically and logically (within political economy) prior to the development of professionalisation as a broader managerial "social mobility project". The exploration of the role of Harmood Banner in the formation of the 1870 society could therefore provide a test of this hypothesis and a basis for sympathetic critique of Walker's (2004) interpretive approach. It could be fruitful to re-examine the archives with the particular intention of understanding the role of Harmood Banner in the development of the ISLA and to ascertain the extent to which the society served the needs of capitalist accounting firms and capitalist investors, rather than simply a reaction to bankruptcy legislation and relations with the legal profession.

Sir Harmood Banner was active in national politics (Chandler, 1997; Harmood Banner, 2008) and an exploration of his activities, using local press reports and parliamentary sources such as *Hansard*, might open up connections between Liverpool and the national context. Further, Liverpool has witnessed many dock strikes and other labour disputes and it would be interesting to evaluate the role that Sir Harmood Banner played, looking for links between his activities and the 'labour danger'. In this way, we could fruitfully combine accounting history and labour history, covering both the 'Edwardian boom' and 'the great depression'.

Another possible approach would be a comparative study of the role of accounting firms in USA/UK accounting histories. Bryer (2008a, 2008b) provides the US side and Maltby (2007) has started to explore the potential of comparative studies.

**The future of the capitalist accounting firm**

My general conclusion is that the contradictions built into capitalist accounting firms are irreconcilable. The authorities will not solve them, but will manage, control and, as far as possible, contain them. The theory set out in the thesis provides a framework for understanding this dynamic process.

The chief drivers will be the rate of profit, the level of labour militancy, changes in the regulatory and accounting regime, the reaction of managers, and the particular tactics adopted by accounting firms. Many scenarios are possible. Marx (1959) predicted that the rate of profit would fall in the long run, and the evidence seems to suggest this time is near at hand (Brenner, 2008). The emergence of social movements, such as the green movement and anti-globalisation movement, will change the social and political landscape, and may hasten this outcome. Simultaneously, the development of global financial markets and financial innovation, such as exotic bonds, might continue to weaken the regulatory regime significantly. Partners in accounting firms could then realise that they have become a source of instability and risk, leading them to adopt less aggressive tactics. Alternatively, they might not! Although nobody can foresee the future, on the basis of the work in this thesis I predict that, however it turns out, the future development of the accounting firm will be driven by the variables it identifies.

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