

Edited by

**Srđan Marinković**  
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# **Rethinking Europe after the Economic Crisis**

**Lessons for the European Core and Periphery**



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## **Preface**

The volume “Rethinking Europe after the Economic Crisis – Lessons for the European Core and Periphery” came out as an outcome of joint effort of chapters’ writers, reviewers and editors. Twenty three authors were working together to accomplish this time-consuming task. It happened that working on this book brought together academics from twelve countries. This gives an international focus to the book.

The idea to write this book arose between editors in late 2012. We spent a whole year working together in writing, reviewing and revising chapters. At the time of launching this book we feel proud about the result. We do hope that the audience will share our enthusiasm about the book.

We strongly appreciate effort made by our reviewers (in alphabetical order): Benjamin Montmartin (GREDEC-CNRS, University of Nice Sophia Antipolis), Danijela Martinović (School of Economics and Business, University of Sarajevo), Metka Tekavčič (Faculty of Economics, University of Ljubljana), Miroslav N. Jovanović (Global Studies Institute of the University of Geneva), Nikola Gradojević, IÉSEG School of Management, Lille), Roman Matousek (Sussex University), Saša Drezgić (Faculty of Economics, University of Rijeka), and Tihomir Vranešević (Faculty of Economics and Business, University of Zagreb). António Portugal Duarte and Sylvie Rochhia, apart of being chapter writer and editor, respectively, took over also a part of reviewing task. They all are distinguished academics and highly recognized in their field of expertise. Their inputs were extremely valuable for the final quality of the book.

In the preparation of this book, we would also like to thank Ms. Marina Stanojević and Ms. Ivana Ranđelović for the technical editing of the book, as well as Ms. Miroslava Đorđević, for the proof-reading.

Editors  
Srđan Marinković  
Sylvie Rochhia



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# **Rethinking Europe After the Economic Crisis**

## **– An Overview**

**Srdan Marinković**

**Sylvie Rochhia**

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The volume assembles thirteen chapters, with each tackling the main theme of the book from different perspectives. Some chapters have rich methodological background, but some are more or less descriptive. The themes of chapters vary from those general in their scope to single country focused research or case studies. Nevertheless, they may be equally interesting to an educated reader. The themes of chapters are assigned according to authors' expertise and, being rather well written, bring the latest progress in each field. Taken together, chapters shed some light on the complex and ardent issues of European future in the hard times of crisis.

We begin with a brief description of the overarching logic that underlies the selection of the topics in this book and their sequence. The impact of globalization of market for goods, above all emergence of low cost producers, sharpening of global financial imbalances, as well as previous advanced countries' experience of steady growth and moderate inflation, are some features of today's world economy that we may take as plausible explanations of unprecedented financial growth and the following crisis experience (Hume and Sentance, 2009, 1444). The European crisis has several layers. Europe today is shaken by a banking crisis, sovereign debt crisis, economic slowdown, and even, in some part of it, real social crisis. Therefore, it is suitable laboratory for studying different socio-economic phenomena that colors economic disturbances. Our choice to start the book

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with discussions about the real economy is deeply rooted in our estimation that many troubles started right there. Insufficient growth potential of old Europe forced its financial community to look for profit outside of Europe. Superficially, it may look that the European crisis originated somewhere else and subsequently imported, merely as a financial type of disturbance. However, this might be only partially true. Moreover, in order to be effective, European crisis resolution undertakings must firstly look for seeds of the crisis sowed in the European backyard.

Therefore, we begin with the discussions about challenges for achieving sustainable and inclusive growth, as well as international competitiveness of Europe. In part I, we have included three chapters. The topic chosen to open this book is *European Integration – The Impact of the Global Economic Crisis on the Catching-Up Process*, by Tykhonenko. She tested  $\beta$ -convergence hypothesis for the heterogeneous European panel data. The Iterative Bayesian procedure delivers rates of real convergence for all enlarged Europe member states. There are clear cut subsamples with significant homogeneity of real convergence speed inside and diversity between them. The results are rather decisive about the conclusion that nowadays Europe drives at variable speed, with Central and Eastern European countries borrowing their growth trajectories over the transition period.

The chapter written by Vaidere, *Sustainable Macroeconomic Policy as a Precondition for Restoring Eurozone's Competitiveness*, is an overview of diagnosis and policy tools aimed to restore the competitiveness of the Eurozone members. The author argues that strong political commitment is paramount to ensure financial discipline and profound structural reforms of inefficient public administration, investment allocation, labor and capital market, stressing the importance of real convergence among the Eurozone members.

The final contribution to this part, *The Eurozone's Shelf Life – When it Expires?* by Ljumović and Pavlović, considers the growth dynamics as well as evolution of financial imbalances across the enlarged Europe. The main conclusion of the chapter is that countries grow rich and prosperous together, not at each other's expense, thereby tackling question raised in the previous chapters. The authors call for serious structural reforms not only on the level of monetary and fiscal policy, but also in the real economy.

Part II brings into the focus monetary integration as a strategic policy choice. The chapter of Bação, Duarte and Monteiro, *Portugal and the Euro – Past, Present and What Future?* takes up in the research focus the issue of monetary integration from the perspective of Portugal. The authors



employed vector-autoregressive (VAR) model using quarterly data for the period spanning from 1984 to 2012. The results suggest that the overall performance of the Portuguese economy would have been better if the country had stayed out of the Eurozone. In terms of specific macroeconomic fundamentals, the evidence are mixed, indicating higher economic growth, more balanced current account, and particularly less malign developments of public debt and unemployment, although the Eurozone option improves inflation performance and choices to solve the incipient financial crisis.

In chapter five, Fetai and Osmani deal with the exchange rate regime choice. Albeit single-country oriented, the study *The Role of Exchange Rate Regime in Small Open Transition Economies – The Case of the Republic of Macedonia*, has important indications for all the countries in which external sector plays inevitably important role for both stability and growth prospects. By employing vector error correction (VEC) model, on the quarterly dataset for last 16 years, the authors found strong evidence in favor of the peg. They found rather strong pass-through effect, indicating that more flexibility will probably bring the worse inflation performance with no real gain in terms of GDP growth.

Part III takes up the issue of credit markets, intermediation, and the real economy. This part opens with chapter written by Malović, provocatively titled *Polio or Premeditated Murder: The Curious Case of the Eurozone's Banking Union*. The issue of non-homogenous Europe, with so much interest to align, in this chapter is put forward in the context of clash between some national initiatives to protect national banking champions and the attempt to establish pan-European control over the European banking industry. By rectifying both the objectives and design of a Eurozone banking union, the author stresses political gridlock that threatens to endanger fully functioning banking union, which is supposed to rest on three pillars scheme: single rule-making and supervisory mechanism, common deposit insurance mechanism as well as single resolution authority.

The very nature of the worldwide economic crisis puts on the forefront of policy discussions the issue of credit crunch. The first chapter to address the issue of financial and economic growth nexus is the chapter *Bank Credit and Economic Growth – The Case of Portugal*, written by Alves and Simões. The authors explore annual data over the past four decades by estimating a trivariate VAR model with real GDP per capita, gross fixed capital formation (GFCF) and credit to the private sector, and applying Johansen cointegration, Granger causality and impulse response function analysis. The boom-bust pattern in bank credit to private sector has proved suitable laboratory for studying credit and economic growth nexus. The results give

partial support for the supply-leading hypothesis in the case of Portugal. There is unidirectional causality from bank credit to output growth, as well as the same way of causality from investment (GFCF) to bank credit. Moreover, impulse-response analysis indicates short-lasting positive effects. From the policy perspective, the authors suggest better access to credit in order to generate output recovery.

The relationship between credit growth and economy growth has two sides. The credit may and does influence output, but it may be also true *vice versa*. Analyses which look out for credit determinants turn the above relationship between credit and output on its head. This direction of causality is known as “demand-following hypothesis”. It follows in the chapter by Marinković and Radović, *External Determinants of Financial Development – A Causality Test*, which addresses the issue on the experience of Serbia. The chapter tested wider set of possible determinants of bank credit to private sector growth, for Granger causality, but with slightly reduced methodology. The authors found external determinants important for credit growth trajectory. Amongst various tested variables, some elements of uncovered interest parity proved significant in explaining the credit market developments. The authors conclude that an economy with close relations with the bigger neighbor must monitor what happens across the border and carefully take any step in policymaking that has a potential to misalign fundamentals, particularly those, which tackle fragile balance between stakes and interests of international financial community and local economy.

The final chapter in this part is Šević and Šević contribution *Does Financial Reporting and Audit Quality Support Economic Growth and Development? A Post-Modernist Re-Interpretation*. With more general focus, the chapter looks for missing parts in the economic growth jigsaw puzzle. The authors argue that today, more than ever before, the accounting and auditing profession is expected to support market economy by generating trust between companies’ insiders and outsiders, tax-payers and government officials, national governments and their supranational supervisors. However, trust rests on truth, which postmodernist accounting and auditing profession allows to be interpreted differently.

Part IV discusses the Western Balkan’s need to solve some issues on its road to the European Union. We start with the chapter *Global Economic Crisis and Regulation – What Can Western Balkan Countries Learn from the EU Smart Regulatory Agenda*, written by Penev. She underlines that the regulatory reform has been one of the main reform areas in the past decade in the Western Balkans. The reform aims at improvement of the competitiveness and economic growth, through the improvement of the legal and regulatory

environment. The author suggests that the Western Balkan countries should benefit from the EU smart regulatory agenda, which evaluates the impact of legislation throughout the whole policy cycle. Their regulatory reform strategies should be incorporated into their development strategies.

Above-mentioned reform of public administration is further discussed in the chapter entitled *The Challenges of Reforming Public Administration in Western Balkan Countries in the Accession Process to the EU*, by Joksimović. The reform is even of bigger importance for the Western Balkan countries, since those countries lagging behind Europe. The chapter examines the impact of internal and external determinants and their interactions on current and perspective trajectories of public administration reform in the Western Balkans.

The final chapter in this part is *Improving the Country Image as the Basis for Successful Involvement in the Integration Processes*, by Stanković, Đukić and Popović. The authors explore mirror image of Serbia, by using easily accessible, non-random samples. They found starlight effect present and suggest active rebranding in order to enhance accession process.

The book closes with the chapter *Economic Science in the Lights of the Development of the Economical Theoretical Imperialism*, by Petrović and Stefanović. It is the sole contribution that shed some light on the issue of contextual and methodological orientation of economic science. It may give us a clue why mainstream economic science gives no answer when answers are desperately needed. It follows from the analysis that the marriage of pure economics with bordering sciences may contribute to richer apparatus, and better understanding of “economic” phenomena. We would add that with a current methodological apparatus fellow economists get detailed vision, able to see clearly a narrow picture of the world. Something must be done to overcome “the crisis of vision in modern economic thought” (Heilbroner and Milberg, 1996).

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## Do Financial Reporting and Audit Quality Support Economic Growth and Development? A Post-Modernist Re-interpretation

Željko Šević  
Aleksandar Šević

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*It is generally accepted, nowadays, that reliable financial information is a prerequisite of a robust market economy and efficient public sector. This position has been strengthened by the recent financial crisis, where financial reporting has not been done up to the expected standard. In this chapter we consider the problem of ‘accounting for growth’. Accounting for growth is a term that has been launched in accounting theory, and generally is rather quite opposite to the notion of growth accounting championed by neo-classical economists. ‘Accounting for growth’ looks at the institutional framework in a particular defined jurisdiction, that regulates accounting, corporate reporting and – auditing.*

### 1. Introduction

The failure of a number of at the time leading companies – like Enron, WorldCom, just to name a few – have pointed to the issues of financial reporting and quality, and as an extension – auditing. The interest in the quality of financial reporting is not only expressed by the external users – primarily investors (to decide where and when to invest), but also the

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internal users – for instance company managers who need good quality financial information to make *informed* financial decisions. Lenders base their decisions as to whether grant a credit or not on the financial information provided. Regulators rely on the published information in the regulatory capture analysis, tax authorities in the tax audit exercise, etc. Although the classical theory emphasises the needs of the users external to the company, the practice shows that equally internal and external users are relying on the information provided. However, it is our (most likely reasonable) assumption that the internal users will always have more information than the external ones (see: Akerlof, 1970; Hoffer and Pratt, 1987).

Well-informed internal users may not necessarily contribute to the economic growth, but may ensure better allocation of resources. Investors, especially foreign investors who do trust financial information publicly provided, may decide to invest into the country and spur economic growth. From a societal point of view, citizens and tax-payers (or the wider civil society) would like to know whether their tax or investment money is being spent responsibly, and to serve as a check on governments and businesses when needed. On the aggregate all the interested parties do behave as the rational economic agents, and improved information availability does promote development in the private and financial sectors, and contributes to the accountability and efficiency in the public sector. The government should provide or ensure adoption of a sound accounting, reporting and auditing system. At the same time it should promote (and support) accounting profession, and continuously enhance efficiency of the public sector.

## **2. Is there a Role of the State in Economic Development and Does it Justifies the Current Extensive Regulatory Capture?**

How is the role of state in the economic development defined? There are many different attempts, many historical considerations, but despite being a hot topic for ages, it is very difficult to authoritatively outline the role of the state in economic development and as a promoter of growth. Finally, is it possible to say what constitutes a good government? Many international organisations (like OECD) attempt to define good governance in society by stressing the relative importance of social responsibility and accountability, but no one will attempt to say what good government is (see: Šević, 2005). In medieval times, it was believed that bad government was depicted by ruin, rape, robbery and murder. In the classical right-wing philosophy the government is there to protect a citizen from other forceful minority groups and allow him or her to live ‘normally’. The concept of ‘normality’ has been

usually associated with some kind of ‘natural order’, ‘natural law’ or ‘natural harmony’ (see: Dworkin, 2011; Finnis, 2011; George, 1994; Laing and Wilcox, 2013).

The State has three duties to perform: 1) to provide institutions (in the widest sense, establishing the rules of the game); 2) to provide income distribution (creating and sustaining the tax system) and 3) to promote economic growth (generally increasing the size of the pie which is shared within society). Although, the state may be, as an alternative view suggests, charged to ‘promote happiness or simply to prevent evil’ (von Humboldt, 1996, p. 19). However, traditionally, the ‘supply of institutions’ has been equalised with Smith’s invisible hand. But, the neo-classicals who base their claim on Smith, do not really regard institutions as proactive. They are rather given variable, beyond societal control. Basic institutions that we associate with the state are the system of property rights and effective and efficient law and order. Anything else the state will provide has, more or less, ideological connotations. Risk sharing and therefore enforced social redistribution is important for sustaining the stability of the state and society (especially if one sees the state as a form of concentrated society). Finally, combining the set of institutions and putting the state into a societal context can result in a ‘developmental State’. The State that shows the result must be able to choose the right business for the society, creating a comparative advantage in the right business. These two choices must be appropriately supported by a functioning infrastructure, standards, etc. A developmental state must provide skilled labour and entrepreneurship when or if in short supply. In the early phases of development a pro-active state can also create a demand within society and this activity gives good results.

Sombart in 1913 emphasised the importance of the creative spirit of man and the organisational capabilities of the state (see: Sombart, 1913). He also pointed out the function of State demand for luxury as a development tool. The State is there to emphasise the importance of education and knowledge in the society. This is not purely normativist, but it requires the creation of learned societies, wider access to education, regulation that respects intellectual and other property (definition of property rights, etc.). The establishment of a sound legal system and effective legal order is also a requirement that strengthens both the society and the role of state within the society. In certain stages of development the State can really be a development tool, especially when it comes to deadlock situations. A high wages strategy, that has the German underling idea (*‘Der Mensch und seine Bedürfnisse<sup>2)</sup>*) led to the situation where wealth maximisation within the

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<sup>2</sup> ‘The man and his needs’

society usually meant maximisation of national wages (and the opposite applies as well). Finally, it leads us to the final point that the State can be an entrepreneur and a capitalist of the last resort. When there is a lack of entrepreneurship in the society the State must act as an entrepreneur and offer the critical mass that is required for the successful national development strategies.

A proactive state develops and treasures new knowledge ensuring that there are positive systemic effects present. The state since the Renaissance onwards has been promoting and protecting new knowledge and innovation. However, as economic history is perceived only through the definition of classical exchange this relevance is lost. Namely, focus on production and accumulation of social capital is required to appreciate the role of the state as keeper of social knowledge and innovation made within the society. Emphasising, or rather over-emphasising the importance of perfect markets and perfect competition led us to view the social production in a short-termist manner. In the pursuit of a 'rational individual' the economists have lost, to a large extent, a sense of collective action. Moreover, in the time of bipolar world, collectivism was attributed to Communism and in the cyclical strict public scrutiny in the West it was not popular to promote positive collective actions, that were seen as destroying the very issue of individualistic, liberal capitalism (although in fact liberal capitalism has long been replaced by 'financial institutional capitalism').

In systems developed by Leibniz and Wolff there is very little conflict between individuals and common weal, as the increased knowledge capacity of an individual benefits the society. As Wolff observed some people collect money, while others collect knowledge. Renaissance scholars appreciated the knowledge, and it was for many of them a starting point. Ignorance was seen as the biggest evil. The state was again there to regulate and support positive social enterprises. Unfortunately, the renaissance notion that learning is able to create development was lost in the classical exchange economy. However, early scholars to a large extent failed to realise the relative importance of knowledge for different types of entrepreneurial activities. This led to conditions of obsession with industrial development (an over-focus on the manufacturing base). In those conditions our *Homo Faber*<sup>3</sup>, an ancestor of a modern entrepreneur, emerged. *Homo Faber*, being the innovator and producer, is opposite to *Homo Oeconomicus*, the (free) trader. Classical (Homo) economics focuses on exchange, accumulation, physical metamorphosis, equilibrium and optimality (Reinert, 1999). In an evolutionary system, no optimality exists, except as a target in the distance

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<sup>3</sup> 'Man the creator'



(Nelson, 1995). Within this framework, our man can be realised as *Homo Faber*, that is he (or she) can explore, invent and cumulatively and continuously create (new) knowledge. Through the process of acquisition of knowledge 'Man' can better himself (or herself) and passes on the acquired knowledge. In the process of passing on knowledge man must be given a chance to 'reinvent' the knowledge; that is to apply the knowledge in a fully innovative way. This is where our modern entrepreneur comes in; leading development, developing new forms of work and bettering the knowledge available.

By opening opportunities the state does supports the economic activity and motivates the economic agents to behave 'rationally' and choose to participate in value-making economic activity, rather than to speculate or remain passive and 'wait'. Waiting or investing in speculative activities certainly does hamper economic growth, and although short-term speculative activity may be tolerated, the long-term speculations do adversely affect the economic stability of the country. The modern state is omni-present, political and highly regulatory, even in the countries that may be formally pursuing Humboldtian 'minimalist state'. The participation of state/public sector in GDP ranges from the high 30s in the US to high 70s or 80s in the welfare states. Although the modern state has traditionally had very strong welfare elements, it is really a question to what extent the welfare state *per se* really contributes to the positive economic growth. Final consumption to some level does positively affect the economic growth, but very early may run into problem of increasingly diminishing returns and the need to intervene with measures of other kind to prevent economic problems.

Ideally, the State, of an optimal size (whatever it means in a respective national context) should create enticing, stimulating environment for the entrepreneurs, investors and other economic agents to initiate new enterprise and develop the existing one, ensured that the property rights are guaranteed, protected effectively and efficiently before the courts. The experience of Latin American countries with the effective registration and legal protection of property has had a very positive effect on the economic growth.

### **3. Importance of Accounting and Auditing for the Economic Growth**

The very perception of '*growth accounting*'<sup>4</sup> differs in the literature. In the 20<sup>th</sup> century's economic theory it has been linked with the 'reporting for

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<sup>4</sup> However, it should be noted here that Solow's work, although leading to the development of the term, was built on the work of others, and most notably Tinbergen (1942), Fabricant (1954) and Abramowitz (1956). It is clear now that Solow was fully aware of the



economic growth' and generally linked with the Solow's work (1956). The *technical change (advancement)* in Solow's extension work (1957) has largely contributed to the development of 'accounting for growth' in a neoclassical framework. Its central equation can be denoted as:  $y = zF(k, l)$ , where  $y$  is an output,  $k$  and  $l$  are the quality uncorrected inputs of capital and labour, respectively; and  $z$  is a measure of state of technology.  $k$  is defined using the perpetual inventory method. If both  $k$  and  $l$  were *homogenous*, this would have been a right way to proceed. In principle, separate measurement of  $k$  and  $l$  would (should) be possible, in contrast to  $z$  that cannot be measured (*cf.* Solow, 1956; 1957). However, the practice has taught us that both or either  $k$  and  $l$  are not homogenous, but it could be hoped for that at aggregate level would validate the procedure.

Further on, this approach regards all 'types' of  $k$  and  $l$  alike; which is especially visible for  $k$ , where all 'vintages of capital' are certainly treated alike; although the positive experience will tell us that the more modern machinery, would have better impact on the output, and hence growth. And, technological investment cannot happen without investment, which is good for supporting the economic growth. But this supposed link (old and new is good and contributes to the growth) cannot hold, as investment in new technology is not free. Also, the fact that the new technology requires 'new labour force' does complicate the situation even more – more advanced labour force is more expensive.

In fact, Solow's own suggestion to treat technical change as embodied in successive vintages of capital clearly (that the way to address the issue of the residual) had some appeal but seems to have been regarded as too difficult to implement in particular in terms of the econometrics of pinning down the rate of improvement of capital quality (see: Nadiri, 1970). Growth accounting has been seen as a procedure to measure the contribution of different factors to economic growth, and to calculate the rate of technological progress as a residual (in the economy). It has particularly been popular with the economic historians on the both sides of the Atlantic, studying the trends in national economy (see: Rostow, 1960; Denison, 1962; McCloskey, 1981; Feinstein, 1981; Crafts and Harley, 1982; Morrison, 1988; Crafts, 1995; Antras and Voth, 2003; Crafts, 2004; Mokyr, 2004). They have addressed some conceptual shortcomings of Solow's approach, most notably realising that far-reaching technological changes such as the invention of the steam engine raise the rate of growth of labour productivity appreciably only with a considerable lag. Second, the idea of the take-off

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contributions made before him to the economic growth literature, and largely has probably seen himself as summarizing the work and extending it further.

propagated by Rostow (1960) is seriously misleading as a description of the transition to modern economic growth in the old industrial economies (see: Crafts, 2004<sup>5</sup>).

However in this chapter we consider the problem of ‘*accounting for growth*’ (in contrast to ‘*growth accounting*’, championed by economists). Accounting for growth is a term that has been launched in accounting theory, and generally is rather quite opposite to the notion of growth accounting championed by neo-classical economists. ‘Accounting for growth’ looks at the institutional framework (settings) in a particular defined jurisdiction, that regulates accounting, corporate reporting and – auditing.

Although it really might be a common sense that the quality of financial reporting and quality of audit have positive impact on the attractiveness of a country to foreign investors; this was not necessarily contributed to the national institutional framework. In a neo-classical paradigm the institutions are given, and hence – disregarded. Institutionalists, in contrast do appreciate that different institutional settings, may in fact generate rather very different outcomes.

So, what good accounting and auditing should enable and what results/outcomes may be expected. Overall it is believed that good corporate reporting, accounting and auditing are crucial for promoting sustainable and equitable private sector-led growth and strengthening governance and accountability. If the financial corporate reporting framework is organised properly; it should then facilitate the access to finance, promote better business climate, enable further economic integrations, effective oversight of the economic agents, financial and economic stability, which would lead to higher level political stability.

Facilitating the access to finance is increasingly becoming a priority for most countries, especially those that are developing and transitional ones, as their financial, especially capital markets are rather shallow, and SMEs are usually those that suffer the most from the lack of funding. Traditionally SMEs are oriented towards the domestic financial markets, as they are small to access finance on the international market, and even if they pull themselves in the larger grouping the size will still be small to appear in the international financial arena.

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<sup>5</sup> Economic historians have not generally interpreted Solow's residual as a measure of technical change. In contrast they have argued that the total factor productivity's (TFP) growth can either over- or under-estimate technical change. Attempts to quantify components of Solow's residual, other than education, have not commanded widespread support (*ibid.*)

More importantly many industrial branches (like for instance – the oil and petroleum industry) have been subjected to mega mergers and hence crowd out those who are not of the size that allows them to execute sizeable projects that a particular industry may command. Improved financial reporting by SMEs would increase their chances of borrowing at lower rates, as it would provide banks and venture capitalists the access to standardised and reliable financial information (see: Rojas- Suarez, 2007). Many capital markets in developed countries remain underdeveloped and illiquid from an international perspective. A stock market is usually existent, but rather dormant or has very low trading patterns. If this is to change the financial information provided by those companies (public, listed, significant entities) has to be of impeccable quality and highly credible with the investors and all other interested parties. Investors do not like to get unpleasant surprises after they ‘enter’ the company and find out that the financial reports have not painted a proper picture.

Good corporate reporting improves the overall business climate, and consequently the governments that foster good business climate are as a rule more financially responsible; and hence are more positively perceived by international financial markets and ultimately rating agencies. Countries with good business climate index usually enjoy cheaper access to credit and can even more offer to the both domestic and international investors. Companies in countries with high investment grades have access to cheaper finance and from ‘institutional investors’ especially very risk-averse ones (like, for instance, pension funds) which may have investment strategy to invest only in the countries of the first group (usually the OECD countries). Further on good quality financial reporting allows comparability, especially in the modern business world where the International Financial Reporting Standards (IFRS) are adopted by an ever increasing number of countries. Similarly, good companies will report in IFRS and US GAAP allowing the international investors familiar with one, but not the other system to make necessary comparisons and conclusions.

Comparative financial accounting (corporate reporting) in the past has been more important, with the variety of national reporting framework, but with the increased international efforts for further convergence between the major systems – it is possible that we will be moving towards one prevalent set of international corporate financial reporting standards; hence enabling investors to understand the financial statements prepared in any jurisdiction. However, the mere adoption of the unified standard will not necessarily lead to the better business climate, as the issue of credibility of the statement prepared remains to be addressed. Credibility of the preparer and the quality

of the statements themselves are to be tested and to develop high level of trust into the submitted documents takes time.

The comparability of the statements generally leads to the higher level of international integration, as the investors in one country may be more prone to invest into another country, if the financial information provided has at least reasonable level of credibility. If one standard is to be applied in a number of countries, this would certainly promote regional integrations – an entrepreneur or/and investor do not have to switch to another reporting model, but can simply expand their activities across the border, with minimum hassle. This is for instance, why some international entities, like the European Union (EU) promote cross-border collaboration and would like to see that the issues of periphery and peripheral development within EU are addressed in an effective manner. Adopting common financial reporting standards not only lowers the cost of doing businesses for these companies, but also facilitates cross- border investments, as potential investors can easily compare financial statements from other countries using standards they are familiar with (see, for instance, amongst others: Hope, Jin, and Kang 2006; Covrig, Defond, and Hung 2007; Bradshaw, Bushee, and Miller 2004).

Lack of transparency generally makes SMEs less attractive to investors when they reach their growth limit and need external funding for growing, or even surviving. Also, the lack of transparency in operations of state-owned enterprise (SOEs) usually leads to irresponsible behaviour of these entities and usually to the further accumulating of debt, which ultimately will be picked up by the government, or ultimately taxpayers. In a country where SOEs are heavily subsidised, operate a ‘soft budget constraint’ and provide quasi-subsidies to the population (though low prices of their services) the tax payers are in fact double taxed – they pay their regular share of taxes, which will go up over time, as the government has to keep the SOEs afloat, even at the expense of ‘reasonable inflation’ (yet another financial burden). Certainly the better management of public funds can be assured if the state enterprises are better managed and made more accountable, not only in accounting terms. Similarly, better quality accounting does have a positive impact on the overall financial stability. For the central bank and/or other banking/financial regulatory authority is easier to supervise the system if they can trust financial information provided by the economic entities. Also, other users of the financial system have genuine interest to know that the financial institutions that they are using sound (economically and financially) and will not go bankrupt, leaving them experiencing losses. So, all depositors, investors, government bodies have interest to have the system operating effectively generating the financial information that is credible and

can lead to an appropriate decision-making by all concerned. As the failure of the financial institutions usually creates a greater social unrest, the government has the interest to avoid such situations and prevent bank-runs. Although banking crises can be very expensive (in some cases the bail-out has amounted to over 25 per cent of GDP), the instability of other financial institutions may in fact be more detrimental for the overall stability, as they might generate substantive systemic risk. Good governance models, supplemented by sound accounting and auditing practices, stringent compliance rules do provide a precondition for a sound financial system.

Appropriate accounting rules, as a part of the wider institutional setting do suggest that the country is most likely politically stable and sound. Historical development has shown that countries that have had robust accounting rules (or applied the international standards in a robust manner) have in fact been successful in demonstrating rather high level of political stability (and maturity). However, in most countries the implementation of accounting reforms has rarely been an easy task. In fact the entrenched interests have often hampered the speed with which the international accounting standards have been first endorsed and then later – applied. Often this is contributed to the different forms of ‘*corporatism*’ (see: Ottaway, 2001). The accounting profession itself has frequently resisted efforts to impose additional obligations upon its members. Finally, public (civil) servants may resist accepting the international standards that were written in an international financial centre (i.e. globally or for global use), which may not that easily accommodate local circumstances or differences in their countries. Also, the regulatory centralisation would prevent them from earning nice extra income they have had from ‘interpreting’ vague and incomplete national rules and regulations, for many private providers of consultancy and advice; as it has been the case in many developing and transitional countries. Overall, the benefit of internationalisation of corporate financial reporting may remain obscure to some social players; who will in turn try to prevent the implementation. However, even the development and implementation of national accounting standards have been subjected to the heavy ‘politicking’ (see, for instance, Stoddart, 2000).

Modern approach to development accounting suggests that the globalisation has certainly pushed forward towards the standardisation of accounting as a prerequisite for the international institutional competitiveness. In the past (according to the dominant neo-classical paradigm) the institutions were given, and as given they have not had much influence on development. However, institutions do matter and as such the countries in fact may compete on institutions, offering better institutional

structures to the potential investors, and other interested parties. In the globalised world, the markets are increasingly national, and traditional in-country competition shows the signs of internationalisation. Even traditional 'corner shops' may in fact face strong international competition sooner, rather than later. In such conditions the quality of corporate reporting not only influence the dynamics and depth of local financial market, but also the ability of the national firms to raise finance internationally.

#### **4. Perspectives on Quality: Accounting and Auditing**

Accounting has been regulated profession for over a century, and although not one of the traditional professions, it is nowadays rather stringently regulated. And, the State (or the Government in Anglo-American terminology) is increasingly more involved into regulating the profession and its *modus operandi*. Traditionally, self-regulation has been dominant in accounting, where the professional accounting organisations have been setting the rules and supervised its membership, ensuring the compliance with the rules. However, Enron, WorldCom and other perceived major financial reporting failures have led to the return of more direct state intervention and the further development of public oversight system. Traditionally, self-regulation entitled the professional organisations to control fully (if not exclusively) the entry, practice and exit from the profession, setting the educational, training and practising standards, i.e. criteria. In such conditions, the professional organisation has genuine interest to ensure that the profession delivers to the expectations of public and ensure that the public trust into the profession is maintained. Adverse practices were not condoned and those breaking them fined, and if necessary expelled. In fact, for rather long time the professional organisations were able to exercise their control and really maintain the high level of quality. However, the accountants have not been fully professionalised in all jurisdictions. Where they were not professionalised the public practice has been swamped by the non-qualified accountants and the quality of financial reporting was largely adversely affected. However, even in the jurisdictions where the accounting is a profession, non-accountants may offer accounting services, but cannot introduce themselves to the market using the titles reserved for professional accountants (chartered accountants, certified accountants, certified public accountants, and similar). Only in those circumstances they may be fined and exposed to the legal persecution.

In the case of auditing (statutory audit) the regulation has been more stringent. As the audit requirements are imposed on the significant



economic, public and listed entities. In other words, wherever there is an external investor involved the audit service is required and the requirement imposed by company law. The role of audit and assurance services is to provide reasonable assurances to the external stakeholders that the financial reports of the company fairly present organisation's position and performance and is done in line with the adopted professional standards. As we know from the theory, the external to the company usually faces information asymmetry problems. And, the lack of information or their poor quality usually puts off any serious investors, and does attract speculators. From a developmental point of view the speculators are really not very welcome, as although they may initially provide investments, in the longer run they do affect adversely the stability of the system. In fact, audit provides *ex post* assessment of the quality of accounting in an audited company; as we do not have *ex ante* proofs. Accounting profession itself still preserves some level of quality through self-regulation and internal monitoring; but increasingly this is difficult with large firms, with the significant market presence.

The International Auditing and Assurance Standards Board (IAASB), an international regulatory body that promulgates audit standards, sees that the quality is achieved when the auditor's opinion on the financial statements can be relied upon as it was based on sufficient appropriate audit evidence obtained by an engagement team that: 1) exhibited appropriate valued, ethics and attitudes; 2) was sufficiently knowledgeable and experienced and has sufficient time allocated to perform the audit work; 3) applied a rigorous audit process and quality control procedures; 4) provided valuable and timely reports, and 5) interacted appropriately with a variety of different stakeholders.

In the case of audit, we generally operate with International Standard of Auditing (ISA) 220 and International Standard of Quality Control (ISQC) 1, which regulate a particular audit engagement and the quality maintenance in an audit firm. ISA220<sup>6</sup> regulates (with other ISAs) the individual engagement and has been in application for a number of years now. ISQC1 is of a newer date and it is still in early stages of implementation – where firms involved in assurance and audit practices are expected to ensure the quality of their processes and procedures. ISQC1 focuses on the a few aspects of quality, most notably: 1) Leadership responsibilities for quality within the firm, 2) Relevant ethical requirements, 3) Acceptance and continuance of client relationships and specific engagements, 4) Human resources, 5) Engagement performance, and 6) Monitoring. Very importantly

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<sup>6</sup> Quality Control for an Audit of Financial Statements

the focus has become on the top of the firm, as the practices has taught us that the partners in the firms set the tone and direct the organisation in an appropriate direction. For instance, the mere pursuance of profit would certainly consider ethical issues as of secondary importance. Or if the partners disregard the audit standards, it is very unlikely that the quality will be upheld by the staff themselves. Ethical issues are to permeate the engagement and processes within the firm. If any of the participants is concerned with an ethical issue, he or she should be in a position to address concerns in an appropriate manner within the firm, and have a senior person in the company making an appropriate decision. Conflict of interests is again strongly on the agenda, and it is reasonable to expect that these issues will be considered very carefully.

The company's audit would depend on the quality of people it is able to engage. Namely, the recruitment and retention are now in the focus, where the companies are to attract staff, cultivate them and retain them. High staff turnover, very present in many industries, is not seen as good practice in auditing (although quite often practiced especially at the bottom of the large/leading audit firms). It takes considerable time to train a (good) auditor, and having a high staff turnover certainly does not command confidence into the company. Audit is a service that largely depends on the quality of staff engaged and their ability to maintain their professional competencies and keep abreast of the development in the discipline. IFAC member organisations/institutes require their members to maintain the high level of professional competence and professional accountants are required to attend minimum 40 hours of continuous professional development (CPD), where at least 20 are structured. Although the professional body monitors the professional development, it is up to firm to create an environment in which members would meet these requirements.

Although audit engagement is primarily defined by ISA 220, ISQC1 spells out what the firm should do to ensure that the individual engagement rules are observed and implemented. Art. 1.32 clearly states that: *'The firm shall establish policies and procedures designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and applicable legal and regulatory requirements, and that the firm or the engagement partner issue reports that are appropriate in the circumstances. Such policies and procedures shall include: (a) Matters relevant to promote consistency in the quality of engagement performance; (b) Supervision responsibilities; and (c) Review responsibilities.'* The responsibility pyramid is to be enforced, as the experienced members of the team are responsible for the learning and



performance of the inexperienced/less experienced members of the team. Team work requires consultations, both within and outside the firm, in order to provide the best service to the client and achieving the public interest (as the audit, although private/commercial(ised) service, it is conducted in public interest. However, in line with the principle of ‘tone at the top’ the engagement partner must take the full responsibility for the work of the team and also make the final decision regarding all the inputs within and outwith the audit team. Planning and supervision are to play a major role in the conducting the audit, allowing the firms to take a longer view and prepare better for undertaking audit activities. Again one should appreciate that the (statutory) audit is a commercially contracted service, which is done, ultimately, in the public interest.

ISQC1 has also emphasised the role of consulting and resorting to collaboration amongst accountants, i.e. auditors. The consultation should be encouraged primarily within the firm and only if there is not enough capacity within the firm, the focus should be on the engaging with the resources outside the firm. However, it does not mean that the consultation could and should not have been undertaken outside the firm immediately, should this have a positive impact on the quality of the audit output/outcome. Focus should be on the significant, difficult and contentious issues, where the consultation can assist in better understanding of the issues. What makes ISQC1 even more attractive is that it has been drafted in a rather practical manner, giving examples when some of the auctions should be undertaken, although leaving this to a particular audit company to decide on the format and the policy.

Quality is also assured through the regulating the difference of the opinion. It is reasonably expected that ‘the firm and its partners and staff take any steps necessary, according to firm and professional standards, to adequately identify, consider, document, and resolve differences of opinion that may arise in a wide range of circumstances’ (ISQC1). In practice the firm has to produce policies that will address these issues and provide guidance as to how the potential conflict would be mitigated and resolved. It is possible to imagine that there would be differences between different members of the engagement team. However, only if there are significant differences, that may influence the outcome of the audit – the issue does attract attention. The process has to ensure that the top of the firm is involved should it become necessary to resolve the issue. This is one of the rare instances, where the engagement partner may not be the decision-maker of the last instance. The firm’s policy must protect the member of staff who has raised the issue, and ensure that no retribution is made, or any career

limitations imposed. However, it is also stated that a member of staff should seriously consider the consequences that the conflict may have on the reputation of all involved.

Quality reviews are now expected and should be done within a firm, or if the firm is small to engage a professional outside the firm. In some cases Engagement Quality Control Review (EQCR) will be more or less compulsory, whilst in others there may be more latitude in choosing whether or not the review should be conducted. In the case of significant clients, the firm does not have a choice, as EQCR has to be conducted. In the case where the audit revenues from one client are greater than 10 or 15 per cent the firm should institute that the EQCR should be compulsory. Choice of a person in charge of quality review has to be paid particular attention. In fact, the firm should establish criteria for the appointment of any quality control reviewer (QCR) for engagement. The person should have a superior specialist knowledge, wide experience and ability to engage with the work (enough time for completing the job appropriately).

The failures in corporate financial reporting and audit have raised the issue of quality of work done by both accountants and auditors. However, as the companies were public entities, the failure of the auditors to notice the errors (or fraud), have undermined the public trust in the publicly made information – which further have undermined the trust into a financial markets – and consequently undermined one of the main pillars of market economy – or ‘capitalism’.

## **5. A Post-Modern (Re)Interpretation**

Accounting *per se* is a rational category. However, the large societal, technological, political, economic and other changes have generally led to the re-examination of the way how we see ‘reality’. In other words, the society has entered the new era – era of postmodernism (see: Harvey, 1989; Pippin, 1991). However, the theoretical framework of postmodernism does not recognise the existence of universal laws and great theories (see: Montagna, 1997). Postmodernism represents a loss of faith in the grand theories (meta-narratives) of modernity, such as the dialectics of spirit, hermeneutics of meaning, emancipation of the rational and working subject, creation of wealth (Lyotard, 1996).

Within the framework of postmodernism the emphasis has also been shifting from objectivity to subjectivity (see: Shin, 1994). Postmodernism has been occupied with ontological questions (in contrast to modernism that explored epistemological ones), exploring the relationship between mankind

and reality (see: Harvey, 1989). Everyone constructs his and her own reality and it is not possible to compare all the 'individual' realities, because there are no independent criteria on which to base such comparison. Postmodernism assumes a multiple realities, and all of them are influenced by metaphysical matters, such as traditions, values and norms. However, the importance of language and appreciation of metaphysical influences opens the problem of 'commensurability'. In other words – how, or how much one can immerse him/herself in another culture, tradition, language, to expand the boundaries of what we would consider knowledge? Within the postmodernist paradigm it can only be addressed through communication and discourse. In fact, the task of enquiry is to keep the conversation going, within the framework of normal and abnormal discourse. And, interdisciplinary research (discourse) is an approach that is favoured in the postmodernist tradition.

However, as the postmodernism refutes the very possibility of discovering the origins of the self, and gives the multitude of the answers – it prevents one to define postmodernism in accurate and comprehensive manner. In fact, we do face three anomalies, first being that the definition per se is a modernist concept, and hence contrary to the very nature of postmodernism. Secondly, as our ideas are expressed through (our) language, which is founded on modernism, it does limit our ability to express ourselves as postmodernists. Finally, any attempts to reconstruct a historical review of events and ideas that lead to postmodernism is in fact leaning towards modernism (see: Arrington, 1997; Montagna, 1997). At the very end second and third criticism can be somewhat 'rationalised', whilst the very first remains open and unresolved. Attempt to define postmodernism, in fact refutes the very basic principles of postmodernism and promotes – a modernistic methodological approach.

Postmodernism postulates that truth is contextual, rather than absolute (see: Cahoon, 1995). One person's truth is equally valid as the others. There are many possible truths, existing in parallel, and there is no 'pecking order' amongst them. Hence, the definition is difficult, if not impossible – opening a question whether something actually exists or is it illusion or myth (individual and/or collective). Giddens (1990) claims that the postmodernism is in fact modernity coming to terms with itself. In the context of accounting, the search for the postmodernist concepts has been on-going. Networks, liberalise, disorganise are the concepts that can be easier understood in the postmodern, than modern tradition. The emphasis on informality and flexibility are certainly economic contribution to postmodernist theory, as Harvey (1989) states that the mode or regulation in the postmodern

organisation is flexible accumulation. Nohria and Berkley (1994) perceive the postmodernist organisation as a virtual organisation in which the hard copy file is replaced by electronic records, face-to-face communication is replaced by electronic exchanges, and the organisation is not structured around human beings, but around information, and so on. The boundaries of the organisation disappear due to increased networking, and job descriptions are replaced by global, computer-enhanced and cross-functional tasks.

Accounting is modernist concept as the principles on which the accounting is based, are modernist: reliability, faithful representation, neutrality, completeness, and true and fair presentation (view). However, the problems of *interpretation* clearly show that we do face the issues of interpretation that is language and culture biased, and does limit to some extent the overall understanding of the accounting regulation. The accounting profession does spread the knowledge, rather than control it, as it has been the case with the modernist profession. Diffusion and dissemination of knowledge does become the major professional driver, in the context of postmodernist (accounting) profession. As we have always had somewhat clear cut between theoretical (scholarly) accounting and accounting profession (practice) – the practical delineations have suffered as well, as ultimately the accounting has been essentially very pragmatic in nature.

## 6. Conclusion

Accounting has still remained within the modernist paradigm. This can be drawn to its historical roots, as it emerged due to the need to keep a record of what is owned to economic agents. Accounts have to be objective, true and fair and represent the truth about the financial state of the organisation. Hence, it is difficult to allow that the differences amongst the ‘truths’ blur the objectivity of the accounts produced and later audited. However, the way we see the information still remains rather personal, and even objective accounting information (whether audited or not) will be understood differently by different information users.

Assuming that the postmodern(ist) profession is to spread the knowledge, rather than to control it, one may in fact assume some degree of freedom of interpretation. A professional accountant is required to exercise his/her professional judgement and make appropriate decisions, which may from time to time differ from the ‘dominant’ view(s).

Rules are rationally initiated, but how they will be seen, understood and implemented is rather different from one jurisdiction to another. Although international standards promote only one standard of service/quality, their

interpretation, more or less, differ from one jurisdiction to another. This is one of the main reasons why internationally endorsed and promoted standards do not have the same reach across the board. However, international standard setters are still proliferating more and more regulations, extending the regulatory capture and ensuring the higher level of consistency amongst the rules. And, although the rules are still rational/modern, the interpretation is becoming increasingly postmodern, suggesting that language, culture, experience do influence the way in which the very rules are understood, interpreted and finally – applied. In postmodernism it is necessary to reduce not only the ambiguity of the term itself, but also the wide scope that comprises ambiguous phenomena (Alvesson, 1995). Rokeachian perspective implies that behaviours are best explained by the entire value system (Thompson and Troester, 2002), but in the process of accounting convergence it is necessary to include the cultural component and evaluate to what extent local practitioners and lawmakers are willing to accept changes. The postmodern science seems to have provided fragmented solutions, but the globalisation drive is strong in various areas, including trade, investments, or, recently, security concerns. It is evident that higher transparency and commonly accepted international standards would facilitate and further promote some of these processes.

The increasingly growing interest in quality within the framework of (post)modernist profession suggests that the regulators are aware of the limitations of regulating issues across the board and are focusing more on a ‘boutique’-like regulation – where, through the policies and other internal implementation documents would be allowed the implementing organisation to customise the general framework to its specific needs. Also, another problem that the professional accounting (and auditing) organisations/institutes face is that the quality is increasingly seen/understood as *compliance*. As long as the documentation can be produced, in line with the current regulations/standards, the (audit) firm has demonstrated the quality. This mechanistic approach in a long-run may be ineffective, but in the short-run does serve the purpose of quality proxy. In fact, focus on compliance can be seen as a modernist instrument of controlling the postmodernist interpretations. Disseminating the knowledge and practice, developing national implementation practices certainly in the longer-run will contribute to the higher international integrations, without losing national characteristics. But, as always with the international regulatory captures, it is difficult to envisage future steps, even if the general directions are known (*Cf.* Colombatto and Macey, 1996).

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