STANDARDIZING FINANCIAL REPORTING REGULATION: WHAT IMPLICATIONS FOR VARIETIES OF CAPITALISM?

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ABSTRACT

Financial reporting is a powerful practice that shapes social and economic processes. This paper argues that there are fundamental reasons against current attempts to establish a single set of global financial reporting standards, moreover tailored to the needs of stock market-based capitalism. Evidence shows that there exists more than one way of doing business. Social market economy, for instance, is one of the founding principles of the European Union. Standardizing financial reporting onto a single economic model could therefore harm alternative forms of capitalism. It is at time of great uncertainty and change that the advantages of variety can be appreciated. Consistent with this view, this paper claims that the optimal design of financial reporting regulation should depend on the specific institutional characteristics of the economic and political systems.

KEYWORDS: Financial Reporting, Varieties of Capitalism, European Union; JEL CLASSIFICATION: M4o, P00, K00

About the Author

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1. INTRODUCTION

The recent economic crisis has given rise to a wide criticism on stock market-based globalization. Along these same lines, this paper argues that there are fundamental reasons against the wisdom of current attempts to establish a single set of financial reporting standards suitable for all the world. In doing this, it focuses on the European Union and sets the discussion within the framework of the Lisbon Treaty (also 'Treaty' hereafter).

The Lisbon Treaty defines the constitutional setting of the European Union, establishing its founding principles and objectives. According to the Treaty, the European Union shall work for a sustainable development based on a highly competitive social market economy aiming at full employment and social progress.

Social market economy represents the economic and social model on which the European Union has decided to build and shape its own future, and proves that there exists more than one way of doing business.

This paper discusses in detail the potentially destabilizing effects of IFRS adoption on social market economies. It shows that IFRS in general and, more specifically, fair value reporting can have detrimental effects on long-term investments, which have been crucial for gaining and maintaining competitive advantages in many social market economies in the European Union. Fair value reporting is also supposed to exacerbate contagion effects among banks, which are core to the European financial system, and to amplify procyclicality and credit crunch, with relevant consequences on real economy.

Current attempts to establish a single set of global financial reporting standards, accommodated to the needs of liberal stock market economies, therefore are not neutral and risk doing harm to alternative forms of capitalism.

The Lisbon Treaty also provides a political construct of the European Union based on federalism. Federalism grounds on a pluralist conception and is conceived as a way to unify different peoples for important but limited purposes, not as a way to destroy their political identities. Prior to IFRS adoption in the European Union, financial reporting for listed companies was regulated by directives. The directives guaranteed the harmonization of financial disclosure, but also allowed European countries to take into accounts the specific characteristics of their socio-economic settings. As a result, the directives were able to conjugate unity and diversity, which is a basic principle in federalism.

According to this paper, the European Union should go back to such an approach in regulating financial reporting issues, and should also promote it at an international level. Rather than accepting European economies to standardize onto a single economic model, the European Union should pursue every effort to target its objective of realizing a social market economy, as it is set out by the Treaty. Consistent with Bertrand Russell (1919), ideals are defined by politics and come first, actions must follow accordingly.

The remainder of this paper is structured as follows. Section 2 describes the main attempts to establish a single set of global financial reporting standards tailored on the needs of liberal stock market-based economies. Section 3 discusses the main characteristics of social market economy, which has been set out in the Lisbon Treaty as a founding principle of the European Union. Section 4 raises several issues that call into question the consistency of IFRS with social market economies. Section 5 discusses the sovereignty paradox of the standards-setting process, while Section 6 provides some conclusions and policy recommendations for the future.

2. THE WISDOM OF A SINGLE SET OF INTERNATIONAL FINANCIAL REPORTING STANDARDS FOR ALL THE WORLD

On January 2005, all listed companies in the European Union started using IFRS set out by the International Accounting Standard Board (IASB). IFRS were introduced in the European Union by the European Parliament and Council Regulation No. 1606, 19 July 2002, which mandates IFRS for consolidated financial statements of listed companies, with a member state option to apply IFRS to other reporting entities. A certain number of states - such as Italy, Belgium and Portugal - have extended IFRS to unlisted banks, insurance and supervised financial institutions, while others - such as Cyprus and Slovakia - require IFRS for all firms. Some other states - including Italy, Cyprus and Slovenia - have also extended IFRS to separate financial statements of certain types of firms. There is also a clear intent on the part of the IASB to push to extend IFRS to all unlisted firms, with the purpose of avoiding inconsistency within the accounting practices of individual countries (IASB, 2009).

One of the purposes of mandating IFRS was to standardize accounting language at a European level and to introduce a single set of high-quality global accounting standards that could be recognized in international financial markets.

Regulation 1606/2002 is very much focused on capital markets. According to Regulation 1606/2002, adopting IFRS should ensure a high degree of transparency in financial statements, which should - in turn - lead to more effective and efficient functioning of capital markets. The same holds for the IASB, which is very focused on equity investors, who are considered to be those most in need of information from financial reports. Moreover, the IASB assumes that, as investors provide risk capital to firms, the financial statements that meet their needs also meet most of the needs of other users (IASB, 2010 BC 1.16).

The IASB's approach to financial reporting is very close to the Financial Accounting Standards Board's (FASB) one[1]. Indeed, the IASB and the FASB have several joint projects aimed at promoting financial reporting's convergence at the international level.

The wide use of fair value accounting under IFRS must be considered in this perspective. Fair value accounting is one of the most important innovations in financial reporting in the European Union, and represents the main difference between IFRS and the former European regulation. Fair value is supposed to provide investors with better information to predict the capacity of firms to generate cash flow from the existing resource base, thereby improving the quality of information for decision usefulness (e.g. Barth *et al.* 2001). Both the IASB and the FASB have made clear their view that fair value is likely to become the primary basis for financial reporting in the future (Jordan *et al.* 2013). Along these lines, in 2009 the IASB issued IFRS 9, *Financial Instruments,* which extends the use of fair value for financial instruments. In 2011, the IASB issued IFRS 13, *Fair Value Measurement*, which provides a single framework for measuring fair value. IFRS 13 is the result of a joint project conducted by the IASB together with the FASB, which however resulted in a passive alignment fair value definition, measurement and disclosure to the US FAS 157.

By adopting IFRS, the European Union, which is the second largest capital market in the world, has delegated standards-setting to a private body, the IASB, over which it has no control (Sinclair, 1994; Cutler et al., 1999; Hall and Biersteker, 2002). To address this issue, Regulation 1606/2002 contains an endorsement mechanism that should guarantee that, among different conditions, IFRS are conducive to the European public good, which – however – has never been defined clearly. The endorsement process involves many institutions at a European level. One of these is the European Financial Reporting Advisory Group (EFRAG), which is a

[1]The FASB is the organization responsible for setting accounting standards for public companies in the United States.

technical advisor group that assists the European Commission in this process. So far, the EFRAG has always given positive advice on IFRS, recommending their adoption in the European Union (Maystadt, 2013). As will be discussed, this paper raises several concerns over the appropriateness of the current standards-setting and endorsement processes.

3. SOCIAL MARKET ECONOMY AS A FOUNDING PRINCIPLE OF THE EUROPEAN UNION

This paper argues that since financial reporting is one of the competences of the European Union, financial reporting regulation must be examined within the constitutional framework of the European Union.

The constitutional setting of the Union is provided by the Lisbon Treaty, which defines the inspiring values and founding principles on which the Union has decided to build and shape its future. The Lisbon Treaty also provides the key conception of "European public good", on which the EFRAG reports.

The Lisbon Treaty came into force on 1 December 2009. It was the outcome of a long and lively debate on the future of the European Union, which started in 2001 at the Laeken European Council and was focused on what kind of economic and social model the European Union would pursue.

The Lisbon Treaty goes beyond the Maastricht architecture of a simple economic and monetary union, establishing the basis for a new economic, political and social governance. For instance, it enshrined a Charter of Fundamental Rights into the European Union's constitutional order for the first time.

According to the Treaty, social market economy is one of the founding principles of the European Union. In fact, the European Union "*shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress*" (art. 3 TEU[2]). Moreover, "*it shall combat social exclusion and discrimination, and shall promote social justice and protection*" (art. 3 TEU).

There is general agreement that the Lisbon Treaty looked to the Rhenish variety of capitalism in setting the social market economy as a guiding principle for the European Union (Glossner 2014). The Rhenish variety of capitalism refers to coordinated market economics

[2] TEU is the acronym for "Treaty on the European Union".

(Hall and Soskice, 2001), whereas the Anglo-Saxon variety refers to liberal market economics. These two models have been developed on the basis of United States and western Europe, while further models are necessary for other economies.

According to the literature, the defining characteristics of the Rhenish model typical of Germany and the Scandinavian Countries are the consensual - for the most part - relationship between labour and capital, the supporting role of the state, and the availability of patient capital provided by the bank system or internally generated funds. These characteristics have been key in developing a long-term perspective on economic decision-making, high skilled labour and quality products based on incremental innovation, each at the basis of post Second World War Germany's economic success (Albert, 1993; Hall and Soskice 2001; Fiss and Zajac, 2004; Perry and Nölke, 2006).

The Anglo-Saxon variety of capitalism, instead, is characterized by comparatively short-term employment, the predominance of financial markets for capital provision, an active market for corporate control, and more adversarial management-labour relations. Given these characteristics, the Anglo-Saxon business model is also called stock-market based capitalism.

Specifically, the term 'social market economy' originates from the post-World War II period, when the shape of the 'New' Germany was being discussed. Social market economy theory was developed by the Freiburg School of economic thought, which was founded in the 1930s at the University of Freiburg, and received major contributions from scholars such as Eucken (1951, 1990), Röpke (1941, 1944, 1946, 1969) and Rüstow (1932, 1960).

In the definition of Müller-Armack (1966), a social market economy seeks to combine market freedom with equitable social development. Social market economics shares with classical market liberalism the firm conviction that markets represent the best way to allocate scarce resources efficiently, while it shares with socialism the concern that markets do not necessarily create equal societies (Marktanner, 2014).

As highlighted by Glossner (2014), a social market economy is not a dogmatic, but a pragmatic concept that implies that conscious and measured state intervention is contingent on economic and social circumstances.

According to social market economics, a free market and private property are the most efficient means of economic coordination and of assuring a high dose of political freedom. However, as a free market does not always work properly, it should be monitored by public authorities who should act and intervene whenever the market provides negative outcomes for society. The social dimension is essential not only for society as a whole, but also for the market to work well. Market efficiency and social justice do not represent a contradiction in terms, as is proven by Germany's post-World War II economic miracle (Spicka, 2007; Pöttering, 2014).

In a social market economy, public authorities must set out the rules and the framework, acting as the referees that enforce the rules. A strong public authority does not assume a lot of tasks, but a power that keeps it independent from lobbies, for the sake of general interest (Gil-Robles, 2014).

Consistently with this view, the Lisbon Treaty contains a 'social clause' requiring the European Union, in conducting its policy, to observe the principle of equality of its citizens, who shall receive equal attention from its institutions, bodies, offices and agencies. In order to promote good governance and ensure the participation of civil society, decisions shall be taken as openly and as closely as possible to citizens (art. 15 TFEU[3]). This should prevent the European institutions from being influenced by special interest groups. The Treaty also highlights the importance of social dialogue, which is one important pillar of social market economy (art. 152 TFEU). In fact, social dialogue has proved to be a valuable asset in the recent crisis: it is no mere coincidence that the best performing member states in terms of economic growth and job creation, such as Germany and Sweden, enjoy strong and institutionalized social dialogue between businesses and trade unions (Andor, 2011).

4. FINANCIAL REPORTING AND VARIETIES OF CAPITALISM: DO IFRS FIT FOR SOCIAL MARKET ECONOMIES?

Of course, a single set of global accounting standards would address the needs of international investors who incur costs and time in translating financial statements. Financial reporting, however, is not just a matter of investors. It serves as a basis for determining a number of rights, which affects a great variety of constituencies: not only market actors such as firms, investors, bankers and auditors, but also ordinary citizens, employees and states. Financial statements, for instance, represent the basis to elaborate public budget and for tax purposes. As a result, financial reporting must be considered with a broader perspective, which takes into account its effects on real economy and society.

[3] TFEU is the acronym for "Treaty on the Functioning of the European Union".

A thorough review of different research streams provides several warning signs with regard to the disruptive effects of reporting under IFRS on social market economy.

As mentioned above, IFRS are very much focused on capital market and therefore optimised for stock market-based capitalism. Fair value reporting as well is considered to be essential for tailoring financial reporting to the information needs of financial markets.

As a matter of fact, in the last 40 years worldwide economies have undergone profound transformations. The role of government has diminished, while that of the markets has increased. Economic transactions between countries have risen substantially, and domestic and international financial transactions have expanded at an exponential rate. In short, neoliberalism, globalization and financialization have been the key features of this changing landscape (Epstein, 2005).

Indeed, financial motives, financial markets, financial actors and financial institutions have played an increasingly prominent role over time in the operation of economies. Accordingly, shareholder value maximization has become a central feature of the corporate governance ideology, which spread across the whole private-sector (Froud et al., 2000; Lazonick and O'Sullivan, 2000).

As highlighted by MacKenzie (2008), financial economic theories have been intrinsic parts of this process. Modigliani and Miller (1958), for instance, looked at the corporation from the perspective of the investors and financial markets, and considered corporate's market maximization as the main priority of management. Agency theory (Jensen and Meckling, 1976) also provided an academic source of legitimacy for a greatly increased proportion of corporate executives' rewards in the form of stocks and stock options, with the specific purpose of aligning the interests of shareholders and managers. In this financial conception of the firm, corporate efficiency was redefined as the ability to maximize dividends and keep stock prices high, thus legitimating a far-reaching redistribution of wealth and power among shareholders, managers and workers (Fligstein, 1990).

There is no reason to think that financial economists saw themselves as acting politically in emphasizing shareholder value. However, as highlighted by Van der Zwan (2014), financial economic theories became the cultural frame for economic actors and intrinsic parts of the economic processes (Fligstein and Markowitz, 1993).

The key question is now whether IFRS fit for all the varieties of capitalism or whether the world would rather be better served by allowing alternative forms of capitalism to develop accounting standards tailored to their needs.

By adopting and extending fair value accounting as much as possible, IFRS institutionalize and spread the shareholder value paradigm in the form of financial reporting practices (e.g. Jürgens et al., 2000; Börsch, 2004; Nölke and Perry, 2007; Widmer, 2011), and reinforce the financialization process by shifting power from managers to markets. For instance, the definition of fair value as a spot market price provided by IFRS 13 reduces the enterprise's voice in favor of that of the market, making reporting of assets, liabilities and income independent of the manager's influence (Barlev and Haddad 2003). When analyzing financial statements under IFRS, readers are now exposed to the 'market's voice'.

In this context, managers are forced to consider the firm as a portfolio of assets that must constantly be reconfigured and rationalized in order to maximize shareholder value and to demand that every corporate asset is put to its most profitable use as judged by market benchmarks. Since capital markets tend to take a more short-term perspective on profit, shareholder value orientation is likely to discourage long-term industrial strategies and to threaten economic growth (e.g. Lazonick and O'Sullivan, 2000; Crotty, 2005; Nölke and Perry, 2007; Milberg, 2008; Baud and Durand, 2012).

Along the same lines, financial reporting no more considers the value of the employment of assets within the firm and, as a result, does not reflect the future cash flows that the assets may in fact generate. Focusing on financial institutions, Allen and Carletti (2008) show that as a consequence of fair value reporting, when liquidity plays an important role, as occurs in financial crises, asset prices on the balance sheets reflect the amount of liquidity available, rather than the actual assets' future cash-flows. As a result, bank assets may fall below their liabilities so that banks become insolvent, despite their capability to fully cover their commitments if they were allowed to continue until the assets matured. This can start the march into insolvency of institutions that would otherwise be solvent, and the insolvency or near insolvency of the institutions that are forced to write down their assets gives rise to write-downs in connected institutions with relevant contagion effects.

Banks play a crucial role in European social market economies. Financial system in the Continental Europe has always been highly bank-oriented (Bank of Italy, 2013)[4], mainly because the backbone of these economies is composed of small- and medium-sized manufacturing firms, which encounter greater difficulties in accessing bond markets than big corporates.

Given this crucial role, financial reporting for the banking system has particularly significant consequences on real economy. The European Central Bank (2004), the Banque de France (2008) and the International Monetary Fund (2009) have in fact raised several concerns on the procyclical effects caused by fair value reporting on firms' financing.

There is general agreement that during the recent financial turmoil, fair value reporting caused a downward spiral in financial markets, which made the crisis more severe, amplifying the credit-crunch (e.g. Persaud, 2008; Plantin et al., 2008; Allen and Carletti, 2012; Ronen, 2012). William Isaac (2010), former Chairman of the Federal Deposit Insurance Corporation (FDIC), considers fair value reporting the primary cause of the recent financial crisis. Plantin et al. (2008) provide evidence that mark-to-market accounting injects an artificial volatility into financial statements, which, rather than reflecting underlying fundamentals, is purely a consequence of the accounting norms and distorts real decisions. Damage done by fair value reporting is particularly severe for assets that are long-lived, illiquid and senior, which are exactly the attributes of the key balance sheet items of banks and insurance companies. Stockhammer (2012) also reports that excessive volatility in asset prices heightens systemic risk and makes the economy prone to recurring crises. These results are in line with Cifuentes et al. (2005), Khan (2009) and Bowen et al. (2010).

Freixas and Tsomocos (2004) show that fair value reporting worsens the role of banks as institutions that smooth inter-temporal shocks. The weakening of bank balance sheets also heightens concerns over the future courses of some markets, the health of banks and, more broadly, the financial system, which results in several runs on banks (Gorton, 2008; Allen et al., 2009b).

Given the key role of banks in the economy, financial distress in the banking system exert disruptive effects on real economy and employment. With this respect, Dell'Ariccia et al. (2008) report a correlation between bank distress and a decline in credit and GDP. Due to the

[4] In 2012 bank debts represented 31.4% of liabilities in the Euro-zone, in contrast to 14.2% in the US (Bank of Italy, 2013).

financial system crisis in 2007-2009, economic activity declined significantly in the European Union and unemployment rose dramatically. All in all, the recent crisis has been the worst since the Great Depression (Allen et al., 2009b).

The choice of full historical accounting made by national regulators for domestic GAAP prior to IFRS was consistent with the socio-economic context in the Continental Europe, where banks were primarily concerned with ensuring the securities of their long-term loans to enterprises, and therefore took a relatively cautious view of the future, acknowledging its inherent uncertainty (Fiss and Zajac, 2004; Perry and Nölke, 2006). A prudent valuation of assets reassured bankers that there was sufficient collateral to support their loans, and employees that the firm was solvent and stable over time.

Evidence shows that rather conservative accounting standards based on the European directives combined with stakeholder corporate governance and bank financing have allowed companies in these countries to follow long-term strategies, such as investing heavily in human resource development. This has been crucial for gaining and maintaining a competitive advantage based on using highly skilled labor to produce high-quality, and often specialized, products (e.g. Sally, 1995; Froud et al., 2000; Lazonick and O'Sullivan, 2000; Perry and Nölke, 2006). Long-term strategies require stewardship, defined as accountability to all stakeholders, to be a primary objective of financial reporting and historical cost to be the relevant measurement basis (Whittington, 2008).

Conversely, IFRS in general and, more specifically, fair value reporting increase pressure from short-termism, namely from the shareholders' focus on quarterly results and short-range returns on investment (Sally, 1995). Different research streams suggest that short-termism is likely to have destabilizing effects on the social market economies in the long run (Perry and Nölke, 2006). Stockhammer (2004) shows that short-termism accompanied by an excessive focus on shareholder value reduce the rate of capital accumulation in the long term and undermine economic growth. Under the pressure of shareholder value, firms tend not to reinvest gains in their productive assets, but to distribute them to shareholders through dividend payouts and share buy-back (Lazonick and O' Sullivan, 2000; Crotty, 2005; Milberg, 2008; Baud and Durand, 2012).

Short-termism also leads to more conflictual relationships between enterprise managers, employees and other stakeholders. The IASB emphasizes the role of financial reporting in serving investors in capital markets. Investors in capital markets, however, are not the only stakeholders of a firm (e.g. Holthausen and Watts, 2001; Whittington, 2008).

In many countries in Europe where a social market economy applies, shareholder wealth maximization has never been the only – or even the primary – goal of the board of directors. In Germany, for instance, firms are legally required to pursue the interests of parties beyond the shareholders through a system of co-determination in which employees and shareholders in large corporations sit together on the supervisory board of the company (Rieckers and Spindler, 2004; Schmidt, 2004). Austria, Denmark, Sweden, France, and Luxembourg also have systems of governance that require some kind of co-determination (Wymeersch, 1998; Ginglinger et al., 2009). While the specific systems of governance in these countries vary widely, the inclusion of parties beyond shareholders is a common concern. As a result, workers play a prominent role and are regarded as important stakeholders in firms. For this reason, it is common to refer to the Rhenish variety of capitalism also as 'stakeholder capitalism'.

However, it is not just the legal systems in these countries that require firms to take stakeholder concerns into account, but social convention as well. Yoshimori (1995), for instance, documents that an overwhelming majority of managers in France and Germany feel that a company exists for the interest of all stakeholders, whereas shareholder interest is the priority for managers in the US and the UK.

In the Rhenish variety of capitalism, companies have been able to develop thanks to consensual corporate governance arrangements. With this respect, research now reports evidence of an unequivocal negative impact of shareholder value policies and short termism on industrial relations (Van der Zwan 2014). Evidence also documents that the shareholder value principle tends to make shareholders and managers rich to the detriment of workers (Lazonick and O'Sullivan, 2000; Fligstein and Shin, 2004; Lin and Tomaskovic-Devey, 2013). Take as a whole, recent research presents a dramatic picture in which the pursuit of shareholder value is directly linked to a decline in working conditions and a rise in social inequality for large segments of the population (Van der Zwan, 2014).

5. THE SOVEREIGNTY PARADOX

By adopting IFRS, the European Union, which is the second largest capital market in the world, has delegated decisions on financial reporting regulation to a private body, the IASB, on which it has no control (Sinclair, 1994; Cutler et al., 1999; Hall and Biersteker, 2002).

Indeed, the IASB represents one of the most fascinating cases of private authority in international affairs. The IASB is a private, independent, British law organization, strongly affected by the structural power of the private financial sector. If one looks at the IASB's composition, this is largely limited to members from the financial industry, as well as from big auditing firms (Perry and Nölke, 2005; Chiapello and Medjad, 2009; Nöel et al., 2010; Crawford et al., 2014).

Consistent with Gramsci's notion of organic intellectuals (1971), expert knowledge is always political because it is acquired in a particular social context, and it reflects the political-economic structure and social relations that generate and reproduce that context. This is also true, of course, for the IASB's members. In fact, research provides specific evidence of a close link between the increasing adoption of the fair value reporting and the financial backgrounds of standards setters, who can use this body as a vehicle for institutionalizing its own perspective on what value is, and how to measure it, within IFRS (Thistlethwaite, 2011; Ramanna, 2013).

Furthermore, the IASB is dominated by representatives from Anglo-Saxon countries and from international organizations whose priorities conform to stock-market based capitalism (IASB, 2013). Many, for instance, highlight the pivotal role played by the SEC, operating through the IOSCO (Crawford et al., 2014; see also Arnold, 2005; Martinez-Diaz, 2005; Nölke and Perry, 2007; Botzem, 2008; Botzem and Quack, 2009; Nöel et al., 2010). IFRS 13, which is virtually identical to its US counterpart SFAS 157, actually exemplifies how a US discourse pervades the IASB and the accounting standards-setting agenda. As mentioned, IFRS 13 is the result of a joint project conducted by the IASB together with the FASB with the specific purpose of harmonizing US GAAP and IFRS, which however resulted in a passive alignment of fair value definition, measurement and disclosure to FAS 157. This is a key issue, given the potential economic and distributional consequences produced by financial reporting.

The same holds for EFRAG, which is a technical expert committee that provides advice to the European Commission on whether IFRS meet the criteria for their endorsement in the European Union. The EFRAG as well is a privately held and managed organization, which operates in a manner very similar to the IASB, and is represented predominately by the financial sector and big auditing firms (Perry and Nölke, 2005; Chiapello and Medjad, 2009; Nöel et al., 2010; Crawford et al., 2014).

As a result, the European Union has no say in how things are done in both the standards-setting and endorsement processes (Maystadt, 2013). As accounting serves not only to inform investors, but also to set the limit for distributable profits, to elaborate public budgets and for tax purposes, this is of course a key issue. There are different perspectives, such as the public interest, which are key at the European level and should be more seriously considered also with regard to financial reporting policies.

6. CONCLUDING REMARKS AND POLICY RECOMMENDATIONS

Proudhon (1846) used to say that "the accountant is the true economist" to highlight that financial reporting is not a neutral, mechanical and objective process that simply measures the economic facts pertaining to a firm. It is rather a powerful calculative practice that is embedded in an institutional context and shapes social and economic processes.

Of course, a single set of global accounting standards would address the needs of international investors who incur costs and time in translating financial statements. However, financial reporting is not just a matter of investors, but a powerful practice that shapes social and economic processes. It serves as a basis for determining a number of rights and therefore affects a great variety of constituencies.

With this respect, academic research reports wide evidence that IFRS in general and, more specifically, fair value reporting are likely to destabilize social market economies.

Social market economy is one of the founding principles of the European Union set out in the Lisbon Treaty. There is a general agreement that the Treaty, in establishing social market economy as a core value of the European Union, looked to the Germany and Scandinavian Countries’ experience (Glossner 2014). In these countries, a consensual relationship between labour and capital, a supporting role of the state, and the availability of patient capital provided by the bank system or internally generated funds have been key in developing long-term perspective on economic decision-making, high skilled labour and quality products based on incremental innovation, each at the basis of their economic successes.

As mentioned above, the choice of full historical accounting made by national regulators in Continental Europe prior to IFRS adoption was consistent with this kind of environment, where banks were primarily concerned with ensuring the securities of their long-term loans to enterprises, and therefore took a relatively cautious view of the future, acknowledging its inherent uncertainty (Fiss and Zajac, 2004; Perry and Nölke, 2006). Conservative accounting standards based on the European directives combined with stakeholder corporate governance and bank financing have also allowed companies to follow long-term strategies, such as investing heavily in human resource development. This has been crucial for gaining and maintaining a competitive advantage based on using highly skilled labor to produce high-quality, and often specialized, products (e.g. Sally, 1995; Froud et al., 2000; Lazonick and O'Sullivan, 2000; Perry and Nölke, 2006).

Mandating IFRS in the European Union goes in exactly the opposite direction. As outlined previously, IFRS institutionalize and spread the shareholder value paradigm in the form of financial reporting practices (e.g. Jürgens et al., 2000; Börsch, 2004; Nölke and Perry, 2007; Widmer, 2011), and reinforce the financialization process by shifting power from managers to markets. Fundamental reasons therefore question the consistency of Regulation 1606/2002, mandating IFRS in the European Union, with the Lisbon Treaty. At the time the IFRS Regulation was issued, the Lisbon Treaty had not yet been signed. Now, thanks to the Treaty, we have a constitutional framework with which to analyse financial reporting policies.

Consistent with this view, this paper argues that some corrective actions should take place in the standards-setting process. First of all, the European Union should restore the legitimacy of the standards-setting process by bringing it back to democratic rules that guarantee the representation of all the stakeholders involved in the economy and a strong role for the European Parliament. While increasing privatization was the general trend in recent years in international accounting standards setting, it is now time for this trend to be reversed and, therefore, for a necessary backing of public actors (e.g. Kerwer 2007, Botzem 2008, Bengstsson 2011).

By setting social market economy as a founding principle of the European Union, the Lisbon Treaty shows that there is more than one way of doing business. Mandating a single set of international financial reporting standards, designed to accommodate the needs of liberal stock market economies, for all the world is not neutral with respect to alternative forms of capitalism, and risks doing harm to these varieties. Financial reporting is not a neutral, mechanical and objective process that simply measures the economic facts pertaining to a firm. It is rather a powerful calculative practice that is embedded in an institutional context and shapes social and economic processes. As Miller and O'Leary (1987) note, accounting normalizes and abstracts a "system of socio-political management".

The adoption of IFRS, which are shaped on stock market-based capitalism, runs the risk of severely harming social market economies. In addition, recent events have raised several doubts about unregulated free stock market capitalism being necessarily the best way to run economy. The worldwide recession caused by the financial market crisis and excessive credit expansion has indeed shown the fragility of stock market-based capitalism as an economic and political process, highlighting the need for alternative way of doing business.

It is at time of great uncertainty and change that the advantages of variety can be appreciated. Financial reporting should therefore be large enough to accommodate different forms of capitalism and to let them compete on a level playing field. The optimal design of financial reporting regulation should depend on the institutional characteristics of the political and economic systems. The European directives, which regulated financial reporting for listed companies prior to IFRS adoption, have been successful in this respect. The European directives provided the same basic principles and a set of minimum accounting rules, but left open to member states some options that could be implemented in national law according to their diverse national historical and economic backgrounds, cultures and legislation. Given such flexibility, the implementation of the accounting directives into national law differed from country to country. For instance, countries could choose between historical cost and fair value for evaluating certain assets. Countries from the Continental European Union required full historical cost accounting, while the United Kingdom, which is closer to stock market-based capitalism, allowed the use of fair value for some items.

The Lisbon Treaty provides a political construct of the European Union based on a federalist approach to integration. Federalism grounds on a pluralist conception and is conceived as a way to unify different peoples for important but limited purposes, not as a way to destroy their political identities.

The European directives have been able to conjugate unity and diversity effectively, guaranteeing the harmonization of financial disclosure, yet allowing countries to take into accounts the specific characteristics of their socio-economic settings. A single set of global financial reporting standards, moreover tailored on the needs of stock market-based capitalism, instead represents a significant monopoly power that harms exiting variety of capitalism and prevents alternative forms from evolving. According to the Lisbon Treaty, the European Union must work in order to pursue its objective of realizing a social market economy. The European Union must therefore exert every effort and use all the available means to reach this goal, including financial reporting regulation.

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