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Is Accounting Neutral to Economy and Society?

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Abstract. Accounting is not simply a metric; it is, rather, a calculative practice that shapes the socio-economic environment. Financial reporting affects a great variety of constituencies: not only market actors such as firms, investors, bankers and auditors but also ordinary citizens, employees and states, as financial information serves as a basis for determining a number of rights. This paper challenges the idea that financial reporting is risk-neutral to economy and society. In doing so, it takes IFRS adoption in the European Union as paramount, focusing specifically on fair value accounting, which represents one of the main innovation introduced by European Regulation 1606/2002. It considers risk related to financial disclosure not at a firm, but at a systemic level, highlighting the role of financial reporting in affecting economic development over the long run. It therefore calls for a better understanding of how accounting operate in its institutional structure of economy in order that better accounting systems might be designed. Such an institutional context is provided for the European Union by the Lisbon Treaty, which sets out the constitutional framework and fundamental objectives for the advancement of European society.

Keywords: Financial disclosure, European Union, Fair Value Accounting, Varieties of Capitalism, Lisbon Treaty

1 Introduction

Financial reporting is usually seen as something very neutral, mechanical and objective, a process that simply measures the economic facts pertaining to a firm, a kind of very boring job specific to accountants. However, this is not exactly the case. Proudhon (1846) used to say that "the accountant is the true economist". Maybe this is a bit excessive, but it gives quite well the idea that financial reporting is a powerful practice that shapes social and economic processes. In fact, financial reporting affects a great variety of constituencies: not only market actors such as firms, investors, bankers and auditors but also ordinary citizens, employees and states, as financial information serves as a basis for determining a number of rights. It serves, for instance, to set the limit for distributable profits, to elaborate public budget and for tax purposes.

This paper challenges the idea that financial reporting is risk-neutral to economy and society. In doing so, it takes IFRS adoption in the European Union (also EU hereafter) as paramount, focusing specifically on fair value accounting, which represents one of the main innovation introduced by Regulation 1606/2002 adopting IFRS.[1] It considers risk related to financial disclosure not from a firm, but from a systemic point of view, highlighting the role of financial reporting in shaping economic and social processes and affecting economic development. It therefore calls for a better understanding of how accounting operate in its institutional structure of economy in order that better accounting systems might be designed (e.g. Cooper and Sherer, 1984).

[1] For simplicity's sake, the term IFRS is used to refer to both the International Accounting Standards (IAS) and to the International Financial Reporting Standards (IFRS). IFRS are issued by the International Accounting Standard boards (IASB), whereas IAS were issued by the International Accounting Standard Committee (IASC) until 2000.

Furthermore, the recent economic crisis has given rise to a wide criticism on stock market-based globalization. Along these 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).

Financial reporting regulation is one of the competences of the European Union, which legislates and adopts those binding acts necessary to pursue the EU's objectives in this field. The objectives of the European Union are set out by the Lisbon Treaty, which provides the constitutional framework of the EU, clearly stating its inspiring values and founding principles. 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 socio-economic model.

This paper raises some concerns about the 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 and to amplify prociclicality and credit crunch, with relevant consequences on the resilience of the financial system, which is core for long-term investments in real economy. As a result, current attempts to establish a single set of global financial reporting standards, moreover accommodated to the needs of liberal stock market economies, are not neutral and can harm alternative forms of capitalism. Consistently with this view, the European Union should discuss accounting standards with respect to its fundamental goal of realizing a social market economy. Regulation 1606/2002 should therefore be deeply considered in terms of its ability to match with the EU constitutional setting established by the Treaty.

The remainder of this paper is structured as follows. Paragraph 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. Paragraph 3 discusses the main characteristics of social market economy, which has been set out by the Lisbon Treaty as a founding principle of the European Union. Paragraph 4 discusses main concerns about the consistency of IFRS with social market economy, while Paragraph 5 concludes.

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, as is the IASB, the body that issues IFRS. IFRS consider investors to be those most in need of information from financial reports since they cannot usually request information directly from the firm. Moreover, as investors provide risk capital to firms, the financial statements that meet their needs are supposed by IFRS to meet most of the needs of other users, too (IASB, 2010 BC 1.16).

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 has however ended up with a passive alignment fair value definition, measurement and disclosure to the US FAS 157.

Consistently with the IASB's focus on investors' interest, mainstream research has largely investigated the effects of adopting IFRS in Europe in terms of their value-relevance to investors or their effects on firms' cost of capital (Palea, 2013 for a review). This kind of research, however, is not exhaustive and comprehensive of all the relevant issues at stake with IFRS adoption in the EU. The current financial reporting environment consists of various groups that are affected by in accounting regulation. Regulation 1606/2002 states that IFRS can be adopted in the EU only if they are conducive to the "European public good". At the time European Regulation 1606/2002 adopting IFRS came into force, the Lisbon Treaty had not been signed yet. A constitutional framework within which analyzing European Regulations was lacking. Nowadays, however, the Treaty is in force and provides us with a definition of what must be intended by "European public good". It therefore represents a broader framework that goes beyond investors' interest, within which financial reporting policies can be discussed in the EU.

3 Social Market Economy as a Founding Principle of the European Union

This paper argues that, as 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 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 (e.g. Glossner 2014). The Rhenish variety of capitalism refers to coordinated market economics, whereas the Anglo-Saxon variety refers to liberal market economics (Hall and Soskice, 2001). These two models have been developed on the basis of United States and western Europe, while further models are of course 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 labor 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 labor and quality products based on incremental innovation, each at the basis of post Second World War Germany’s economic success (Hall and Soskice 2001; 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-labor 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), Röpke (1941) and Rüstow (1932). 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. 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).

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). 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

[2] TEU is the acronym for “Treaty on the European Union”, while TFEU is the acronym for “Treaty on the Functioning of the European Union”.

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 Variety of Capitalism: Do IFRS Fit for All?

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 in a broader perspective, which takes into account its effects on real economy and society.

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 optimized 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. From a Lisbon Treaty' s perspective, there are two main issues related to fair value accounting that deserve to be investigated in the context of social market economics. The first relates to fair value definition provided by IFRS 13, Fair Value Measurement, and short-termism it may induce with potentially disruptive effects on long-term development. The second relates to the ability of fair value accounting to match with the objective of a financial system less prone to crisis and more resilient, which is at the basis of sustainable economic growth.

According to IFRS 13, fair value is an exit price, i.e. the amount that would be received when selling an asset in an orderly transaction between market participants at the measurement date. Fair value is therefore a spot market price.

There is general agreement that fair value definition as an exit price institutionalizes the shareholder value paradigm in the form of accounting practices (Müller, 2014; Nölke and Perry, 2007; Zhang and Andrew, 2014; Widmer, 2011). It therefore leads managers and investors to consider the firm as a portfolio of assets that must constantly be reconfigured and rationalized in order to maximize shareholder value and, as a result, to demand that every corporate asset is put to its most profitable use as judged by market benchmarks (Boyer, 2007). Since capital markets tend to take a more short-term perspective on profit, several concerns can be raised on the consistency of this definition with long-term industrial strategies, which have been - and are still expected to be - key for developing and maintaining the competitive advantage in many EU countries (Nölke and Perry, 2007).

Along the same lines, financial reporting no more consider the value of the employment of assets within the firm and, as a result, do not reflect the future cash flows that the assets may in fact generate. 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 (e.g. Crotty, 2005).

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. 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 (e.g. Schmidt, 2004). Austria, Denmark, Sweden, France, and Luxembourg also have systems of governance that require some kind of co-determination (e.g. 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'. With this respect, research now reports evidence of an unequivocal negative impact of shareholder value policies and short termism on industrial relations (e.g. Van der Zwan 2014). Evidence also documents that the shareholder value principle tends to make shareholders and managers rich to the detriment of workers (e.g. Lin and Tomaskovic-Devey, 2013). Take as a whole, recent research presents a picture in which the pursuit of shareholder value is linked to a decline in working conditions and a rise in social inequality for large segments of the population (e.g. Van der Zwan, 2014).

Sustainable economic development requires long-term investment strategies, which in turn need stable financing and thereby a resilient financial system. Financial system in the Continental Europe has always been highly bank-oriented (Bank of Italy, 2013)[3], 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 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. Allen and Carletti, 2009; 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 increases systemic risk and makes the economy prone to recurring crises. 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 (e.g. Allen et al., 2009).

Schwarz et al. (2015) argue that there cannot be clearer evidence of fair value involvement in the crisis than the decision taken by both IASB and FASB to allow banks to reclassify, from the third quarter of 2008, certain non-derivative financial assets, which were measured at fair value, to amortized costs under certain circumstances. Jarolim and Öppinger (2012) show that the reclassification option was used quite extensively by the European banks and avoided recognition of losses of almost 900 million euros, on average, per bank. Many more banks could have run into substantial problems if accounting rules had not been amended at the peak of the crisis. De Jager (2014) points out that the existing

[3] 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).

debate has focused too much on the role of fair value during the crisis, while ignoring its role in masking balance sheet fragility in pre-crisis periods. In such times, fair value accounting leads to banks appearing healthier than they are, facilitating further asset expansion financed by debt. During the crisis, however, banks' deleveraging leads to a downward spiral with forced sales of assets and shrinking balance sheets that significantly impair banks' capability to lend money.

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 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., 2009).

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 (e.g. 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; Perry and Nölke, 2006).

5 Concluding Remarks

So far, IFRS have been mandated only for listed companies, i.e. for big corporates. Many initiatives at a European level, however, including Green Paper on Capital Market Union, aim at improving access to risky capital for small and medium-sized enterprises (SMEs). Furthermore, proposals for adopting a lighter version of IFRS for SMEs are quite recurrent (European Commission, 2015). Directives 2013/34 has also aligned to IFRS in some respects, such as permitting fair value for some assets and no more allowing capitalizing research expenditure. There is clear evidence of a dominant trend towards extending IFRS adoption to SMEs, too. This is not a trivial issue, as SMEs are the backbone of the economy and the main job creators in the European Union, representing 99% of enterprises in the EU (Enterprise Europe Network, 2015). Standard-setting is not a marginal matter, yet a complex process that must be carefully thought through.

As mentioned above, a single set of global accounting standards would of course 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, yet 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 has provided some evidence suggesting that IFRS and, more specifically, fair value reporting are likely to affect significantly social welfare.

There is a general agreement that the Lisbon Treaty, in establishing social market economy as a core value of the European Union, looked to the Germany and Scandinavian Countries' experience. In these countries, conservative accounting standards combined with stakeholder corporate governance and bank financing have 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; 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. 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 analyze financial reporting policies.

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.

Taken as a whole, many doubts arise about the capability of fair value accounting to match with the EU's objectives of a social market economy. How, and to what extent, does fair value exacerbate short-termism and thereby threaten the Rhenish variety of capitalism? Is its adoption consistent with a social market economy or does it just suit stock market-oriented economies and, more generally, the Anglo-Saxon variety of capitalism? Shouldn't financial reporting regulation be large enough to accommodate different forms of capitalism and let them compete on a level playing field? Shouldn't the "optimal" design of financial reporting regulation depend on the institutional characteristics of the political and economic systems and on the objectives relevant to society? Still further, is fair value adoption consistent with the purpose to provide stable financing to long-term investors so as to make the European economy more resilient? Wouldn't historical cost better suit European economy based on long-term strategies?

A single set of global financial reporting standards, moreover tailored on the needs of stock market-based capitalism 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 a social market economy. All the questions raised above should therefore be carefully addressed in order to assess whether the current financial reporting regulation is really conducive to the economic and social model that the EU has set as its fundamental objective.

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