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Financial reporting for sustainable development: Critical insights into IFRS implementation in the European Union

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ABSTRACT

By adopting a political economy perspective to accounting, this paper provides an overall post-implementation assessment of International Financial Reporting Standards (IFRS) adoption relative to the European Union's (EU's) fundamental goal of sustainable development. The paper questions the consistency of the International Accounting Standards Board's business view with the EU's and provides some critical insights into the potential long-run effects of IFRS on the European economy and society. Therefore, it raises several doubts about unquestioned accounting standardization at a global level and makes some suggestions for future policymaking and research.

"The economy does not have a purposeful life separated from politics and hopefully it will not, in the future, either" (Galbraith, History of Economics, 1988)

1. Introduction

A decade has passed since the global financial crisis started in the United States (US). There is a wide consensus that this has been the worst crisis since the Great Depression (e.g., Draghi, 2016). In Europe, the crisis has led to major destruction of economic activities, dramatic job losses, and a rise in inequality and poverty. Unemployment, especially among young people, has reached unprecedented levels and welfare states have been constrained by low growth and stretched public finances (e.g., Pianta, 2015).

The fragility shown by laissez-faire capitalism has raised wide debate on the need for alternative ways of doing business (European Commission, 2010). It is well established in the literature that the global financial crisis was caused by the availability of easy credit, short-termism, and excessive risk-taking in financial markets, which led to speculative behavior, bubble-driven growth, and significant imbalances (European Commission, 2010). By contrast, countries with higher shares of industry in their GDP have been more resilient to the crisis (e.g., Walz, 2015).[1] A call for an industrial renaissance has therefore become quite strong in the European Union (EU), changing the policy discourse (e.g., Mazzucato, 2015). Political engagement in pursuit of economic recovery based on industry has never been greater (UNEP, 2015).

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[1] According to the European Commission (2014), industry includes the whole non-financial business economy, that is, manufacturing, raw materials, energy, business services (e.g., logistics), consumer services (e.g., after-sales services for durable goods) and tourism. In 2013, the EU-28's non-financial business economy generated a total of EUR 6,240 billion of gross value added at factory cost. The non-financial business economy workforce reached 133 million people employed, representing around three-fifths of those employed in the EU-28. In the non-financial business economy, manufacturing is the largest in terms of value added: 2 million manufacturing enterprises generated EUR 1,630 billion of value added in 2013, while providing employment for about 29.7 million people (Structural Business Statistics Overview, 2018).

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Consistently, European policymakers have set a variety of industrial policies for the manufacturing sector based on smart, green, and inclusive growth (2014, European Commission, 2010). Importantly, such policies not only act as a counter-cyclical tool to overcome the crisis but are also part of a long-term strategy to support sustainable development, which represents one important constitutional objective of the EU (European Commission, 2010; Lisbon Treaty, 2007).

In recent times, the EU has experienced huge shocks, one of these being Brexit. Nonetheless, as Mario Draghi notes (2016), "the structure of the European Union is solid and its fundamentalvalues remain its base. But the integration process needs to be guided towards outcomes that are more efficient and more directly aimed at the people, their needs and their fears." Economic recovery, social justice, and environmental protection are three such outcomes.

One important question now is whether, and how, financial reporting can affect the EU's objective of sustainable development. Financial reporting and accounting has proved over time to be a powerful practice, which is embedded in an institutional context and shapes economic and social processes (e.g., Soll, 2015). Despite this, so far, mainstream accounting research has mainly investigated financial accounting by focusing on the economic consequences for shareholders or their agents, that is, corporate management (Callen, 2015; Hopwood, 2009; MacKenzie, 2008; Sikka, 2015; Wilkinson & Durden, 2015). Along these lines, accounting studies have mostly considered the effects of adopting IFRS in the EU from a stock market-oriented perspective (e.g., Palea, 2013). Little scope has been left for European economic and socio-political specificities and for the needs of other than investors. Neo-classical economists would probably argue that investors are best placed to ensure efficient allocation of a nation's resources and thus, that the public good is best served by their capacities for judgement, identifying the most profitable projects, and managing risks. However, as the next sections show, critical research tells another story.

Different from the mainstream, this paper adopts a political economy approach to the discussion, which recognizes the specific historical and institutional environment of the society in which accounting operates (Cooper & Sherer, 1984). This view of society is holistic; it does not seek to separate out domains, but rather studies the interdependence between the economy and the polity of a country.[2] Along these lines, Palea (2017) suggests that, when discussing IFRS adoption in the EU, the uniqueness of the EU institutional context should be taken into account. Financial reporting regulation is one of the competences of the EU. Consequently, it should be consistent with the constitutional framework of the EU, which is defined by the Lisbon Treaty (2007) and includes sustainable development among its main objectives.

Over time, sustainable development has gained growing influence in the accounting literature, with a special call for more research on accounting for sustainability (e.g., Lamberton, 2005; Unerman & Chapman, 2014).[3] This paper aims to answer this call by analyzing the capability of IFRS to support sustainable development. Maystadt's report (2013), which requires IFRS to be tested in terms of the contribution to financial stability and economic development, provides significant support for this kind of approach. The European Financial Reporting Advisory Group's board President Gauzès (2017), too, has highlighted the need for research to move beyond technical accounting, and to consider the wider impacts of IFRS on the economy. More recently, the High-Level Expert Group on Sustainable Finance (HLEG, 2018) has acknowledged the need for better consideration of sustainability issues in accounting standards.

As Gray (2010) points out, there is no single definition of sustainable development. There is a widely shared view, however, that the concept of sustainable development has three strictly linked dimensions: economic, social, and environmental (e.g., Kahn, 1995). This paper adopts the widely accepted definition of economic sustainability as long-run maintenance of capital. This is about, and in theory ensures, the capability of the economy to maintain a defined level of production over the long term (Goodland, 2002). This is the same definition adopted by the HLEG (2018). Social sustainability is defined as a positive condition marked by a strong sense of social cohesion and equity of access to key services, including health, education, and housing (McKenzie, 2004). Finally, environmental sustainability aims to preserve natural ecosystems (Bruntland Report, 1987).

This paper addresses two important issues for European policymakers. One relates more generally to the consistency of the IFRS Conceptual Framework, and its shareholder-oriented view of business, with a public interest perspective that characterizes the view of business in the EU's constitutional framework. Clearly, public interest encompasses economic, social, and environmental sustainability. Discussing this issue is important, as the Conceptual Framework drives the whole standards-setting process. This paper highlights that the EU's founding principles set out in the Lisbon Treaty provide an entity view of the firm—rather than a shareholder approach—with a sound legal basis, which goes beyond a simple academic perspective, thereby leading to considerable legal uncertainty about the framework of the International Accounting Standards Board (IASB).

Another important issue refers, more specifically, to the ability of fair value accounting to support the EU's objective of sustainable development. Fair value accounting represents the main difference from the financial reporting regulation under the European directives. Nonetheless, fair value accounting has mainly been investigated in terms of its value-relevance for capital markets. This paper, instead, investigates fair value accounting from a different perspective, by considering its effects on the real economy and sustainability. The final purpose is to provide an informed assessment of IFRS relative to the EU's fundamental goals, which could help policymakers to better orient financial reporting regulation toward the goal of sustainable development.

In tackling these issues, this paper focuses on the industrial sector, which dominates the EU economy and, for this reason, is the main beneficiary of the European Commission's initiatives to boost investments in the real economy. Specific attention is paid to

[2] For insights into the distinctive characteristics of a political economy of accounting see Cooper and Sherer (1984).

[3] In line with Gray (2010), this paper uses the terms "sustainability" and "sustainable development" interchangeably. There is a slight difference between the two expressions, in which "sustainability" refers to a state, while "sustainable development" refers to the process of achieving this state.

small and medium-sized enterprises (SMEs) and family firms, which characterize the European business system.[4]

Discussing the relationship between financial accounting rules and sustainable development is challenging, as there is no direct evidence on the topic. The issue is too complex to be grasped by single empirical studies. As a result, the present paper undertakes a wide literature review, which considers very different academic research streams, including accounting studies, research on SMEs and family businesses, economic literature on varieties of capitalism, and legal studies on the EU. It also integrates academic literature with reports on sustainable development delivered by expert groups appointed by the United Nations and the European Commission. Taken as a whole, this study provides warning signs on the effects of IFRS adoption in the EU on sustainable development.

The rest of the paper is structured as follows. Section 2 provides a general framework for discussion by considering EU policies for sustainable development and the role of financial reporting as a tool of political economy. Section 3 examines the consistency of the IASB's view of business with the EU's ideal of sustainable development. Sections 4–6 focus on fair value accounting, discussing some important questions about its capability to support sustainable growth. Section 7 draws conclusions and makes some suggestions for future policies and research.

2. European policies for sustainable development: is there a role for financial reporting?

Sustainability has long been at the heart of the European integration project. The Lisbon Treaty (2007) gives specific recognition to sustainable development as a main goal of the EU.[5] Coherently, the European Commission has incorporated sustainable issues into its policies.

Achieving sustainable development goals requires important investments. However, one of the major consequences of the Great Recession in Europe has been the fall in investments, which exceeded 550 billion Euros between 2007 and 2014 (Garonna & Reviglio, 2015). Such a dramatic decline affected both private and public investment expenditures in all the EU economies, with SMEs being the weakest spots in the map of European vulnerabilities (Garonna & Reviglio, 2015).

Industry based on SMEs is the backbone of the European economy (European Commission, 2014) and, thereby, the main beneficiary of EU policies. SMEs account for two-thirds of employment and 58% of growth in EU value added (Garonna & Reviglio, 2015). Most SMEs are family businesses, firmly rooted in their regional and national cultures.

Industrial policy is one of the competences of the EU (Treaty on the functioning of the European Union, 2007, art. 173) and one important means by which to achieve sustainable development. Consistently over time, the European Commission has adopted a number of initiatives to support industrial investments and infrastructure. Some of these, such as the European Fund for Strategic Investment, provide support to industrial companies' investment in fixed assets (European Regulation 1017/2015); others are specifically targeted at substituting "dirty" technologies with "clean" ones, with significant structural and investment funds available for firms to finance green investments (European Commission, 2018a; Walz, 2015). Importantly, such concepts as natural wealth and the circular, green economy have become the backbone of European economic strategies and policies for businesses.

The European Commission (2018a) acknowledges that a substantial part of the flows for such investments will have to come from the private sector. A resilient financial system is in fact a necessity for providing stable financing for long-term investments (European Commission, 2018a). The European Commission has adopted the Action Plan on the "Capital Market Union" to achieve a true single market for capital in Europe (European Commission, 2015) along with that on "Financing Sustainable Growth" to incorporate sustainability issues into investment analysis and decision-making (European Commission, 2018b).

Several authors have pointed out that industrial policies require a consistent regulatory framework (e.g., Bassanini & Reviglio, 2015; Mazzucato, 2015). Cultivating sustainable development is, in fact, a complex challenge. Aware of this, the European Commission has made the commitment to involve stakeholders from different sectors, including academics, in order to develop a new framework for a modern industrial policy that combines different policy instruments, including standard-setting (European Commission, 2010). Accordingly, the European Commission has launched a multi-stakeholder platform to follow up and exchange best practices on sustainability policies. It has also made substantial funding available for research on these topics (European Commission, 2018a).

Developing a new framework requires reconsidering the status quo with a critical approach, which, according to this paper, should also apply to financial reporting regulation. The European Commission itself recognizes that accounting is not neutral (European Commission, 2013). Baker and Barbu (2007) indeed show that accounting has been an integral part of human civilization for 4000 years. Soll (2015) demonstrates the remarkable impact of accounting on the rise and fall of great nations. The founders of modern economic thought—from Adam Smith to Karl Marx—also considered accounting as essential to developing successful businesses and modern capitalism (Soll, 2015). Accounting affects a great variety of stakeholders: not only firms, investors, bankers, and auditors, but also ordinary citizens, employees, and states. Accounting, for instance, serves as a basis to set the limit for distributable profits, to calculate taxes, and to define the public budget to which social welfare is parametrized (Palea, 2015). For

[4] In 2013, the overwhelming majority (99.8%) of enterprises active within the EU-28's non-financial business economy were micro, small, and medium-sized enterprises—some 22.6 million (Structural Business Statistics Overview, 2018). Family businesses account for 75% of European employment in Italy, Germany, and France; 85% in Spain; 70% in Belgium and Luxemburg; and 80% in Finland (KPMG, 2018).

[5] Art. 3 of the Treaty on the European Union (2007), as emended by the Lisbon Treaty, states that the EU 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, and a high level of protection and improvement of the quality of the environment."

example, social security benefits in EU countries are parametrized on their GDP/debt ratio. For firms, the GDP calculation depends on accounting data.

In this context, financial reporting regulation can be considered one important tool for political economy. The European Commission (2018c), in its request to EFRAG for technical advice on possible alternative accounting to fair value measurement for long-term investments of equity or equity-type investments, supports this view. As part of its Action Plan on "Financing Sustainable Growth," the European Commission has announced that it will explore possible alternative accounting measurements that could enhance investors' insights into the long-term performance of investments as opposed to recognizing point in time market-based value changes. According to the Commission, "possible accounting treatments should properly portray the performance and risk for long-term investments […] which are much needed for achieving UN Sustainable Development Goals and the goals on Paris Agreement on climate change" (European Commission, 2018c, p. 1).

While the Commission's specific focus is on long-term investment portfolios of equity and equity-type instruments, the consistency of fair value accounting with sustainable development needs to be investigated from a wider perspective, which also considers its effects on manufacturing companies' management. From a balance sheet perspective, fair value accounting can affect both the assets and liabilities of industrial firms. On the asset side, short-termism related to fair value accounting can generate undue pressure on managers when devising their strategies, with negative effects on capital allocation and economic growth. On the liability side, long-term investments needed to re-orient an economy toward sustainability goals require stable financing and, therefore, resilient financial systems that can ensure consistent financing for industrial projects. Furthermore, the lower is economic growth and the more fragile the economic system is, the more difficult it is to realize equitable social development. As discussed in the next section, fair value accounting underpins the shareholder view of the firm. Therefore, an important issue relates to the effects of fair value accounting on wealth distribution among profits and wages and on the labor–capital relationship, which has been key for European social democracies to succeed. All these issues are thoroughly discussed in Sections 4–6.

3. Economy and society in the IASB'S and EU'S views

One important step in discussing the consistency of IFRS with the EU's objective of sustainable development requires comparing the view of business underpinning IFRS, as it emerges from the Conceptual Framework, with the EU's perspective.

As mentioned above, financial reporting regulation is one of the competences of the EU and, in fact, European Regulation 1606/2002 mandated IFRS in the EU. According to the hierarchy of laws, European regulations and directives must comply with the objectives of the Lisbon Treaty (Eur-Lex, 2018). This implies that the objective of sustainable development of the EU set out by the Treaty prevails over the purposes of Regulation 1606/2002 adopting IFRS. By defining the founding objectives of the EU, the Lisbon Treaty has clarified what must be intended by European public good, providing such a concept with a sound legal basis. This allows us to assess IFRS on constitutional grounds.

As is well known, IFRS are mandatory for the consolidated financial statements of listed corporate groups, with an option for member states to require or permit the application of the IFRS for other reporting entities. Differently from other jurisdictions, private companies in the EU are required by law to publicly disclose the results of their financial operations and, with some exceptions, apply domestic accounting standards based on European directive 34/2013. Compared to the previous ones, directive 34/2013 has taken several steps toward IFRS. Although still requiring historical cost as a basic measurement criterion, the directive is more explicit than previous directives about measuring assets at fair value. Moreover, for the first time, it makes clear reference to IFRS for a definition of fair value. Such changes definitely mark an underlying tendency to align domestic Generally Accepted Accounting Principles (GAAP) to IFRS and to extend IFRS to private firms. This is a critical issue given that private businesses are the backbone of Europe's economy, which makes investigating IFRS effects on the real economy even more compelling.

It is well established in the literature that accounting rule-making is deeply ideological (e.g., Cooper, 2015; Ramanna, 2015; Walker, 2010). Different measurement systems correspond to different views of business in society as well as different notions of capital (Cooper, 2015; Müller, 2014; Zhang & Andrew, 2014). This, in turn, implies that different levels of priority are given to societal stakeholders. Considering the IASB Conceptual Framework, one can note that the IASB includes existing and potential investors, creditors, and lenders as primary users of financial reporting. However, the degree of the IASB's emphasis on securities markets suggests a greater emphasis on the needs of equity investors (Ramanna, 2015). While other parties, such as regulators and members of the public other than investors, may find financial statements useful, these reports are not primarily considered for these other groups (IASB, 2010, p. OB 10).[6] Such concern for equity investors and capital markets makes an implicit value judgment that the needs of investors are of primary importance. Clearly, IFRS are designed for securities markets. Over time there has also been a tendency to align the IFRS to US GAAP issued by the Financial Accounting Standards Board, which are tailored to the needs of stock market-based economies.

[6] Even though the current "Exposure Draft Conceptual Framework for Financial Reporting" (IASB, 2015) states that "financial statements are prepared from the perspective of the entity as a whole instead of from the perspective of any particular group of investors, lenders or other creditors" (par. 3.9.), it then reaffirms several times its main focus on capital market participants in general and, more specifically, on investors. For instance, it states that "the Conceptual Framework: a) contributes to transparency […] enabling investors and other market participants to make informed economic decisions, b) strengthens accountability by reducing the information gap between the providers of capital and the people to whom they have entrusted their money […] c) contributes to economic efficiency by helping investors to identify opportunities and risk across the world" (IN 5).

It is apparent that the IASB's focus on investors has an elective affinity with the proprietary theory of the firm, according to which the firm is an exclusive vehicle for its proprietors to increase their wealth (e.g., Biondi, 2011; Van Mourik, 2014). Accordingly, the IASB has increased the use of fair value over time, considering it essential for tailoring financial reporting to the information needs of investors (De Jager, 2014; Müller, 2014; Zhang & Andrew, 2014). In fact, fair value accounting is undertaken from the shareholders' perspective and firm performance, that is, net income, is defined in terms of changes in the market values of assets and liabilities (IASB, 2010, p. 4.47). Investments are evaluated from a market perspective rather than by their contribution to the productive activity (e.g., Börsch, 2004; Jürgens, Naumann, & Rupp, 2000; Widmer, 2011). Fair value accounting does not reflect the value of the employment of assets within the firm. It obscures the value creation process and clashes with the temporality of productive activity, which is quite a big issue for investments in the real economy that require time to yield results (e.g., Aglietta & Rebérioux, 2005; Aspara, Pajunen, Tikkanen, & Tainio, 2014; Müller, 2014; Boyer, 2007).

The IASB's view of business does not match with the EU's, in which social welfare dominates and societal stakeholders are all on the same level. Art. 9 of the Treaty on the European Union (2007), as emended by the Lisbon Treaty, further reinforces art. 3 on the objectives of the Union by affirming the democratic principle of equality of its citizens, who must receive equal attention from their institutions. This implies that all societal stakeholders are equal. Considering the EU's institutional framework, the entity view of the firm, rather than the proprietary one, better fits the socio-economic model that the EU wants to pursue. Based on the "social institution" theory of business (i.e., Edwards, 1989; Müller, 2014; Van Mourik, 2014), the entity view of the firm considers the company to be not only a private association for the purpose of personal enrichment but also a vehicle to serve some larger social good.

Importantly, this view of the firm does not involve any sort of philanthropy; rather, it represents a new way to achieve economic success. In the wake of the Global Financial Crisis, many scholars have called for a more radical paradigm shift in the foundations of contemporary capitalism, which could better meet society's broader challenges. Porter and Kramer (2011), for instance, talk of shared value to underline the need for more connection between firms, economic goals, and societal progress. Shared value involves creating value in a way that also creates value for society by addressing its needs and challenges. This new concept of capitalism fits well into the EU's view of society.

The entity view of the firm is more than a theory of how to run a company better. It has far-reaching economic and social implications. In sharp contrast to the proprietary theory of business, the entity view emphasizes the social relationship between management and employees, and between the company and the community. These relationships give the firm not only financial but also social goals. Accordingly, the firm is seen as a production unit that is embedded into a socio-economic environment with multiple social and economic long-term relations to workers, suppliers, customers, and creditors (Mazzucato, 2018; Van Mourik, 2014). All stakeholders are on the same level, and what counts is the generation of revenue from which to meet the claims of various stakeholders, from capital providers to tax authorities. In this view, people are regarded not just as inputs but also as essential contributors to value creation, which is a collective process. Along the same lines, the entity view of the firm denotes a very different type of finance, which is more patient and supports long-term investment (Mazzucato, 2018).

Finally, the entity view of the firm fits the specificities of the European economy better. The European economy largely comprises private companies and family businesses, which pay great attention to social and reputational capital as an important source of competitive advantages. Different from some capital marked-oriented economies, such as the US, in the EU, these businesses are required by law to disclose the results of their financial operations to stakeholders. As a result, stewardship and social accountability are key and financial reporting must determine profit for distribution to the shareholders in a prudent way. Ferracci (2016), for instance, shows that IFRS are detrimental to some information needs of employees, such as long-term company sustainability and equitable distribution of value added.

In the entity view of the firm, financial reporting focuses more on determining efficiency by matching the proceeds from operating activities with expenses incurred, than on valuation (Müller, 2014). For this reason, the entity view of the firm has an elective affinity with historical cost accounting, which depicts the use-value aspect of capitalist production, keeping track of costs through the enterprises in a way that mirrors actual organizational and labor processes over time (Paton & Littleton, 1957).

The consistency of the entity view of the firm with the EU's institutional framework has received further support from the European Court of Justice's judgment (2013/ C-322/12), which has affirmed a tight link among prudence, historical cost accounting, and capital maintenance.[7] The judgment remarks that accounts are not only of importance for the protection of shareholders but also for third parties, as enterprises offer no safeguards to third parties beyond the amounts of their net assets. Therefore, it becomes clear that the "decision usefulness" model of accounting, which characterizes IFRS, fails to meet the "capital adequacy" function of accounting. Taken as a whole, this judgment provides support for historical cost accounting being more akin than other types of accounting to support economic sustainable development based on industrial recovery. In this respect, Hoffman and Detzen (2013) note that historical cost accounting contributed significantly to Germany's economic recovery and stability after the Second World War, stabilizing its economy and attracting investments.

As Müller (2014) notes, fair value and historical cost measurements are neither reducible to each other nor reconcilable; while historical accounting better suits the circuit of industrial capital, fair value accounting is for the circuit of money capital (Bryer, 1999; Marx, 1978). These two measurements correspond to different views of business in society—they are not just clashes between

[7] The European Court of Justice's judgment concerns the interpretation of the principle that a "true and fair view" must be given of companies' assets, liabilities, financial position and profit or loss. Specifically, the judgment concerns the treatment, for accounting purposes, of the acquisition of shares that were resold, 1 month after their acquisition, at a price that was 3,400 times their purchase price.

economic productivity and performance but between social models (Richard, 2012). Along the same lines, this paper points out that there is considerable legal uncertainty regarding the consistency of the IASB's Conceptual Framework with the view of business that has emerged from the EU constitutional setting. Since the Conceptual Framework drives the whole standards-setting process, its inconsistency would expand to all IFRS. This view is further supported by the fact that the Conceptual Framework has never been approved via the EU endorsement process.

4. Fair value accounting and long-term investments in the industry

As mentioned above, the industrial sector is the main beneficiary of the European Commission's initiatives targeted at boosting large-scale investments in the real economy. Such investments are usually amortized not over a few months but over several years. Therefore, a better understanding of the effects of fair value accounting on the investment behavior of industrial firms is necessary.

Indeed, fair value accounting as defined by IFRS 13 well reflects the conflict between the IASB's focus on equity investors and policymakers' objectives of promoting economic growth and recovery (Ronen, 2014); and between the short-termism typical of capital markets and the long-term orientation needed to support investments in real economy. As Kay notes (2012), in business, short-termism occurs when companies invest too little, either in the physical assets of the business or in the intangibles that are generally the source of their competitive advantage—their reputation, their capacity for innovation, and in the skills and capabilities of their employees. The European Commission (2018b), too, regards short-termism as an obstacle to long-term value creation in the real economy.

From an operating perspective, accounting is key for monitoring the effects of managers' strategies. Managers themselves want reporting systems that can reflect their efforts (Gilliam & Hofmann, 2018). A manager's job is to generate sales growth and expand market shares, which requires investments. When managers make investments, they do so through conscience acquisition, that is, they need more assets to implement their business strategies. If investments are held at historical cost, managers have complete control over their investment, in that they know what the costs are, and they can keep control of the effect of their operating decision and strategies. With historical cost, managers feel responsible for changes in assets values. On the other hand, when accounting rules force adjustments of the value of a firm's assets according to the short-term whims of the market, it is difficult for managers to feel responsible (e.g., Benston, 2006, 2008; Gilliam & Hofmann, 2018). Changes in asset value become largely unpredictable and out of management's control. Furthermore, fair value accounting turns a financial statement based on a going concern into a liquidation report, which is a rather unlikely event. From a managerial perspective, this results in suboptimal short-term decision-making (Graham, Harvey, & Rajgopal, 2005). From the investors' perspective, this makes them lose insight of the management's stewardship.

In his famous "tragedy of the horizon" speech, Bank of England governor Carney (2015) underlined that sustainability cannot develop in a context in which investment is dominated by short-term considerations. This statement finds significant support from Asker, Farre-Mensa, and Ljungqvist (2015) and Davies, Haldane, Nielsen, and Pezzini (2014), who report lower rates of investment in fixed assets in the presence of short-term pressures on managers. Further research highlights the significant role played by IFRS in conveying short-termism to business strategies (e.g., Andersson, Haslam, Lee, & Tsitsianis, 2008; Andersson, Lee, Theodosopoulos, Yin, & Haslam, 2014; De Jager, 2014; Haslam, Tsitsianis, Hoinaru, Andersson, & Katechos, 2015). Andersson et al. (2008), for instance, show that mark-to-market accounting for mergers leads to a mechanical inflation of balance sheets and net worth that negatively affects performance measures, such as return on equity. Under pressure from equity investors, managers tend to neutralize such effects by paying dividends and share buybacks financed by debt. A statement made by the company Piteco (2015) in adopting IFRS is anecdotal with respect to the link between IFRS adoption and payout policies: "if the Company should decide to share the net income of 2015 performance, adoption of IAS/IFRS will guarantee a distribution of a greater dividend." Given the same fundamentals, IFRS adoption allows higher dividends for shareholders.

The allocation of corporate profits to dividends and stock buybacks leaves very little for investments in productive capability, green technologies, or higher income for employees (e.g., Lazonick, Mazzucato, & Tulum, 2013). Onaran, Stockhammer, and Grafl (2011), for instance, report a negative correlation between dividends/interest payments and real investment at the macro level for the US economy, while Orhangazi (2008) finds similar results at the firm level. These results are consistent with the EU setting (e.g., Alvarez, 2015; Duménil & Lévy, 2004). Furthermore, when financed with debt, dividends and stock buybacks make companies financially more vulnerable, independently of the quality of their industrial projects. This introduces a financial risk that has little to do with firms' investment opportunities.

Finally, evidence suggests that under the pressure of shareholder focus on short-term returns, managers of non-financial corporations tend to increase financial investments at the expense of real investments, especially in times of upward market trends (e.g., Andersson et al., 2008; Froud, Haslam, Sukhdev, & Williams, 2000; Serfati, 2012). Fair value measurement, by accruing holding gains for assets when markets inflate, reinforces this trend, with detrimental effects on long-term real investments and capital accumulation. Moreover, most of these investments are financed with debt, which further increases corporate leverage and risk (e.g., Müller, 2014; Nölke & Perry, 2007).

If many doubts can already be raised over the capability of the IFRS to support long-term investment in the real economy, this issue becomes even more compelling if one considers the specific characteristics of the EU's economy. Family firms dominate the European economy, making up more than 60% of all companies in Europe and accounting for more than 70% of employment (KPMG, 2018).

Well-established literature shows that the multigenerational perspectives of family owners gives them an inherent incentive to consider the long-term impact of decisions (e.g., Lumpkin, Brigham, & Moss, 2010; Mazzola & De Buglio, 2018). The most well-known book on family firms written by leading management scholars is tellingly entitled *Managing for the Long Run* (Miller & Le

Breton-Miller, 2005). As Deeg and Hardie (2016) point out, family firms have the longest investment and management horizons of any firm type. Short-termism is banned from their business strategies (Culpepper, 2005; Deeg & Hardie, 2016; Roe, 2012). Furthermore, even when they are listed, the decision making of family firms does not focus only on economic goals. Family firms rather pay great attention to social and reputational capital, emphasizing the relationship with key stakeholders, such as employees and the local community (Newbert & Craig, 2017). Lehrer and Celo (2016) define family firms as "Durkheimian" institutions, to underline their being rooted in norms of community, solidarity and mutual obligations. As a result, stewardship and prudence in monitoring company management are family businesses' priority (e.g., Lehrer & Celo, 2016; Mazzola & De Buglio, 2018). As the case of Germany suggests, family firms have emerged from the crisis as more competitive than non-family firms have, which indicates that long-term orientation is rewarding (Gottschalk, Niefert, Licht, & Wagner, 2014).

5. Fair value accounting and stable finance for business

It is widely accepted that sustainable development needs resilient and long-term oriented financial systems, which can support investments that take time to yield results (UNEP, 2015).

In the EU, the financial system is highly bank-oriented. Bank loans are the main source of external financing, representing almost 30% of companies' financing in the EU compared to 13% in the US (Bank of Italy, 2017). This is mainly because SMEs face more difficulties in entering securities markets. As a result, distress in the banking system has significant consequences for investment in the real economy and employment.

Furthermore, in the past 10 years, the banking industry has undergone an accelerated process for the application of more stringent rules, with a consequent tightening in banks' financing. Given this context, the European Commission has taken several actions to mobilize and channel capital toward business and infrastructure. For instance, European Long-Term Investment Funds have been created with the specific objective of providing stable financing, especially equity, to SMEs. The relationship between accounting standards and institutional investors is, therefore, another key issue. In 2009, the High-Level Group on Financial Supervision in the EU, chaired by Jacques de Larosière, addressed this subject by claiming that the business model of pension funds or insurance companies should be taken into account, especially if made up of long-term assets and liabilities. Accordingly, the Group asked that accounting standards should not penalize long-term investment made by intermediaries.

Let us first consider how fair value accounting can affect the banking system. It has already been noted that mark-to-market accounting injects volatility into banks' financial statements (e.g., Casabona & Shoaf, 2010; Enria et al., 2004; Magnan, 2009; Novoa, Scarlata, & Solé, 2009; Persaud, 2008; Plantin, Sapra, & Hyun, 2008; Schwarz, Karakitsos, Merriman, & Studener, 2015). For Level 2 and 3 assets, volatility is further exacerbated by measurement errors, which are purely a consequence of accounting norms rather than fundamental values (e.g., Barth, 2004; Maino & Palea, 2013; Penman, 2007). Since financial statements form the bedrock of prudential regulation for credit institutions, this is a key issue for stable financing of the real economy (European Regulation 258/2014; European Regulation 575/2013). When market prices deviate from their true values for a protracted period, fair value accounting not only provides unwarranted volatility but also incurs the risk of unjustifiable bankruptcy. Ball and Haldane (2018), for instance, report that during the crisis, the UK banking system in aggregate would have been technically insolvent on a mark-to-market basis. During turmoil, asset fair values may fall below liabilities, so that banks become insolvent, despite their ability to cover their commitments fully if allowed to continue until the assets mature. Plantin et al. (2008) prove that this is particularly the case for assets that are long-lived, illiquid, and senior, which are the exact attributes of the key balance sheet items of banks and insurance companies. These results are consistent with those of Biondi and Giannoccolo (2015), who show that fair value accounting makes financial systems more unstable than historical cost accounting does.

For the same reasons, in the wake of the financial crisis, the IASB allowed 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 (Schwarz et al., 2015). The fair value principle was suspended with regard to recognition of unrealized losses because of the systemic risk that a sudden drop in all banks' balance sheet would have generated. Fiechter (2011) reports that around one-third of a sample of 219 European banks took up the reclassification option, which avoided substantial fair value losses. Similarly, Jarolim and Öppinger (2012) find that the reclassification option was used quite extensively by 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. This is a sensitive issue, since the banking system does not simply allocate but also generates purchasing power (De Jager, 2014).[8]

Furthermore, in the EU's economy, bank loans and their ties with firms usually have a strategic long-term nature. A productive capital view dominates industry–finance relationships (e.g., Albert, 1993; Fiss & Zajac, 2004; Kädtler, 2010). Furthermore, banks well protect the confidentiality of the family firm's finances (Lehrer & Celo, 2016). In such a context, banks have long been concerned with ensuring the securities of their long-term loans to enterprises. Accordingly, they have adopted a relatively cautious view of the future, acknowledging its inherent uncertainty (e.g., Fiss & Zajac, 2004; Perry & Nölke, 2006). In this respect, historical cost accounting over time has provided bankers with a prudent valuation of firms' assets. By matching incurred expenses with collected revenues generated from operating activities, income has been able to measure the firm's real operating performance (Zhang & Andrew, 2014).

Let us now turn to pension funds and life insurances. The European Commission acknowledges that to finance the transition

[8] In considering empirical literature, the focus is on European Union banks, whose prudential regulatory framework, which played a role in banks' deleveraging, shows some differences from the US.

toward sustainable development, the investment portfolio of such institutional investors needs to be mobilized, including by engaging them in equity financing for long-term investments much more strongly (HLEG, 2018). Such intermediaries represent the channel through which private savings can be directed toward financing European investment needs. This is an ambitious challenge, which needs a consistent regulatory framework.

Pension funds and life insurers have repeatedly raised the issue of the inconsistency of mark-to-market accounting with their business models. These entities have underlined that short-term fluctuations create undue volatility in their balance sheets, pushing them to avoid equity investment or to reduce them to a minimum. This is undesirable not only from a business model but also from a general economic point of view, as equity investment reduces the debt bias in the economy. Along the same lines, the HLEG (2018, p. 71) remarks that "the obligation entailed in IFRS accounting rules to use current market values for equity investment discourages the use of equity for long-term investment […] a more long- term, stable accounting framework would bring the reported balance-sheet much more in line with the actual business model […] By the way of scale, even if only 1 percentage point of assets were to move from debt to equity, this would entail additional equity investment of 100 billion Euros and reduce the debt bias in the EU economy."

The report on the interaction of IFRS 9 and long-term investment decisions written by Barone and Gullkvist (2018) provides significant support for the HLEG. Although direct evidence on mark-to-market accounting for investment portfolios is still lacking, a few studies report changes in investment strategies in response to changes in accounting standards that increase volatility in financial statement. Specifically, research shows that the risk of increased volatility induces firms to shift their pension portfolios from equity to debt securities (Barthelme, Paraskevi, & Sellhorn, 2018; Amir, Yanling, & Oswald, 2010). This research is important, because it shows how firms adjust their investment behavior to mitigate undesired effects of accounting standards on equity book values. As Barone and Gullkvist (2018) point out, managers' concerns about equity volatility well complement documented concerns over earning effects in influencing investment behavior.

Taken as a whole, the evidence provides support for the European Commission's (2018c) request to investigate alternative accounting approaches to mark-to-market valuation in order to mitigate the undue impact of short-term market price movements on equity portfolios that are managed according to long-term investment criteria. Some long-term investors, for instance, have recommended reintroducing the concept of value in use, as defined in IAS 36, for their investments (Bassanini & Reviglio, 2015). This suggests that there is still a long way to go in designing a financial system that can help target the needs of the European economy and society.

6. Fair value accounting and the codetermination system typical of social market economies

As mentioned above, IFRS adoption in the EU has been motivated by the need to make financial markets more efficient. IFRS consider securities markets and financial actors as prominent stakeholders in society. However, as the literature on the varieties of capitalism documents, there are different ways of doing business (Hall & Soskice, 2001).

The EU has set the social market economy at the heart of its project (Treaty on the European Union, 2007, art. 3). As von Hauff (2009) notes, the social market economy and the sustainable development paradigms have always co-existed side by side, and numerous experts have even found it impossible to draw a clear substantive distinction between them. Nevertheless, one key feature of social market economy is that it originates from West Germany's economic and social recovery after the Second World War.[9] In setting social market economy as a fundamental objective of the EU, the Lisbon Treaty in fact looked at the German socio-economic model (Muresan, 2014; Palea, 2015; Šmejkal, 2015; Velo, 2018).

Although social market democracies in the EU have recently been under pressure from neoliberal ideologies, these countries have been able to keep distributional considerations, such as economic equality and social justice, central to their political agenda. Empirical evidence indeed suggests that the categorization of advanced industrialized economies into liberal market economies and social market democracies is still effective (e.g., Witt et al., 2018).

Importantly, in social market democracies, the inclusion of parties beyond shareholders in corporate governance is a common concern. Workers, for instance, play a prominent role and are regarded as important stakeholders in firms. In Germany, workers sit together on the supervisory boards of large corporations, and some kind of co-determination is also required in Austria, Denmark, Sweden, France, and Luxembourg (Rieckers & Spindler, 2004; Schmidt, 2004). For this reason, it is common to refer to social market democracies as "stakeholder capitalism" as opposed to the "shareholder capitalism" that is typical of neoliberal economies.

It is well established in the literature that these distinctive characteristics have been key for such democracies in developing a long-term perspective on economic decision-making, high-skilled labor, and quality products based on incremental innovation (Hall & Soskice, 2001; Witt et al., 2018). This is even more apparent in the case of family businesses, which encompass not only investment

[9] As is well known, social market economics shares with classical market liberalism the firm conviction that markets represent the best way to allocate scarce resources, while it shares with socialism the concern that markets do not necessarily create equal societies (Müller-Armack, 1966). Since a free market does not always work properly, public authorities should act and intervene to prevent it from providing negative outcomes for society (Spicka, 2007). It is also common to refer to social market economies as the "Rhenish" variety of capitalism, and to liberal market economies as the "Anglo-Saxon" variety of capitalism (e.g., Albert, 1993; Hall & Soskice, 2001). For other capitalist economies, different models are necessary (e.g., Witt et al., 2018). For further insights into the key features of social market democracies, see Albert (1993), Hall and Soskice (2001), and Witt et al. (2018). Many could argue that so far, European institutions, such as the European Commission, have not done enough to reach these objectives. Nonetheless, this does not undermine the relevance of the EU's ideals. As Noël, Ayayi, and Blum (2010) note in their article on Habermas' discourse of ethics applied to accounting policy, ideals give rise to action even if they are not or cannot be enforced, since they inspire us to improve our institutions and behavior.

capital but also the accumulation of social and reputational capital as major sources of competitive advantage. Long-term orientation and the strong sense of responsibility toward stakeholders, including employees and local communities, have always been peculiar to family firms (Lumpkin et al., 2010; Mazzola & De Buglio, 2018).

This environment increases the demand for verifiability and conservatism in financial reporting (Ramanna, 2015). Stewardship, defined as accountability to all stakeholders, becomes a primary objective of financial reporting, and historical cost the relevant measurement basis. Whittington (2008) notes that this approach to financial reporting serves investors as well. It seeks information that is relevant to forecasting future cash flows, but assumes that this can be achieved by providing information that is useful as an input to valuation models, rather than through the direct valuation of future cash flows. Indeed, conservative accounting contributed significantly to the German government's objectives of economic recovery and stability after the Second World War. The choice of historical cost accounting made by the Fourth Directive was the result of a working group supervised by German Professor Wilheim Elmendorff, and was consistent with a business environment in which the industrial circuit of capital was dominant. Not even during the oil crises of the 1970s were attempts made to change accounting regulation (Hoffman & Detzen, 2013). From the employees' point of view, historical cost enabled focus on the creation of wealth generated by the use of firms' resources, providing a prudent basis for distribution among different stakeholders. This was key for works councils: it created a good social climate emphasizing the contribution made by employees to the company's results and ensured greater attention to productivity issues (Ferracci, 2016).

Empirical data confirm that the best performing member states in terms of economic growth, job creation, and lower level of inequality, such as Germany and Sweden, enjoy strong and institutionalized social dialogue between businesses and trade unions (Andor, 2011; OECD Forum, 2015). Competitiveness and labor welfare prove to be directly linked to each other (e.g., Claessens & Ueda, 2008; Fauver & Fuerst, 2006; Ginglinger, Megginson, & Waxin, 2009; Page, 2015). Social democracies also better resisted the crisis (OECD Forum, 2015).

Research suggests that the pursuit of the shareholder value maximization principle has led to increasing dividends and interest payments to the financial sector, a falling labor income share, and increasing inequality of wages (e.g., Lin & Tomaskovic-Devey, 2013; Hein, Detzer, & Dodig, 2016). Along the same line, Roe (2012) notes that short-term expectations, which are typical of stock-market based economies, tend to exert disruptive effects on labor skills. Shareholders' return expectations cause pressure on wages in order to boost profits, which disconnect wages and productivity, while encouraging household debt so as to maintain consumption levels (e.g., Ferracci, 2016; Hein et al., 2016). This is in stark contrast to the claim of neo-classical economists that maximizing shareholder value is consistent with long-term societal objectives. As many authors point out, such a shift of income from wages to profits and dividends has been strongly supported and legitimized by a shift in accounting views and calculations toward fair value measurement (e.g., Shipman, 2015; Sikka, 2015).

7. Discussion and conclusions

Previous sections show how financial reporting regulation represents a critical institution in modern capitalism. Accounting rules define the fundamental notion of profitability and affect capital allocation. As a result, the health of the accounting system impacts the health of the economy and the distribution of wealth and income therein (Cooper, 2015).

In the EU, public awareness of the role of public policies in aligning the real economy to sustainable development outcomes has never been greater (Lipsky, 2015). The European Parliament (2016) has called for better understanding of the macroeconomic effects of financial reporting regulation. It has also urged the European Commission to issue clear guidelines on the meaning of "public good" in order to provide a better understanding of the endorsement criteria. This study points out that a clear definition of "public good" already exists in the Lisbon Treaty, which sets the fundamental goals of the EU, including sustainable development. As Section 3 shows, considering accounting regulation in terms of its capability to pursue public good, as defined by the Lisbon Treaty, provides the stakeholder theory of the firm with a strong legal basis, distancing it from being just an academic perspective. The Treaty considers all the stakeholders in society on the same level and includes social equality as a main goal of the EU. Furthermore, this study questions the capability of IFRS in general and, more specifically, of fair value accounting to support the objective of sustainable development. It contends that fair value measurement as defined by IFRS 13 is an obsolete tool for a socio-economic model that looks at physical—rather than financial—maintenance of capital.

Unlike other regulations, over time, accounting regulations have become almost uniform throughout all free market economies, and is constantly expanding (e.g., Carneiro, Rodrigues, & Craig, 2017; Irvine, 2008; Lev & Gu, 2016). While cultures, economic institutions, and development history exert strong effects on national laws, financial reporting regulation defies diversity. Unlike other fields, there is no competition in financial reporting. Even small differences between US GAAP and IFRS are gradually disappearing owing to the pressure to converge these systems. IFRS 13 on fair value measurement is anecdotal in this respect. Furthermore, IFRS incorporate postulates and calculation conventions that are rooted in financial theory and promote the viewpoint and interests of financial actors.

A single set of global financial reporting standards tailored to the needs of stock market-based capitalism represents a significant monopoly power, which could endanger the varieties of capitalism. As Bassanini and Reviglio note (2015, p. 64), "accounting regulation which penalizes the financing of real economy […] has become a major weapon in the global economic and financial war, hitting Europe more than other economies". Indeed, the EU's financial system, which is more bank oriented than most of the other major financial systems in the world, has so far payed a greater price owing to accounting standards being unfriendly for long-term investments and for the financing of the real economy.

One important conclusion is that a reverse process should be adopted in discussing financial reporting regulation, which tests accounting standards against the specificities of the European business system. The key point is not to evaluate a certain accounting measurement *per se* but rather relative to certain specific societal goals. There is no consistent, let alone universally agreed, financial reporting standard that is appropriate for all policy goals. The European Commission (2018c) seems to have become fully aware of the issues at stake. Along these lines, convergence is not an objective in itself but only desirable if it results in better accounting standards that reflect an orientation toward the European public good. Consistent with the hierarchy of laws, comparability among financial statements set out by Regulation 1606/2002 is a lower priority than meeting the Lisbon Treaty's objective of sustainability. The judgement by the European Court of Justice (2013/ C-322/12), which links the "true and fair view" principle with prudence, capital maintenance, and historical cost accounting, also reveals a tension between IFRS and the constitutional framework of the EU, which drives the Court's decisions.

In conclusion, accounting rule-making is a strong political process. As shown in Section 3, different accounting measurement systems correspond to different views of business in society. By adopting IFRS, the EU has dismantled financial reporting regulation under the control of the European Parliament, delegating it to the IASB, which is a private, UK law organization over which it has no control (e.g., Chiapello & Medjad, 2009; Gallhofer & Haslam, 2007; Müller, 2014). Therefore, European governance of accounting standards is unique in the world. The EU is the only major constituency that has legally committed itself to make IFRS compulsory for listed companies; yet, it has no right to make amendments to specific rules issued by the IASB if they could harm the European economy. It appears clear that the "rules of the game" in accounting rule-making need thorough rethinking. While in recent years, increasing privatization was the general trend in international accounting standards setting, it is now time to reverse this trend for the sake of the general interest (e.g., Botzem, 2008; Bengtsson, 2011; Kerwer, 2007). The European Parliament (2016) shares the concern that deeper democratic scrutiny of financial reporting rules is needed. For this reason, it has called for more involvement in the development of financial reporting standards and their endorsement. At least, the EU should amend specific rules that could cause problems for its broader policy objectives.

Public scrutiny of financial reporting also requires more socially engaged research, which focuses on issues that are critical for the EU's uniqueness. This is consistent with the significant investments that the EU is making in research on EU policies (European Commission, 2014). The research program Horizon 2020, for instance, includes social sciences, which are considered key to help Europe implement its strategy for economic recovery and social reforms (ERAB, 2012). Along the same lines, accounting research has the potential to make a significant contribution to the development of a financial reporting system that is fit for purpose of serving the needs of a sustainable development.[10] European regulators and academics are called to deal with this challenging task.

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[10] In this respect, the recent constitution of the EFRAG academic panel along with the EFRAG Academic Network should be welcomed, with the purpose of providing effective contribution on accounting issues that are relevant to European constituents.

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