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THE POLITICS OF FAIR VALUE REPORTING AND THE GOVERNANCE OF THE STANDARDS-SETTING PROCESS: CRITICAL ISSUES AND PITFALLS FROM A EUROPEAN PERSPECTIVE

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THE POLITICAL ECONOMY OF FAIR VALUE REPORTING AND THE GOVERNANCE OF THE STANDARDS-SETTING PROCESS: CRITICAL ISSUES AND PITFALLS FROM A CONTINENTAL EUROPEAN UNION PERSPECTIVE

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ABSTRACT: Accounting is not simply a metric; it is, rather, a calculative practice that shapes the socio-economic environment. To look at the substance of accounting standards alone is therefore sometimes inadequate.

From a Continental European Union perspective, this paper provides a general framework that deals with the potential changes in society produced by financial reporting. More specifically, it discusses fair value reporting from two points of view that are closely linked. The first relates to the political economy of fair value reporting and its potential impact on the economic and social system, while the second relates to the governance of the standards-setting process.

In discussing such issues, this paper suggests that the fundamental principles set out by the Lisbon Treaty should be used as a framework to analyze financial reporting policies in the European Union.

KEYWORDS: Critical, Public Interest, Fair Value Reporting, Lisbon Treaty, Rhenish Capitalism

JEL CLASSIFICATION: M40, P00, K00

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"*There are more things in heaven and earth, Horatio,*
Than are dreamt of in your philosophy".
(W. Shakespeare, 1603, Hamlet, Act I scene V)

1. INTRODUCTION

Financial reporting is not a neutral, mechanical and objective process that simply measures the economic facts pertaining to a firm. It is rather a powerful calculative practice that is embedded in an institutional context and shapes social and economic processes. Deconstructing the influence of technical accounting standards reveals that accounting normalizes and abstracts a "*system of socio-political management*" (Miller and O'Leary, 1987). To consider accounting standards independently of their social context, as we normally do as accounting scholars, is therefore sometimes inadequate.

Mainstream empirical research usually investigates accounting standards in terms of their efficiency, principal-agent conflicts and information asymmetry. This paper, instead, adopts a broader view and considers financial reporting issues in terms of their potential effects on the socio-economic system. More specifically, it focuses on fair value reporting and, while doing so, adopts a Continental European Union perspective. Furthermore, it critically examines the institutional organization of the standards-setting and endorsement processes in the European Union.

There already exists a well-established body of literature that draws attention to the political aspects of accounting regulation (e.g. Perry and Nölke, 2006; Chiapello and Medjad, 2009; Noël et al., 2010; Bengtsson, 2011; Crawford et al., 2014). This paper, however, adds to previous literature by setting the discussion of financial reporting regulation issues within the framework of the Lisbon Treaty (also 'Treaty' hereafter). In doing so, it relies on an interdisciplinary approach that considers accounting policies within macro politics and economics as well as within the constitutional setting of the European Union.

The constitutional setting of the European Union is set out by the Lisbon Treaty, which defines the objectives of the European Union and the means whereby they can be achieved. The Lisbon Treaty states that the European Union shall work for the sustainable development of Europe based on balanced economic growth, price stability and a highly competitive social market economy aiming at full employment and social progress. It also contains a 'social clause' whereby the social issues, including social protection, must be taken into account when defining and implementing all policies.

The European Union should indeed combat social exclusion and discrimination and should promote social justice and protection.

Since financial reporting is one of the competences of the European Union, the European Union must legislate and adopt the binding acts necessary to pursue its objectives in this field. The Lisbon Treaty therefore represents the framework within which financial reporting policies and their potential effects on the European socio-economic context should be considered. In accordance with this view, this paper discusses fair value reporting, as well as the governance of the standards-setting and endorsement processes, with the aim of highlighting those issues that raise the greatest concerns over their appropriateness to the European constitutional setting.

Based on empirical research, this paper highlights three central issues related to fair value reporting that would require investigation in light of the Lisbon Treaty. The first relates to procyclicality and the contagion effects that fair value accounting is supposed to cause in the banking system, with potentially disruptive effects on real economy financing. The second regards the reliability of fair value estimates based on valuation techniques, which exacerbate volatility, affecting the capital requirements of financial institutions and the financing of enterprises. The third relates to the definition of fair value as an exit price, which fails to consider the strategic intent of the asset value, with potentially detrimental effects on long-term investments, which have been crucial for gaining and maintaining competitive advantage in many countries of the Continental European Union.

The Lisbon Treaty is also used in this paper as a framework for discussion of the governance of the standards-setting and endorsement processes in the European Union. According to the Treaty, the European Union shall observe the principles of equality of its citizens, who shall receive equal attention from its institutions, and decisions shall be taken as openly as possible. The Lisbon Treaty also highlights the importance of social dialogue, which is key to the European social model.

This paper highlights the fact that, in contrast to these principles, by issuing Regulation 1606/2002 (also 'IFRS Regulation' hereafter) the European Union has delegated the standards-setting and endorsement processes to private authorities whose composition is skewed towards the financial and auditing industries. Some important stakeholders - such as the manufacturing industry and labor representatives – are not part of the process. This is a major issue if we consider the tight link between the power of the financial and auditing industries within standards-setting bodies and the increasing use of fair value reporting.

The remainder of this paper is structured as follows: Section 2 introduces the Lisbon Treaty as a framework for discussing financial reporting regulation, while Section 3 examines the main characteristics of financial reporting Regulation 1606/2002, which mandated IFRS[1] in the European Union. Section 4 discusses the main issues related to fair value which raise concerns over their consistency with the objectives of the European Union. Section 5 focuses on the political economy of fair value reporting, while Section 6 discusses its potential effects on the socio-economic system of the Continental European Union. Section 7 presents the governance weaknesses of the standards-setting and endorsement processes in light of the Lisbon Treaty. Finally, Section 8 provides some conclusions and directions for future work.

2. EXAMINING FINANCIAL REPORTING POLICIES WITHIN THE FRAMEWORK OF THE LISBON TREATY

Proudhon (1846) used to say that "*the accountant is the true economist*". Indeed, 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 therefore adopts a broader view which considers financial reporting issues regarding their potential effects on the socio-economic system. A specific focus is placed on the Continental European Union, whose socio-economic features are particularly relevant to this discussion.

Financial reporting is one of the competences of the European Union, which must legislate and adopt binding acts necessary to pursue its objectives in this field. The objectives of the European Union are set out by the Lisbon Treaty, which was signed by the European Union member states on 13 December 2007, and came into force on 1 December 2009. The Lisbon Treaty amends the two previous Treaties which constitute the basis of the European Union: the Maastricht Treaty, also known as the Treaty on the European Union, and the Rome Treaty establishing the European Community.

The Lisbon Treaty clearly states the inspiring values and founding principles of the European Union. It goes beyond the Maastricht architecture of a simple economic and monetary union and provides the basis for a new economic and social governance. It also enshrined a Charter of Fundamental Rights in the European Union's constitutional

[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.

order for the first time, thereby establishing not only economic, but also political and social rights for citizens and residents of the European Union.

The Lisbon Treaty 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 centred on two main issues. The first issue was to set the economic and social model that the European Union would pursue; the second was to define the powers which were to be transferred to the European Union and the institutions and rules which would guarantee its implementation.

According to the Treaty, 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 [...] it shall combat social exclusion and discrimination, and shall promote social justice and protection*" (art. 3). As is clear, the concept of a social market economy emerged as a guiding idea of the European Union. A social market economy is one of the main objectives of the Lisbon Treaty and represents the core value on which the European Union has decided to build and shape its future. This is therefore the framework within which European policies must be defined and their possible outcomes discussed.

The term 'social market economy' originates from the post-World War II period, when the shape of the 'New' Germany was being discussed. Social market economy theory was developed by the Freiburg School of economic thought, which was founded in the 1930s at the University of Freiburg, and received major contributions from scholars such as Eucken (1951, 1990), Röpke (1941, 1944, 1946, 1969) and Rüstow (1932, 1960). In the definition of Müller-Armack (1966), a social market economy is primarily a normative value system that is not unique and seeks to combine market freedom with equitable social development. It is a process, as opposed to something static, which changes form while keeping its essential content. Social market economics shares with classical market liberalism the firm conviction that markets represent the best way to allocate scarce resources efficiently, while it shares with socialism the concern that markets do not necessarily create equal societies (Marktanner, 2014). Market efficiency and social justice do not therefore represent a contradiction in terms, as is proven by Germany's post-World War II economic miracle (Spicka, 2007; Pöttering, 2014).

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.

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

In order to work effectively, a social market economy shall organize the state-citizen relationship along two principles: the organization of the state according to subsidiarity and the division of the government from special interest groups (Eucken, 1952). Both of these ideas are included in the Lisbon Treaty, which states that the use of Union competences is governed by the principles of subsidiarity (art. 5). Financial reporting regulation, for instance, is included in the single market policies that are conferred upon the European Union and therefore delegated to the European institutions.

Moreover, the 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). This should prevent the European institutions from being influenced by special interest groups. The Treaty also highlights the importance of social dialogue, which is one important pillar of the European social model (art. 152). Indeed, 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).

As the Lisbon Treaty represents the legal framework within which the European Union must act, financial reporting issues must be considered in this context. Both the potential effects of fair value accounting on society and the governance of the standards-setting and endorsement processes should be discussed in terms of their capability to match the objectives of the Treaty: is an extensive use of fair value reporting likely to promote a social market economy based on balanced economic

growth? Does the current governance of the standards-setting process promote social inclusion, justice and protection, or is it rather controlled by special interest groups?

This paper cannot provide definitive answers for such complex questions, yet it conducts a ground-clearing exercise designed to set the framework within which financial reporting regulation should be discussed in the European Union. The European Regulation 1606/2002 mandating IFRS was issued in 2002 and became effective in 2005, before the Lisbon Treaty was signed. Now that it is in force, the Treaty provides us with the objectives of the European Union and its ideal economic and social model. It is therefore time we reconsider the IFRS Regulation with regard to its consistency with the founding principles of the European Union.

3. FINANCIAL REPORTING IN THE EUROPEAN UNION: REGULATION 1606/2002

As already mentioned, European Union competences are governed by the principle of subsidiarity. Financial reporting regulation is included in the single market policies that are conferred upon the European Union and is therefore set out by the European institutions.

In 2002, the European Union issued the European Parliament and Council Regulation No. 1606, 19 July 2002, which mandated IFRS for consolidated financial statements of listed companies starting from 2005, with a member state option to apply IFRS to other reporting entities. A number of states, including Italy, Belgium and Portugal, took up this option, extending IFRS to unlisted banks, insurance firms and supervised financial institutions, while others - such as Cyprus and Slovakia - required IFRS for all firms. Some states, such as Italy, Cyprus and Slovenia, also required IFRS for separate financial statements of certain types of firms. There is also a clear intent on the part of the International Accounting Standard Board (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 set of accounting rules that could be recognized at an international level.

In actual fact, efforts to harmonize financial reporting in the European Union date back to the 1960s. The Treaty of Rome, which was signed in 1957, stated that freedom of establishment and the free movement of capital were fundamental objectives of the European Union. Such objectives required a common environment within which

companies could conduct their business, and accounting legislation was part of this harmonization program. Harmonization did not require that the same rules should be applied in all member states, but that the prevailing rules were compatible with those in the other member states.

Financial regulation for listed companies in Europe prior to IFRS adoption was based on the fourth and seventh European directives[2]. These directives provided the same basic principles and a set of minimum accounting rules, but left member states some options that could be implemented in national law according to their diverse national historical and economic backgrounds, cultures and legislation. Given such flexibility, the implementation of the accounting directives into national law differed from country to country. For instance, countries could choose between historical cost and fair value for evaluating certain assets. While countries from the Continental European Union required full historical cost accounting, the UK allowed the use of fair value for some items. There is a wide consensus that historical cost accounting, being more conservative and concerned with the protection of debt holders, has been crucial for highly bank-oriented financial systems such as that of the Continental European Union (e.g. Sally, 1995; Froud et al., 2000; Lazonick and O'Sullivan, 2000; Perry and Nölke, 2006).

Given the internationalization of companies, the achievement of a single market and the globalization of financial markets, the European regulator quickly became aware of the need to standardize financial reporting at a European level and to introduce a set of accounting rules that could be recognized in international financial markets. Rather than working on a revision of the directives, the European Union opted for the adoption of IFRS, which were able to offer Member States a set of common standards acceptable to all and were suitable for rapid recognition at an international level. As Chiapello and Medjad point out (2009), the choice of adopting IFRS was driven by the European Union's inability to get its members to agree on a common accounting system. To overcome this obstacle, the European Union therefore decided to take a secondary role and to delegate the standards-setting process to the IASB.

According to Regulation 1606/2002, adopting IFRS should ensure a high degree of transparency in financial statements and a high degree of comparability among the financial statements of firms from different countries that previously used domestic GAAP based on the European directives. This should in turn lead to more effective and

[2] Domestic Generally Accepted Accounting Principles (GAAP) based on the European directives still apply to firms not adopting IFRS.

efficient functioning of the European capital market. Regulation 1606/2002 is very much focused on capital markets, as is the IASB, the body that issues IFRS. The IASB considers investors to be those most in need of information from financial reports as they cannot usually request information directly from the firm. Moreover, it assumes that, as investors provide risk capital to firms, the financial statements that meet their needs also meet most of the needs of other users (IASB, 2010 BC 1.16).

Fair value reporting must be considered from this perspective. Fair value accounting is supposed to provide investors with better information to predict the capacity of firms to generate cash flow from the existing resource base, which should improve the decision usefulness of financial information (e.g. Barth et al*.,* 2001). Under fair value reporting, the concept of income changes from income produced to mixed income, which also includes potential profits. The concept of net worth is divested of its strictly juridical connotation and assumes a more economic meaning, which makes a firm's net worth converge with its current market value. As stated by Sir David Tweedie, former chairman of the IASB, "*the IASB and partner standard setters are tackling some of the fundamental challenges facing accounting today in order to make the accounting model relevant [...] Publicly traded companies are complex entities, engaged in a wide range of activities and subject to different market pressures and fluctuations. Accounting should reflect these fluctuations and risks. [...] The current direction we are taking will be what I like to call 'tell it like it is' accounting. This means an increasing reliance on fair values*".

Fair value is the primary basis for asset and liability measurement under IFRS. A substantial portion of a firm's assets and liabilities are stated in the balance sheet at fair value – including pension assets and liabilities, derivative financial instruments, certain other financial assets and liabilities, tangible and intangible fixed assets that have been acquired in a business combination, assets held for disposal, share-based payment liabilities, provisions and biological assets. Fair value is an option for some other assets, such as investment properties. Moreover, the IASB seems to be willing to further increase the use of fair value, as suggested by IFRS 9, *Financial Instruments*, which extends the use of fair value for financial instruments.

As will be discussed in Section 7, with the adoption of IFRS, at least for all listed firms, the European Union has, in substance, delegated the development of accounting standards to an international private standard setter over which it has no control. To address this concern, Regulation 1606/2002 contains an endorsement mechanism that should guarantee that IFRS are adopted only on the condition that they conform with

the 'true and fair view' that is dominant in the European directives; they are conducive to the European public good, which – however – has never been clearly defined; and they meet the criteria of understandability, relevance, reliability, and comparability needed to make economic decisions and assess stewardship.

The endorsement process involves many institutions at a European level. One of these is the European Financial Reporting Advisory Group (EFRAG), which is a technical advisor group that assists the European Commission in this process and is responsible for assessing whether the standards fulfil such criteria. Based on the EFRAG's advice, the Commission prepares a draft endorsement Regulation, which is voted by the Accounting Regulatory Committee (ARC). The ARC is composed of representatives from member states and represents the political level in the endorsement process. If the ARC's vote is favorable, which is the case for the vast majority of the standards to be endorsed, the European Parliament and the Council of the European Union have three months to oppose the adoption of the draft Regulation by the Commission. After the three months have elapsed without opposition from their side, the Commission adopts the draft Regulation. In practice, the EFRAG has always judged these criteria to have been fulfilled, and all the standards issued by the IASB have so far been adopted by the European Union (Maystadt, 2013).

4. CRITICAL ISSUES IN FAIR VALUE REPORTING

As mentioned, consistency with the European public good is one of the criteria that an accounting standard must meet in order to be endorsed in the European Union. Nevertheless, this criterion has never been elaborated on. At the time the IFRS Regulation was issued, the Lisbon Treaty had not yet been signed. Nowadays, however, the Treaty is in force and provides us with the key conception of the European public good. As a result, accounting standards in general and, more specifically, fair value reporting must now be considered in light of their consistency with the objectives of the European Union set out by the Treaty.

Fair value accounting already came up for discussion during the recent financial crisis, leading to a major policy debate involving, among others, the US Congress and the European Commission as well as banking and accounting regulators worldwide. Critics argue that fair value accounting has significantly contributed to the financial crisis and exacerbated its severity for financial institutions all around the world. Opponents claim that fair value is not relevant and is potentially misleading for assets that are held for a long period, particularly those held to maturity; prices could be

distorted by market inefficiencies, investor irrationality, or liquidity problems; fair values based on models are not reliable and increase volatility; and fair value accounting contributes to the procyclicality of the financial system (e.g. Benston, 2008; Ryan, 2008). At the other extreme, proponents of fair value reporting argue that it has merely played the role of the proverbial messenger, now being shot. Many claim that fair values for assets or liabilities reflect current market conditions, providing timely information, increasing transparency and encouraging prompt corrective action (e.g. Turner, 2008; Veron, 2008).

Few dispute the importance of transparency, but the controversy rests on whether fair value reporting is really helpful in providing transparency or whether it leads to undesirable actions on the part of banks and firms. This paper will suggest that doubts as to the consistency of fair value reporting with the Lisbon Treaty regard three main issues. The first refers to the procyclicality and contagion effects that fair value accounting is supposed to cause in the banking system, with potentially disruptive effects on real economy financing and employment. The second concerns the reliability of fair value estimates based on valuation techniques, which are especially problematic when active markets do not exist, as was the case for the interbank market during the financial crisis in 2007-2008, and are therefore deemed to exacerbate volatility. This is a key issue, as volatility affects financial institutions' capital requirements and enterprises' financing, thereby threatening economic growth. Finally, the third issue relates to the definition of fair value as an exit price. This definition fails to consider the strategic intent of the asset, with potentially detrimental effects on long-term investments, which have been crucial for gaining and maintaining a competitive advantage and high economic growth rates in many countries of the Continental European Union. As economic growth, full employment and social progress are among the goals of the Lisbon Treaty, the consistency of fair value reporting with the objectives of the European Union is therefore questionable.

4.1. Fair value as a vector of crisis

Fair value reporting has been the subject of considerable debate by the European Central Bank (2004), the Banque de France (2008) and the International Monetary Fund (2009) for its procyclical effects on real economy financing. According to William Isaac (2010), former Chairman of the Federal Deposit Insurance Corporation (FDIC), the fair value accounting regulation was the primary cause of the recent financial crisis.

Many scholars agree that fair value reporting caused a downward spiral in financial markets, which made the recent crisis more severe, amplifying the credit-crunch (e.g.

Persaud, 2008; Plantin et al., 2008). Specifically, in 2007 significant signs of weakness in the real estate market began to emerge in the US and the non-payment of mortgages led to a sharp increase in foreclosures. This, in turn, led to a downgrading of exotic financial instruments such as securitized mortgages in the form of collateralized mortgage obligations (CMOs), which affected their prices negatively. The financial crisis was further aggravated by the derivative markets, which were hit particularly hard by defaults in the underlying mortgage assets. As a result of mark-to-market regulation, the asset values of financial institutions – especially those of mortgage-backed securities - declined significantly. In such a distressed market, it was difficult to sell these securities, and the lack of demand resulted in more drastic reductions in their market value. The fear of a contagion effect induced banks to get rid of their securities, which depressed prices further and forced write-downs. Banks started accumulating huge losses, which significantly impaired their capability to lend money, provoking a domino effect (Jaggi et al., 2010).

Allen and Carletti (2008) and Plantin et al. (2008) provide useful insights into the role of fair value reporting in financial crises. Allen and Carletti show that, when mark-to-market accounting applies, the balance sheets of financial institutions are driven by short-term market fluctuations that do not reflect their fundamentals. During financial crises, asset prices reflect the amount of liquidity available rather than the asset's future cash flows. Asset fair values may, consequently, fall below liabilities so that banks become insolvent, despite their capability to cover their commitments fully if allowed to continue until the assets mature. Likewise, Plantin et al. (2008) show 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. Their analysis also suggests that the damage done by mark-to-market accounting 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. These results are also consistent with Cifuentes et al. (2005), Khan (2009) and Bowen et al. (2010).

Novoa et al. (2009) show that sale decisions in distressed markets with already falling prices activate margin calls and sale triggers, which are components of risk management, contributing further to the downward trend. Ronen (2012) notes that, because many contracts require cash collateral payments when one party's debts are downgraded, debt downgrades trigger cash collateral demands and increase the strain on the liquidity of the downgraded institution. In addition, the downgrades may trigger

demands by regulators for the infusion of additional equity capital precisely at the point in time when markets are illiquid and the cost of capital is unusually high. This can start the march into insolvency of institutions that would otherwise be solvent, and the insolvency or near insolvency of the institutions that are forced to write down their assets gives rise to write-downs in connected institutions with relevant contagion effects. The weakening of bank balance sheets during the crisis also heightened concerns over the future courses of some markets, the health of banks and, more broadly, the financial system, which resulted in several runs on banks (Gorton, 2008; Allen et al., 2009b).

As banks play a crucial role in the economy as a whole, financial distress in the banking system has significant consequences on real economy and employment. Freixas and Tsomocos (2004) show that mark-to-market accounting worsens the role of banks as institutions that smooth inter-temporal shocks. Dell'Ariccia et al. (2008) provide evidence of the correlation between bank distress and a decline in credit and GDP. Due to the financial system crisis in 2007-2009, economic activity declined significantly both in the US and in the European Union and unemployment rose dramatically. There is a wide consensus that this is the worst crisis since the Great Depression (Allen et al., 2009b).

4.2. Mark-to-model accounting and the potential effects of measurement errors

Laux and Leuz (2009) suggest that one way to tackle the procyclicality of fair value accounting and its contagion effects is to deviate from market prices in situations where contagion is likely to occur. In order to protect against negative spillovers from distressed banks, both IFRS 13 and FAS 157 state that market prices from forced sales shall not be used and that fair value shall be derived from valuation models. As a matter of fact, as the illiquidity of certain products became more severe during the financial crisis, financial institutions turned increasingly to model-based valuations, and Level 2 and 3 assets represented a great amount on the balance sheets of large bank holdings and investment banks (Laux and Leuz, 2010). Although mark-to-model accounting was expected to reduce procyclicality and financial market volatility, it was accompanied by growing opacity in the classification of products across the fair value spectrum, which increased the uncertainty among financial institutions, supervisors and investors regarding the valuation of financial products in stressed liquidity conditions (Novoa et al., 2009).

Two main issues related to mark-to-model accounting are relevant to this paper.

The first issue relates to the fact that mark-to-model accounting, by introducing measurement errors in assessing fair values, injects artificial volatility into financial statements (Watts, 2003a; Watts, 2003b; Landsman, 2007; Penman, 2007).

As Barth (2004) points out, in a semi-strong form of market efficiency, volatility from period-to-period in fair values and thereby in financial statements derives from two sources. One is the firm's activity during the period and the changes in economic conditions. This volatility, called inherent volatility, is the volatility of the asset itself and derives from economic forces. However, there is another source of volatility, which is called estimation error volatility. Estimation error volatility relates to the fact that accountants usually do not observe the fair value of an asset and need to estimate it.

Fair values obtained by valuation techniques entail estimation errors, and the resulting asset volatility is attributable not only to inherent changes in economic conditions, but also to measurement errors. Measurement errors produce artificial volatility, which exacerbates the overall volatility of the asset. Maino and Palea (2013), for instance, document that even transaction and market multiples, which are considered as the most unbiased valuation inputs, systematically overestimate actual exit values and volatility. For the same reasons, Warren Buffet (2003) has defined mark-to-model accounting as "*a large scale mischief*".

Valuation uncertainty due to mark-to-model accounting is one of the main concerns of regulators. The Financial Stability Board (2011), for instance, recommends that standards setters require firms to adjust valuations in order to avoid the overstatement of income when significant uncertainty about valuation exists. The European Central Bank highlights that artificial volatility affects bank capital requirements and exerts negative effects on a stable financing system for enterprises, which is one of the key factors for stable growth (Enria et al., 2004).

Many scholars also argue that excessive volatility in asset prices heightens systemic risk and makes the economy prone to recurring crises (e.g. Stockhammer, 2012). Even investors, who are considered by the IASB to be those most in need of information from financial reports, are aware of estimation errors and value the three fair value levels differently (e.g. Petroni and Wahlen, 1995; Eccher et al., 1996; Nelson, 1996). Kolev (2009) shows that investors place less weight on less reliable fair-value measurements. Goh et al. (2009) observe significant variation in the pricing of different levels of fair value assets, with the pricing being lower for mark-to-model assets. Likewise, Song et al. (2010) provide evidence that Level 3 fair value measurements are valued less by investors than Level 1 and Level 2 assets. Finally, Fiechter and Novotny-Farkas (2011)

show that the value relevance of fair value assets decreased as the financial crisis worsened, which suggests increased uncertainty about the reliability of financial data.

Taken as a whole, empirical research suggests that the use of valuation techniques is complex and risky for both the financial system and the real economy.

The second issue of relevance for this paper is the fact that mark-to-model accounting, by increasing opacity in financial statements, reduces the ability of stakeholders to monitor managerial behavior, thus adding a potentially serious threat to the economy (Benston, 2006; Benston, 2008). Many studies discussing the role of financial accounting information as a mechanism to discipline managerial behavior have demonstrated that as financial information reliability decreases, stakeholders lose their ability to link manager activities to firm performance (Bushman and Smith, 2001; Lombardo and Pagano, 2002; Bens and Monahan, 2004; Kanodia et al., 2004; Biddle and Hilary, 2006; Hope and Thomas, 2008). Without the disciplining mechanism afforded by reliable financial accounting information, managers are held less accountable for their actions and operate firms less efficiently or extract private benefits directly, all of which may have disruptive effects on firms. In this regard, the Enron experience should give the FASB, IASB and others who would mandate Level 2 and 3 fair value accounting reason to be cautious.

Indeed, Enron's demise provides some evidence that concerns about the potentially disruptive effects of mark-to-market accounting on firms and on the economy, as a whole, are not misplaced or overstated. As Benston (2006) notes, once Enron was permitted to use fair values for energy contracts, it extended revaluations to a wide and increasing range of assets, both for external reporting and internal personnel evaluations and compensation. The result was the overstatement of revenue and net income, and the structuring of transactions to present cash flows from operations rather than from financing. Basing compensation on fair values also gave employees strong incentives to develop and overvalue projects, resulting in high operating expenses and in projects which were rarely successful. The losses incurred gave rise to additional accounting subterfuges, until the entire enterprise collapsed.

Recently, the European Commission has become aware of all these concerns and claimed that, given the impact of accounting policies on public interests, choices in this area need to be carefully thought through (European Commission, 2013a).

4.3. Fair value as an exit price and long-term investments

In 2011, the IASB issued IFRS 13, *Fair Value Measurement,* which sets out a single framework for measuring fair value and provides comprehensive guidance on 'how' to

measure fair value. IFRS 13 is the result of a joint project conducted by the IASB and the FASB with the specific purpose of harmonizing US GAAP and IFRS. It resulted, however, in a passive alignment of the fair value definition, measurement and disclosure requirements to FAS 157.

According to IFRS 13, fair value is a market-based measurement that reflects the amount that would be received when selling an asset in an orderly transaction between market participants at the measurement date. Fair value is a spot market price, not an entity-specific measurement, and the firm's intention to hold an asset is completely irrelevant.

This definition of fair value has raised a number of concerns even among many of those who support fair value accounting, as it completely ignores the value in use of the assets within the firm (e.g. Whittington, 2008). Allen and Carletti (2008), for instance, show that as a consequence of the definition of fair value as an exit price, the balance sheets of financial institutions are driven by short-term market fluctuations which do not reflect their fundamentals. When liquidity plays an important role, as occurs in financial crises, asset prices reflect the amount of liquidity available rather than the actual assets' future cash-flows. As a result, bank assets may fall below their liabilities so that banks become insolvent, despite their capability to fully cover their commitments if they were allowed to continue until the assets matured.

The definition of fair value as an exit price proves a short-term approach to valuation and financial reporting, useful primarily to creditors and shareholders of companies that face likely liquidation rather than to stakeholders in going concerns. Indeed, exit values are clearly not relevant to the latter, except in those instances where the assets are soon to be sold (Ryan, 2008; Koonce et al., 2011).

Wüstemann and Bischof (2007) point out that a definition of fair value as an exit price entails an itemized understanding of a firm, whose financial position can simply be derived from the fair value measurement of all the individual investments into which the firm can be subdivided. By giving a seemingly relevant liquidation value at each point, exit prices obscure the value creation process. The exit value does not reflect the value of the employment of assets within the firm and does not inform stakeholders of the future cash flows that the assets may generate. The management's own private information about future cash flows and company risks is ignored, and managers' ability to create value cannot be properly measured (Ronen, 2012). In this respect, Boyer (2007) argues that exit price accounting paradoxically exchanges the supposedly low quality of information provided by historical cost for the less accurate assessment

of the valuation of the firm were it to be liquidated today, which is a rather unlikely event. As a result, the definition of fair value as an exit price falls short of the informational objective of financial statements (e.g. Benston, 2008; Whittington, 2008; Ronen, 2012).

The definition of fair value as an exit price also emphasizes the role of financial reporting in serving investors in capital markets. Markets are considered as sufficiently complete and efficient to provide evidence for representationally faithful measurement, and relevance is the primary characteristic required in financial statements, with reliability seen as less important (Whittington, 2008). As already mentioned, this is the approach to financial reporting adopted by the IASB.

Investors in capital markets, however, are not the only users of financial statements (e.g. Holthausen and Watts, 2001; Whittington, 2008). There exist other financial reporting users, such as banks and employees, who require a long-term approach to financial reporting. Such an approach requires stewardship, defined as accountability to all stakeholders, to be a primary objective of financial reporting, and historical cost to be the relevant measurement basis (Whittington, 2008). Although this approach also serves investors, it gives priority to all existing stakeholders and regards stewardship as an important and distinct function of financial reporting. It seeks accounting 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.

The antithesis between these two different approaches to financial reporting is not merely a theoretical issue for accounting scholars, but instead constitutes a highly relevant issue because of its potential effects on the economy. As will be discussed, short-termism underpinning exit price accounting can have detrimental effects on long-term investments and can undermine economic growth (e.g. Lazonick and O'Sullivan, 2000; Crotty, 2005; Milberg, 2008; Baud and Durand, 2012). This is therefore a key issue in discussion of the potential effects of fair value reporting on society.

5. FAIR VALUE REPORTING AS DISCURSIVE PRACTICE FOR THE FINANCIALIZATION OF ECONOMY

Several concerns make fair value reporting somewhat controversial as far as its consistency with the Lisbon Treaty. If this is the case, why and how has such a controversial accounting method gained so much support?

In order to answer this question, one must take a much broader view that considers the structural changes that have altered industrial economies over time.

In the last 40 years, worldwide economies have undergone profound transformations. The role of government has diminished, while that of the markets has increased. Economic transactions between countries have risen substantially, and domestic and international financial transactions have expanded at an exponential rate. In short, neoliberalism, globalization and financialization have been the key features of this changing landscape (Epstein, 2005). Financial motives, financial markets, financial actors and financial institutions have played an increasingly prominent role over time in the operation of economies.

MacKenzie (2008) highlights the fundamental role played by economic theory in this process. Modigliani and Miller (1958), for instance, looked at the corporation from the 'outside', i.e. from the perspective of the investors and financial markets, and considered corporate's market maximization as the main priority of management. Accordingly, shareholder value maximization became a central feature of the corporate governance ideology, which spread across the whole private-sector (Froud et al., 2000; Lazonick and O'Sullivan, 2000). Agency theory (Jensen and Meckling, 1976) also provided an academic source of legitimacy for a greatly increased proportion of corporate executives' rewards in the form of stocks and stock options, with the specific purpose of aligning the interests of shareholders and managers. In this financial conception of the firm, corporate efficiency was redefined as the ability to maximize dividends and keep stock prices high (Fligstein, 1990).

There is no reason to think that financial economists saw themselves as acting politically in emphasizing shareholder value. Nonetheless, Van der Zwan (2014) notes that, for scholars in this body of work, shareholder value was not a neutral concept but an ideological construct that legitimized a far-reaching redistribution of wealth and power among shareholders, managers and workers. Financial economic theories therefore became the cultural frame for economic actors and intrinsic parts of the economic processes (Fligstein and Markowitz, 1993). Paraphrasing Milton Friedman, economic models were an engine of inquiry, rather than a camera to reproduce empirical facts (MacKenzie, 2008).

As a matter of fact, the definition of fair value as an exit price institutionalizes the shareholder value paradigm in the form of accounting practices (e.g. Jürgens et al., 2000; Börsch, 2004; Nölke and Perry, 2007; Widmer, 2011), and reinforces the financialization process by shifting power from managers to markets. As outlined by

Barlev and Haddad (2003), such a definition reduces the enterprise's voice in favor of that of the market, and the reporting of assets, liabilities and income becomes independent of the manager's influence. When analyzing financial statements, readers are now sensitive to the 'market's voice'.

The definition of fair value as an exit price 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. Since capital markets tend to take a more short-term perspective on profit, fair value reporting is likely to discourage long-term industrial strategies and to threaten economic growth (Nölke and Perry, 2007).

Viewing fair value as an exit price requires efficiency to be defined in purely monetary as opposed to industrial terms, and exclusively from the perspective of the financial sector (e.g. Jürgens et al., 2000; Börsch, 2004; Widmer, 2011). Since owners of shares do not – for the most part – actively participate in trading, but rather delegate this task to investment funds, pension funds, insurance companies and investment banks, these latter can freely profit from, and at the same time perpetuate, the shareholder value ideology. Similarly, market-based asset prices do not represent some sort of abstract social equilibrium, but represent the actions of traders, which in turn reflect the views of dominant market analysts and pundits who do not necessarily make long-term calculations oriented to broader societal interests. As a result, enterprise managers lose further power, and most of the principals in the financial system, such as savers and pensioners, remain out of the picture (Davis, 2008).

6. FAIR VALUE REPORTING AND SOCIAL MARKET ECONOMY

Although we are as yet lacking a sound empirical analysis of a direct link between fair value reporting and real economy, a thorough review of different research streams already provides several warning signs with regard to the potential effects of fair value reporting on society in the Continental European Union.

In the case of today's advanced industrialized economies, the socio-economic context may be characterized in terms of 'Anglo-Saxon' or 'Rhenish' varieties of capitalism[3]. The Rhenish model is typical of Germany and Scandinavian countries and is based on a social market economy. These countries are characterized by the

[3] The 'Anglo-Saxon' model refers to liberal market economics, whereas the 'Rhenish' model refers to coordinated market economics (e.g. Albert, 1993; Hall and Soskice, 2001). These two models have been developed on the basis of the US and western Europe. For other capitalist economies, different models are of course necessary (Nölke and Vliegenthart, 2006).

consensual - for the most part - relationship between labor and capital and the supporting role of the state, along with the availability of patient capital provided by the bank system or internally generated funds (Albert, 1993; Fiss and Zajac, 2004; Perry and Nölke, 2006). As highlighted by Hall and Soskice (2001), 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, which have been at the basis of post World War II Germany's economic success.

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

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

Allen et al. (2009a) highlight that stakeholder capitalism can also be beneficial for company value and investors. Hillman and Keim (2001) and Claessens and Ueda (2008) find that greater stakeholder involvement in the form of stakeholder management or employment protection improves efficiency and firm value. Likewise, Fauver and Fuerst (2006) and Ginglinger et al. (2009) find that employee representation on the board increases firm value as measured by Tobin's Q and profitability. In addition, stakeholder governance may reduce the probability of failure, increasing debt capacity and consolidating a close relationship between banks and

firms, which is important in highly bank-oriented financial systems (Allen et al., 2009a).

The financial system in Continental Europe is highly bank-oriented (Bank of Italy, 2013)[4], mainly because the backbone of the economy in the Continental European Union is composed of small- and medium-sized manufacturing firms, which encounter greater difficulties in accessing bond markets than big corporates. The choice of full historical accounting made by national regulators for domestic GAAP in Continental Europe was consistent with this kind of environment, where banks were primarily concerned with ensuring the securities of their long-term loans to enterprises, and therefore took a relatively cautious view of the future, acknowledging its inherent uncertainty (Fiss and Zajac, 2004; Perry and Nölke, 2006). A prudent valuation of assets served to reassure bankers that there was sufficient collateral to support their loans and employees and that the firm was solvent and stable over time. There is general agreement that rather conservative accounting standards based on the European directives combined with stakeholder corporate governance and bank financing have allowed companies in Continental Europe to follow long-term strategies, such as investing heavily in human resource development. This has been crucial for gaining and maintaining a competitive advantage based on using highly skilled labor to produce high-quality, and often specialized, products (e.g. Sally, 1995; Froud et al., 2000; Lazonick and O'Sullivan, 2000; Perry and Nölke, 2006).

Conversely, fair value reporting increases pressure from short-termism, namely from the shareholders' focus on quarterly results and short-range returns on investment (Sally, 1995). Fair value accounting has been developed within the Anglo-Saxon variety of capitalism, which is characterized by more adversarial management-labor relationships, comparatively short-term employment, the predominance of financial markets for capital provision, an active market for corporate control, and increased emphasis on short-term price movement in stock markets (Albert, 1993; Hall and Soskice, 2001).

Different research streams suggest that short-termism is likely to exert disruptive effects on the Rhenish variety of capitalism in the long run (Perry and Nölke, 2006). Stockhammer (2004), for instance, 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

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

tend not to reinvest gains in their productive assets, but to distribute them to shareholders through dividend payouts and share buy-back (Lazonick and O' Sullivan, 2000; Crotty, 2005; Milberg, 2008; Baud and Durand, 2012).

Short-termism also leads to more conflictual relationships between enterprise managers, employees and other stakeholders. Van der Zwan (2014) reports evidence of the unequivocal impact of shareholder value policies on industrial relations, which is quite a big issue in those countries where companies have developed on the basis consensual corporate governance arrangements. Moreover, the shareholder value principle tends to make shareholders and managers rich to the detriment of workers (Lazonick and O'Sullivan, 2000; Fligstein and Shin, 2004; Lin and Tomaskovic-Devey, 2013). This strand of research presents a dramatic picture in which the pursuit of shareholder value is directly linked to a decline in working conditions and a rise in social inequality for large segments of the population (Van der Zwan, 2014).

7. GOVERNANCE OF THE STANDARDS-SETTING PROCESS

Considering the potentially disruptive effects of fair value accounting, a question naturally arises: how has fair value reporting been able to gain such authority so quickly? Why did those social constituencies that lost power from the shift to fair value accounting have no way of making their voices heard during the standards-setting process? Are all social groups affected, albeit indirectly, by the accounting regulation represented in the standards-setting process?

Prior to the adoption of IFRS, accounting standards in the European Union were set at a national level by a combination of public and private actors within the context of the European directives laid out by the European Parliament. With the introduction of IFRS, the standards-setting process has instead been delegated to the IASB. Chiapello and Medjad (2009) maintain that the choice to delegate the standards-setting process to the IASB was made only because there was no other option. The IASB was the only body able to offer divided Member States a set of common standards that would be acceptable to all and suitable for rapid recognition in international financial markets. Many have also blamed the European Parliament for having adopted Regulation 1606/2002 with the support of a large number of votes in favor (e.g. Biondi and Suzuki, 2007). Several explanations could however be provided for this, one of them being that the Lisbon Treaty had not yet been signed.

Taking a more proactive and forward-looking perspective, the key point is now to discuss whether, in the current constitutional framework, the IFRS Regulation is

consistent with the objectives of the European Union. By adopting IFRS, the European Union – which is the second largest capital market in the world - has contributed towards creating a new space at an international level where financial accounting practices and their influence on socio-economic processes are exposed to the decision-making of a private body (Sinclair, 1994; Cutler et al., 1999; Hall and Biersteker, 2002).

The IASB represents one of the most fascinating cases of private authority in international affairs. The IASB is a private, independent, British law organization that is controlled by the IFRS foundation. The foundation is a non-profit private-sector organization registered in the US state of Delaware, and is financed by large industrial and service companies, auditing firms and both international and public organizations (IFRS Foundation, 2013).

The IASB is composed of sixteen accounting experts appointed by a group of trustees on the grounds of their professional accomplishments and experience in the accounting sector. The trustees are in turn appointed by a monitoring board composed of public officials from the International Organization of Securities Commissions (IOSCO), the European Commission, the Financial Services Agency of Japan, and the US Securities and Exchange Commission (SEC). This process should reinforce the independence of the IASB members and should ensure that the IASB is composed of experts who are free from any commercial and political interests and have demonstrated expertise in addressing the informational needs of capital markets (Turner, 1999; Veron et al., 2006).

Consistent with Gramsci's notion of organic intellectuals (1971), expert knowledge is however always political because it is acquired in a particular social context, and it reflects the political-economic structure and social relations that generate and reproduce that context. If one considers the IASB's composition, this is largely limited to members from the financial industry, as well as from big auditing firms (Perry and Nölke, 2005; Chiapello and Medjad, 2009; Nöel et al., 2010; Crawford et al., 2014). In this respect, the IASB is strongly affected by the structural power of the private financial sector, which can use this body as a vehicle for institutionalizing its own perspective on what value is, and how to measure it, within international financial reporting standards (Thistlethwaite, 2011). Other types of actors, including companies from the manufacturing sector, domestic regulatory agencies and labor unions, are not in the picture. For this reason, several doubts can be raised regarding the IASB's composition and independence (e.g. Simmons, 2001; Drezner, 2007).

Research has provided specific evidence of a close link between the increasing adoption of the fair value criterion and the financial backgrounds of standards setters (Ramanna, 2013). Different reasons have been outlined for their strong support for fair value reporting. The first and most naïve reason is that investment banks and asset managers are accustomed to using fair value in risk management, and this has shaped their preferences in public financial reporting standards. The second, and less naïve, reason is that fair value accounting accelerates the recognition of gains: to the extent that managerial bonuses are based on profit numbers, financial service executives reap richer rewards in a fair value regime. The third is that the use of fair value to determine the impairment of goodwill from merger and acquisition activity, as opposed to the historical cost approach of amortizing goodwill, imposes a less systematic drag on earnings, thus potentially boosting merger and acquisition activity, which is a major source of revenue for investment banks (Ramanna, 2013).

Furthermore, the composition of the IASB is dominated by representatives from Anglo-Saxon countries and from international organizations whose priorities conform to Anglo-Saxon preferences (IASB, 2013). Many have highlighted the pivotal role played by the SEC, operating through the IOSCO, "*who have pushed for accounting practices that are broadly aligned with Anglo-American hegemony*" (Crawford et al., 2014; see also Arnold, 2005; Martinez-Diaz, 2005; Nölke and Perry, 2007; Botzem, 2008; Botzem and Quack, 2009; Nöel et al., 2010). IFRS 13, which is virtually identical to its US counterpart SFAS 157, actually exemplifies how a US discourse pervades the IASB and the accounting standards-setting agenda. This is a key issue, given the potential economic and distributional consequences produced by financial reporting.

As mentioned in Section 3, in order to come into force in the European Union, IFRS must go through an endorsement process consisting in several steps and involving many institutions. One of these latter is EFRAG, which is a technical expert committee that provides advice to the European Union on whether a new standard meets the criteria for endorsement. Even though it is not required to report on this, the EFRAG also delivers its advice on whether the new standard is conducive to the European public good and is, therefore, of overall interest to the European Union. In practice, the EFRAG has judged that the endorsement criteria have always been fulfilled. As a result, all the standards issued by the IASB have so far been adopted by the European Union (Maystadt, 2013). IFRS 13, for instance, was endorsed by the European Union at the end of 2012 on the basis of positive advice from the EFRAG, which stated that "*IFRS 13 is not contrary to the principle of 'true and fair view' [...] and meets the criteria of*

understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management. For the reasons given above, EFRAG is not aware of any reason to believe that it is not conducive to the European public good to adopt IFRS 13 and, accordingly, EFRAG recommends its adoption". Based on previous discussions, several doubts can instead be raised over the capability of IFRS 13 to be conducive to the European public good.

Like the IASB, the EFRAG is a privately held and managed organization, funded by its members. The EFRAG operates in a manner very similar to the IASB, with a two-tier structure and the same distribution of roles. The members of its supervisory board (equivalent to the IFRS Foundation's trustees) are appointed by the organizations that founded, and finance, the EFRAG. Its Technical Expert Group (TEG) – the equivalent to the IASB – has twelve voting members, selected from a range of professional and geographical backgrounds from throughout Europe. However, if one looks at the TEG's composition, it is represented predominately by the financial sector and big auditing firms, just as in the case of the IASB (Perry and Nölke, 2005; Chiapello and Medjad, 2009; Nöel et al., 2010; Crawford et al., 2014).

All in all, the European Union's move to IFRS adoption has led to a dismantling of accounting regulation under the control of the European Parliament in favor of practices developed and endorsed by private institutions with an over-representation of financial market organizations, financial institutions and big auditing firms. Several concerns can therefore be raised as to the consistency of the standards-setting and endorsement processes in the European Union with the Lisbon Treaty, particularly with regard to the social clause of taking decisions as openly and as closely as possible to citizens in order to prevent the European institutions from being influenced by interest groups. The Lisbon Treaty highlights the importance of social dialogue, which is considered an important pillar of the European social model.

On the contrary, the choice made by the European Council and Parliament of transnational private governance over public regulation makes it impossible for some stakeholders to be part of the standards-setting and endorsement processes, and this influences the outcome of the processes in question. Although an open consultation mechanism exists in the standards-setting process, final decisions are up to the IASB. Moreover, this body has the tendency to favor actions with the FASB promoting convergence and the search for new regions to commit to IFRS, to the detriment of those actions requested by states that already apply IFRS. The European Union has no

say in how things are done and cannot decide whether and when a given accounting issue should be examined (Maystadt, 2013). As accounting serves not only to inform investors, but also to set the limit for distributable profits, to elaborate public budgets and for tax purposes[5], this is of course a key issue. The G-20 economies share this same concern and have issued a number of calls regarding the need to adjust the governance of the IASB. In their September 2009 meeting, the G-20 countries emphasized that IASB "*should improve the involvement of stakeholders, including prudential regulators and the emerging markets*" (G-20, 2009).

Likewise, the endorsement process in the European Union is essentially delegated to the EFRAG. Although an open consultation mechanism also exists in this case and the formal decision on endorsing a certain IFRS is one of the European Commission's competences, the European Commission, the European Parliament and the ARC, which are political bodies, largely rely on the EFRAG's final technical advice (Maystadt, 2013). The EFRAG, which should be Europe's voice in the accounting debate, does not at present take all stakeholders sufficiently into account. There are different perspectives, such as the public interest, which are key at the European level and should therefore be more seriously considered when endorsing financial reporting standards.

Recently, the European Union has become aware that "*accounting policy choices have an impact on the public interest and so our choices in this area need to be carefully thought through*" (European Commission, 2013a). Examples include links with prudential requirements for banks and insurance companies, as well as the rules applicable to the shadow banking system, the impact of long-term investments and access to financing for firms.

One step has been made in the direction of restoring control over the standards-setting process with the Commission's choice to reject the option to adopt IFRS for small and medium enterprises in the European Union, and to make changes to their financial reporting through European Directive 34/2013. This tool has been considered to be more flexible and better able to serve the accounting needs of small and medium-sized companies, which are the backbone of the European economy and the main job creators in the European Union (European Commission, 2013b). Another important step is the appointment of Philippe Maystadt as the European Commission's special adviser with the task of enhancing the European Union's role in promoting high-quality accounting standards (European Commission, 2013b). More specifically, Maystadt's

[5] For instance, a number of states, including Italy, Greece, the Czech Republic, Estonia, Slovakia, Slovenia, also require IFRS for separate financial statements.

mission focuses on reviewing the governance of the European Union's bodies in the field of financial reporting so as to strengthen the European Union in the international standards-setting arena.

8. CONCLUSIONS

Financial reporting affects a great variety of constituencies: not only market actors, such as firms, investors, bankers and auditors, but also simple citizens, employees, and states, as financial information serves as a basis for determining a number of rights. It is therefore inadequate to consider accounting standards independently of the socio-economic context.

This paper argues that, as financial reporting regulation is one of the competences of the European Union, accounting issues must be examined in the framework of the Lisbon Treaty. The Lisbon Treaty states that the European Union's objective is to promote sustainable development in Europe based on balanced economic growth and a highly competitive social market economy. The European Union should combat social exclusion and discrimination and promote social justice and protection. These are the principles on which the European Union decided to build and shape its future. In a manner consistent with this view, fair value reporting, as well as the governance of the standards-setting process, should be considered in terms of their capability to match with, and promote, a sustainable social market economy.

First of all, this paper focuses on fair value accounting and shows how it is integral to the financialization of the economy. The definition of fair value as an exit price institutionalizes shareholder value in accounting practices, with potentially disruptive effects on social market economies. Shareholder value maximization tends to hamper long-term strategies, which have played a key role for some countries in the European Union in developing and maintaining their competitive advantage. Furthermore, the shareholder value paradigm is likely to alter the relationships between managers, financiers and wage earners and, in the end, the socio-economic environment typical of the Rhenish variety of capitalism. These issues should be carefully considered when discussing the capability of fair value reporting to be conducive to the European public good.

According to the IFRS Regulation, consistency with the European public good is one of the criteria that an accounting standard must meet in order to be endorsed. This criterion, however, has never been fully defined. At the time the IFRS Regulation was issued, the Lisbon Treaty had not yet been signed. This paper claims that, thanks to the

Lisbon Treaty, we now have a framework with which to analyze financial reporting policies. The key concept of the European public good should therefore be aligned with the objectives of the European Union.

Today we are concerned with fair value reporting, but new controversial issues in accounting are looming large. One such problem relates, for instance, to environmental accounting, which can affect firms' choices with important outcomes for the global environment. With respect to petroleum resources, prospecting and evaluation, a number of doubts have already been raised on the legitimacy and ethics of the IASB's work. Due to their potential effects on society, accounting choices on environmental issues should also be considered in the constitutional framework of the European Union, which is very progressive on this point. Indeed, the Treaty defines both environmental protection and sustainable development as fundamental objectives of the European Union and of its ideal economic and social model (art. 11).

Furthermore, this paper highlights how delegating the standards-setting process to the IASB has been crucial to the shift to fair value accounting. The IASB is largely influenced by, but also empowers, the private financial sector in governing how accounting standards measure value. The same holds for the EFRAG, which suffers from an under representation of some important stakeholders involved in the European Union economy, such as employees and managers from the manufacturing industry. In light of the current governance of the standards-setting and endorsement processes, several doubts can be raised over their consistency with the Lisbon Treaty.

The founding principles of the Union suggest that the dominant paradigm of private self-regulation should be reoriented and that the imbalance of stakeholder groups in the standards-setting process should be fixed. While there has been a general trend for increasing privatization in recent years, the global financial crisis calls for this to be reversed and for the backing of public actors (e.g. Kerwer, 2007; Botzem, 2008; Bengtsson, 2011).

Financial markets and their regulations, including financial reporting issues, are not forces of nature, but human creations. They are means to be modified, redesigned, improved, and on occasion delimited according to the system of ideals set out by politics. MacKenzie (2008) highlights that academic discipline is an intrinsic part of economic processes. If it is true that economic theories are an engine for change in society, it is also true that economics should serve people. Further research would therefore be required into whether the current financial reporting regulation matches the objectives of the European Union, as well as the means to reach these objectives.

As Russell (1919) points out, science cannot decide which goals must be reached, yet it can help find the means to reach them. It is also the responsibility of academics not to let the highly progressive principles of the European Union, as set out in the Lisbon Treaty, become empty phrases.

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