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.

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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 & 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 & Nölke, 2006; Chiapello & Medjad, 2009; Noël, Ayayi, & Blum, 2010; Bengtsson, 2011; Crawford, * Italy, Department of Economics and Statistics “Cognetti de Martis”, Campus Luigi Einaudi, Lungo Dora Siena 100/A.
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Ferguson, Helliar, & Power, 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 procyclical 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 IFRS1 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

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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.
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