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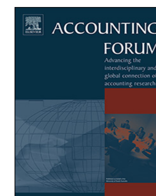

Financial reporting for sustainable development: Critical insights into IFRS implementation in the European Union

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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.

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