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Stress testing International Financial Reporting Standards (IFRS):
Accounting for stability and the public good in a financialized world

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Contents

Abstract.....	2
Acknowledgements.....	2
1. Introduction	3
2. IFRS in the European context: the current state of affairs	4
2.1 Accounting standards: Information disclosure and public interest.....	7
2.2 Accounting standards: Moral hazard and the public interest	9
3. Financial reporting and the financialized firm	12
4. Stress testing IFRS in a Financialized World.....	15
5. Summary/Discussion.....	23
References	25

Abstract

The recent Maystadt report (2013) challenged the European Parliament to modify governance arrangements surrounding the design and endorsement of international financial reporting standards (IFRS) issued by the International Accounting Standards Board (IASB). In addition the Maystadt report constructs an argument that accounting information has the capacity to also modify behaviour and that this might not be conducive for the European public good, financial stability and economic development. In this paper we argue that IFRS need to be stress tested for their impact on firm-level financial stability in a financialized world. The financialized firm can revalue a range of assets to their market value crystalizing future earnings into current values but these valuations can become impaired. Asset value impairments will be charged to shareholder equity but this is being hollowed out because a higher proportion of earnings are being distributed to shareholders. Accounting disclosures are not only an information feed to users they inform the stewardship and control of a firm's resources and in the financialized firm the potential for financial instability is heightened and this can translate into a moral hazard for society.

Keywords: International Financial Reporting Standards; Accounting Conceptual Framework; Financialization; Stress Testing Financial Standards

JEL Classifications: F3, G32

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1. Introduction

In this paper we argue that it is necessary to differentiate between international financial reporting standards (IFRS) as an information feed to ‘users’ and IFRS disclosures that impact upon the structure of financial statements and line items in ways that could potentially undermine the financial stability of firms, modify resource stewardship and generate a moral hazard to society. This paper presents three challenges for policy and academic research. First is it possible to design a conceptual framework for accounting that incorporates the public interest? Second, can researchers conceptualise and develop new innovative modelling frameworks that stress test changes to IFRS in terms of their compounding effects and simulate how these would impact upon a firm’s financial stability? Third, to what extent is the promotion of firm-level financial stability compatible with safeguarding the public interest? These are a key set of challenges for accounting academics, policy advisers, practitioners and regulatory bodies following the publication of the Maystadt report.

Phillip Maystadt’s 2013 report “Should IFRS standards be more European?” argued that governance arrangements surrounding the endorsement of (IFRS) need to change. It also opens up a broader challenge which is to stress test IFRS in terms of their contribution to: the European public good; financial stability and economic development. The argument developed in this paper is that it is necessary to differentiate between accounting standards as defining the provision of information and accounting standards as reinforcing moral hazard to society. We are primarily concerned with the second of these challenges, that is, stress testing IFRS in relation to the preservation of firm-level financial stability and thereby restricting moral hazard to society. This notion of ‘stress testing’ IFRS would be similar to the approach adopted by banking regulatory bodies such as that provided by the Basel Committee on banking regulation. These regulations are focussed on improving the banking sector’s capacity to absorb financial shocks, improve risk management, modify governance arrangements and strengthen information disclosures¹. The alternative framework for stress testing IFRS constructed in this paper draws upon three elements that define the ‘financialized’ firm. The first of these describes how the composition of corporate balance sheets has changed from tangible to intangible assets and financial assets. Second, in the financialized firm speculative ‘narratives and numbers’ exaggerate intangible and financial asset values in current time but these can be impaired when market prices deflate. Third, pressure from institutional investor’s has forced managers to distribute profits to boost share prices but this leads to a corresponding hollowing out of shareholder funds. These three elements of the financialized firm are interconnected by virtue of double-entry book-keeping that transmits adjustments within and across financial statements and connect up different line items. Thus impairments to intangible asset values will be charged against

¹ <http://www.bis.org/bcbs/basel3.htm?m=3%7C14%7C572>

shareholder funds which may, for example, not contain sufficient reserves to prevent insolvency.

To evaluate this financialized framework of analysis, and the potential for intangible asset value impairments to comprise the financial stability of firms, we review the key financials of firms listed in the FTSEurofirst300 constituent list for the period 2000 to 2014. We find that there has been a significant adjustment in the structure of corporate balance sheets from tangible to intangible assets. These intangible assets contain potential value at risk arising, for example, from goodwill accumulations and estimates employed to construct mark to market valuations. In addition pressure from institutional investors has forced an increasing number of the FTSEurofirst300 to distribute more of their earnings as dividends and share buy-backs. This hollows out shareholder equity funds which provide the financial buffer to absorb intangible asset impairments. We find over the period 2000 to 2014 the proportion of firm's listed in the FTSEurofirst300 distributing more than 75 percent of their income increased from 8 to 25 percent of firms listed. Furthermore, the number of firms with intangible asset valuations exceeding shareholder equity increased from 17 to 28 percent of the sample.

The rest of the article is organised as follows. The next section provides a summary of the current state of accounting affairs in Europe, drawing upon the Maystadt Report. The second section discusses accounting in the context of the financialized firm using this framework of understanding to construct an alternative approach to stress test the impact of IFRS on firm financial stability. The third section employs descriptive financial statistics to evaluate the extent to which the FTSEurofirst300 group of firms are increasingly financialized and are at heightened risk of insolvency².

2. IFRS in the European context: the current state of affairs

Philippe Maystadt's report: 'Should IFRS Standards be more European?' published in October 2013 (Maystadt, 2013) raised two fundamental challenges. The first of these concerned the governance process surrounding European endorsement of IFRS prepared by International Accounting Standards Board (IASB). The second was concerned with the general purpose of financial reporting and the extent to which IFRS improved information transparency for investors and capital market efficiency at the expense of financial stability and the public interest. In June 2015 the European Commission published a Staff Working Document (EC, SWD, 2015) on progress achieved in the implementation of governance reforms recommended in the Matstadt report. It also provided some opinion on the extent to which the adoption of fair value accounting (FVA) within IFRS facilitates capital market efficiency for investors at the expense of financial market stability and the public good.

² Our focus is on the solvency of firms and we do not construe that insolvent firms are also bankrupt firms.

Maystadt's first challenge was concerned with modifying the governance relationship between the IASB, the European Financial Reporting Advisory Group (EFRAG), Accounting Regulatory Committee (ARC) and European Parliament. EFRAG is made up of experts from the private sector, and is supported by an Accounting Regulatory Committee (ARC) which votes on and approves IFRS issued by the IASB on behalf of the European Parliament. The European Parliament has chosen to renounce its regulatory sovereignty in accounting deciding, instead, to apply accounting standards (IFRS) drawn up by a not for-profit private sector organisation based in London, the IASB. Changes in governance arrangements are being enacted to ensure that the European Parliament is more pro-actively involved in the IFRS endorsement process. EFRAG, for example, will be more integrated with the Accounting Regulatory Committee (ARC) and European Parliament.

At the ECOFIN Council of 13 November 2012, the Ministers for Finance discussed the means by which the European Union could defend its interests more adequately in the international accounting debate. They indicated that ARC is the body that should represent the European public interest, whereas EFRAG as a technical body, made up of experts mainly from the private sector, has no mandate from the Member States and ... that in view of the need for both a better coordination of the accounting debate in Europe and for a more adequate consideration of the stakes related to the political choices in the field of accounting, the existing structures (ARC and EFRAG) should be reviewed and new structures should be established if necessary (Maystadt, 2013: 5).

A second challenge questioned the general purpose of financial statements; that of providing decision useful information for investors to facilitate capital market efficiency. The Maystadt report observes that: 'policy choices in the field of accounting involve public interest stakes' and 'accounting standards are more than a mere language convention. By influencing the behaviour of actors in financial markets, they can have an impact on the stability of those markets' (Maystadt Report, 2013:5). Thus, at a technical level, IFRS presented for approval to the European Parliament will need to be stress-tested in terms of their impact upon the European public good; financial stability and economic development (EFRAG, London, May 2015). This will require a significant re-orientation because the IFRS conceptual framework and objectives of IFRS are geared up to provide decision useful information to investors and promote capital market efficiency. And, although there is support for these changes there is also a considerable amount of ideological and institutional resistance.

A recent Institute of Chartered Accounting in England and Wales (ICAEW) report 'Moving to IFRS reporting: seven lessons learned from the European experience' (2015) observes that:

The influential 'Maystadt Report', submitted to the Commission in October 2013, considered ways in which the EU could enhance its role in international accounting standard-setting. The recommendations of the report on the endorsement process – now in the process of being implemented – discussed in particular the possibility of expanding the 'public good' criterion to make it clear in the law that any accounting standards adopted should neither jeopardise financial stability in the EU nor hinder the EU's economic development. (ICAEW, 2015:19)

The issue of how and in what ways accounting standards can heighten the risk of financial instability and thereby establish a moral hazard to society is the focus of this paper. The IASB's Conceptual Framework governing the general purpose and objectives of financial reporting has traditionally been geared towards the provision of relevant information to investors to promote efficient capital markets (an outcome which has been challenged in the aftermath of the financial crisis). The conceptual framework governing financial reporting also has a tendency to conflate the disclosure of relevant information to investors with that of also satisfying the 'public interest'. This compression of investor interests with the public interest is apparent in the IASB's principal stated objective which is:

'to develop, in the public interest, a single set of high quality, understandable, enforceable and globally accepted international financial reporting standards (IFRSs) based upon clearly articulated principles. These standards should require high quality, transparent and comparable information in financial statements and other financial reporting to help investors, other participants in the world's capital markets and other users of financial information make economic decisions'.³

The IASB's position is that whilst other stakeholders may find financial disclosures of interest the provision of information within financial statements is not 'primarily directed to these other groups'

Other parties, such as regulators and members of the public other than investors, lenders and other creditors, may also find general purpose financial reports useful. However, those reports are not primarily directed to these other groups (IASB, Conceptual Framework 2010; OB10).

This conflation of 'investor interests' with the 'public interest' can be challenged on two counts. First, accounting standards and financial disclosures have become increasingly focussed on the needs of investors and capital markets at the expense of a broader group of stakeholders. Second, changes to accounting standards and financial disclosure have complex compound impacts that can effect changes to a firms reported financial stability and thereby signal adjustments in the stewardship and governance of resources in ways that can translate into a real moral hazard to society.

³ <http://www.iasplus.com/en-gb/standards/other/preface>

2.1 Accounting standards: Information disclosure and public interest

The 'public interest' could be served if the objective of IFRS disclosures were expanded to meet the needs of a broader group of stakeholders (see IIRC, 2013; Haslam et al 2015). After the recent financial crisis the *public interest* might also be served by promoting firm-level 'financial stability'. This latter aim could legitimately take its place alongside *relevance* and *true and fair view* in the conceptual framework governing accounting and thereby reinforce the *public-facing* standards setting agenda. The financialized firm, which we conceptualise later, employs fair value accounting (FVA) to de-temporalize returns, that is, bring forward earnings to revalue assets in current time. This presents a potential moral hazard for society (see Ireland, 2010) because line items reported within and across financial statements have variable properties that can act, in combination, to heighten insolvency risk. Accounting standards set out the rules about financial disclosures but the information generated in financial statements is also a control device that activates resource stewardship responses from managers (see Bowman et al 2015 forthcoming; Biondi 2011).

With regards to the extending the 'public interest' through changes in information disclosure Zeff (1999) reminds us that accounting standards and provision of financial information could be designed in such a way so as to be of interest to a broader group of stakeholders. The IASB's own discussions, in 2005, on the accounting conceptual framework reveal that some consideration had been given to the disclosure of information to a broader group of stakeholders: present and potential investors, employees, lenders, suppliers and other trade creditors and customers, governments and their agencies and public enterprise (See IASB, 2005). It is worth noting these in full.

- (a) Investors. The providers of shareholders equity and their advisers are concerned with the risk inherent in, and return provided by, their investments. They need information to help them determine whether they should buy, hold or sell. Shareholders are also interested in information which enables them to assess the ability of the entity to generate earnings that may enable dividends payment, share buy backs and other corporate interventions in capital markets.
- (b) Employees. Employees and their representative groups are interested in information about the stability and profitability of their employers. They are also interested in information which enables them to assess the ability of the entity to provide remuneration, retirement benefits and employment opportunities.
- (c) Lenders. Lenders are interested in information that enables them to determine whether their loans, and the interest attaching to them, will be paid when due.
- (d) Suppliers and other trade creditors. Suppliers and other creditors are interested in information that enables them to determine whether amounts owing to them will be

paid when due. Trade creditors are likely to be interested in an entity over a shorter period than lenders unless they are dependent upon the continuation of the entity as a major customer.

- (e) Customers. Customers have an interest in information about the continuance of an entity, especially when they have a long-term involvement with, or are dependent on, the entity as a supplier of goods and services.
- (f) Governments and their agencies. Governments and their agencies are interested in the allocation of resources and, therefore, the activities of entities. They also require information in order to regulate the activities of entities, determine taxation policies and as the basis for national income and similar statistics.
- (g) Local communities. Entities affect members of the neighbours in a variety of ways. For example, entities may make a substantial contribution to the local economy in many ways including the number of people they employ and their patronage of local suppliers. Financial statements may assist the public by providing information about the trends and recent developments in the prosperity of the entity and the range of its activities (see IASB, 2005).
- (h) Public debate and attention to corporate strategies and their shortcomings from a financial and extra-financial perspective.

A recent IASB discussion paper has set about amending and updating the accounting conceptual framework but the focus remains with the provision of decision useful and relevant information to investors (IASB, DP/2013/1).

The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to users of financial statements (existing and potential investors, lenders and other creditors) in making decisions about providing resources to the entity (IASB, 2013:20)

In the aforementioned ICAEW (2015) report the benefits of IFRS are rehearsed and include: transparency, comparability, cost of capital, market liquidity, corporate investment efficiency and international capital flows. The ICAEW report goes on to make a more pointed observation that it would not be sensible to interfere with the IASB's progress in terms of harmonising global financial reporting because this would generate too much additional uncertainty for capital markets and thus impede economic development.

The IFRS 'brand', recognised by capital market participants around the world, cannot be trifled with without a risk of devaluing it entirely, endangering the whole global IFRS project (ICAEW, 2015:9)

Paul Lee, head of investment affairs at the UK National Association of Pension Funds is also quoted in a recent ICAEW blog saying: 'There are certainly some who want to have political control of international standards. There is a threat – and that's not too strong a word – that such an approach will start to move us towards an EU version of IFRS. 'If what we are looking for is comparability, different markets having different flavours of international standards is potentially a disaster and takes us back towards the situation where we had numerous different GAAPs. Most of all it will erode confidence and that will increase the cost of capital,'⁴

2.2 Accounting standards: Moral hazard and the public interest

There has been a progressive reorientation in accounting standards from historic cost accounting (HCA) towards FVA disclosures for investors. HCA traditionally recorded realised revenues and how changes and movements in revenues and expenses impact upon the financial position of the firm in the balance sheet. FVA reveals how changes in the market value of assets (traded or estimated) impact upon comprehensive income and shareholder equity. According to Palea (2014)

Fair value accounting is one of the most important innovations in financial reporting in the European Union, and represents the main difference between IFRS and the former European regulation. Fair value is supposed to provide investors with better information to predict the capacity of firms to generate cash flow from the existing resource base, thereby improving the quality of information for decision usefulness (Palea, 2014:3)

Littleton (2011) observed that economists seek to capitalize future earnings into current asset valuations but accountants have been generally predisposed to measure costs actually incurred by an enterprise before the current date.

Economists consider the current value of a business enterprise to be measurable by capitalizing the expected earnings of that company...Accountants find expected earnings unacceptable for most accounting uses. The reason is found in an unwillingness to cut loose their thinking and their service from the provable objectivity of accounts kept and financial statements made in terms of costs actually incurred by this enterprise before the current date. (Littleton, 2011:4-5)

⁴ <http://economia.icaew.com/finance/january-2015/ifrs-common-good#sthash.6KpyH3LM.dpuf>

Biondi (2011) explores the contradictions established by the HCA/FVA duality where fair value accounting 'focalizes on the market reference' whilst 'the cost accounting focus is on the economic and monetary process generated by the whole enterprise as an economic entity and a going concern'(Biondi, 2011:37-8). A number of IFRS now promote the application of fair value reporting, that is, either the primary reference is to current market prices (if available), or the capitalization of expected future earnings of a firm's assets, into on-going revaluations of assets and liabilities. For example, IFRS 13⁵ outlines a general 'fair value hierarchy' for the valuation of corporate assets.

- a] Asset value can be based on quoted prices in active markets for identical assets or liabilities,
- b] quoted prices for similar assets or liabilities in active markets, or
- c] a reporting entity can develop and model, using unobservable inputs, to generate a valuation (using the best information available in the circumstances).

At the top of the hierarchy values can be adjusted against identical assets traded in active markets. Alternatively, towards the bottom of the hierarchy asset values adjusted on the basis of estimates and judgements about anticipated future cash flows discounted by an appropriate discount rate. Thus, the recognition and measurement of some asset values in a firm's balance sheet are based on estimates, judgements and models rather than exact depictions. As a result of the uncertainties inherent in business activities, certain items in financial statements cannot be measured precisely but can only be estimated. Estimation involves judgements based on the latest available reliable information (EU Directive 2013/34: para 2).

The ICAEW (2015) in defence of fair value reporting observed that:

'The increased use in financial reporting of fair value measurements – and their allegedly pro-cyclical nature – had perhaps received the most attention. We noted that in practice, there was no compelling evidence that the use of fair value accounting had any significant role in causing or exacerbating the crisis, despite the many claims and assertions made in this context' (ICAEW, 2015:23 and see also ICAEW, 2014).

On the contrary it has been argued that this shift in emphasis towards FVA across a number of key IFRS contributed to capital market instability during the recent financial crisis (see Biondi, 2011; Biondi and Giannoccolo, 2015). The possibility that fair value accounting standards exaggerated capital market instability was a key concern raised in the Maystadt Report (2013). In June 2015 the European Commission published a Staff Working Document

⁵ <http://www.iasplus.com/en/standards/ifrs/ifrs13>

(SWD, 2015:120⁶) 'Evaluation of Regulation (EC) N° 1606/2002 of 19 July 2002 on the application of International Accounting Standards'. This document summarises a review of the literature on the impact of the mandatory adoption of IFRS in the EU and on the performance of IFRS during the (financial) crisis. It also drew upon internal experience of relevant international and European bodies and the evaluation took account of the Maystadt recommendations. This report observes that:

The crisis evidenced the need to understand the effects of regulations on financial markets and on economies. The IAS Regulation specifies that as a condition to being brought into EU, international standards must be conducive to the European public good. The term 'public good' is not defined but may be understood to encompass broad financial stability and economic considerations. In particular, it is necessary to assess whether accounting standards could be detrimental to the economy or to particular stakeholders, such as long-term investors. There is also a growing call for regulations to be considered holistically in terms of their cumulative effects. (European Commission, 2015:7)

The European Commission and European Parliament are rightly concerned to ensure that IFRS contribute to 'financial stability' and do not present a moral hazard to society. This means that the IASB and European regulatory bodies need to ensure that accounting standards are reviewed holistically to evaluate their 'cumulative effects'. It is necessary to stress test accounting standards in terms of their compound relation and impact on the financial stability and solvency of firms in the public interest (Haslam, 2015). FVA has been deployed within a number of key IFRS and our argument is that these changes have not been adequately stress-tested to assess their impact on firm financial stability and moral hazard to society. This weakness is evident in Bischof and Daske (2015) report 'Endorsement Criteria in Relation to IFRS 9' commissioned by the European Department for Economic Policy. Bischof and Daske argue that the European Public Good (EPG) is captured within the process of IFRS endorsement. With regards to IFRS9 the opinions of key stakeholders, that is, preparers and users of financial information are collected and these are employed to construct a cost-benefit evaluation. This cost-benefit analysis compares 'net costs' and 'net benefits' to preparers and users and the difference then employed to generate the overall position on endorsement: 'the vast majority of stakeholders consider IFRS 9 as contributing to the EPG' (Bischof and Daske, 2015:38).

Overall, we still tend to conclude that, at least, many features of IFRS 9 are an improvement over IAS 39, which would be the alternative if the EU voted against the endorsement of IFRS 9. Therefore, we argue that IFRS 9 is likely to be conducive to the European public good and we recommend the standard to be endorsed by the EU (Bischof and Daske, 2015:39).

⁶ http://ec.europa.eu/finance/accounting/docs/ias-evaluation/20150618-swd_en.pdf

The endorsement process described by Bischof and Daske reinforces a narrow stakeholder engagement because the opinions that matter are predominantly those from users and preparers of financial statements. Furthermore, collecting opinions on a standard is not the same as carrying out a robust stress test to evaluate the compound and inter-related impacts that new and modified IFRS might have on the financial stability of firms. In this paper we argue that it is necessary to contextualize the endorsement of accounting standards within a financialized world. The literature on financialization provides a useful framing device within which to locate financial reporting because it reveals cumulative effects and how these impact on firm solvency and financial stability. IFRS issued by the IASB are not simply an abstract technical reporting function. In a financialized world the reported financial numbers and related accounting standards are influenced by institutional relations and agency realignments that are dynamically recalibrating the nature and properties of reported financial information. On the asset side we observe a compositional shift from tangible to intangible assets including accumulating goodwill which records the difference between the market and book value of business combinations (Biondi, 2013). Tangible assets such as real estate, financial assets, marketable securities and derivatives, are also periodically marked to market. On the liabilities side of the balance sheet shareholder equity functions as a firebreak absorbing fluctuations in earnings and also buffering the impact of asset value impairments. The accumulation of shareholder equity itself depends upon whether dividends pay-out ratios and share buy backs are increasing because a higher distribution of earnings will impact negatively on the accumulation of a firm's retained earnings which are also a major component of shareholder equity.

In a financialized world the asset values reported by firms on their balance sheets are increasingly de-temporalized because they embody past, present and future speculation about cash flows and discount rates. Small changes in assumptions about the future will have a magnified impact on asset values in current time. Changes to the value of assets will be transmitted by virtue of the system of double entry book-keeping into shareholder equity on the liabilities side of the balance sheet. Double entry book-keeping not only transmits financial disturbance between line items but there is the added risk that relatively immaterial adjustments to one line item can trigger a material change in another. For example, goodwill or other assets impairments, as well as on-going revaluations, could undermine shareholder equity (Haslam et al, 2012). In the next section of this article we argue that the endorsement of financial reporting standards needs to be contextualised within a process of economic transformation that we summarise as the 'financialized firm'

3. Financial reporting and the financialized firm

According to Epstein 'some writers use the term 'financialization' to mean the ascendancy of 'shareholder value' as a mode of corporate governance; some use it to refer to the growing dominance of capital market financial systems over bank-based financial systems;

some to the increasing political and economic power of a particular class grouping: the 'rentier class' (Epstein, 2005:3). Orhangazi uses the term 'financialization' to capture the complex relations between 'financial markets and other aspects of the economy' (Orhangazi, 2008 xiv). Carruthers (2015) observing that financialization, involves the development and evolution of financial markets and how institutions adapt and respond to: governing property rights, information exchange, regulation and failure of firms (Carruthers, 2015:379-380). Van der Zwan (2014) notes that: 'scholars of financialization should pay more attention to the complex processes of transformation, which sometimes advance and at other times hamper the advent of finance capitalism in the advanced political economies' (Van der Zwan, 2014:120).

For the purpose of this paper we argue that the literature on financialization can be employed to generate insight about structural adjustments to the nature of corporate financial statements. First, Krippner (2005) describes the process of financialization as the 'rise of finance in the United States' where profits accrue through financial channels rather than through trade and commodity production. Financial here refers to activities relating to the provision (or transfer) of liquid capital in expectation of future interest, dividends, or capital gains' (Krippner, 2005:174-5). Watkins (2015) notes that Keynes, in an earlier period, was concerned with 'changing views about the future' where value no longer simply arises from producing commodities in the present but also depends on expectations. Thus a firm's assets are valued not on cost, but on 'prospective earning capacity' and this transforms 'the determination of the value of an asset from the costs of physical commodities to intangible assets' and a new way of making money (Watkins, 2015:7). Second, Froud et al (2000, 2006) argue that financialization is about how the asset valuation process combines both 'technical' and 'rhetorical' elements as 'numbers and narratives' (Froud et al, 2006:71). Thus asset values marked to market in a firm's balance sheet not only embody speculative assumptions about a firm's future earnings possibilities but also capture the *modus operandi* of active capital markets that promote the vendibility of assets at the expense of the serviceability of these assets (Haslam et al, 2012). The health warning, as Veblen observed, is that 'it is the intangible element of value that tends to be the widest and the freest' (Veblen, 2005:76). Third, Lazonick (2013) argues that financialization is about a dominant ideology of shareholder value, that is, the 'mode of corporate resource allocation has been legitimized by the ideology, itself a product of the 1980s and 1990s, that a business corporation should be run to *maximize shareholder value*' (Lazonick, 2013: 859). Lazonick's argument is that firms, in the US, have become preoccupied with maximising short-run returns on capital to investors and this includes distributing more profit to shareholders, as dividends and share buy-backs (See also Andersson et al 2008; Lazonick, 2011; Biondi 2012; Haslam et al, 2012; Stout, 2012; Clarke, 2013)

Accounting numbers are not simply a record describing the financial performance of the firm they are also a mirror reflecting the financialized world. Asset valuations become the

product of speculation and expectations about future cash flows adjusted by discount rates. Managers are encouraged by institutional investors and financial incentives to distribute profits either as dividends or share buy-backs rather than retain funds in shareholder equity reserves. In this financialized world speculative intangible asset values accumulate but there is the risk of financial instability when valuations become impaired. In circumstances where managers are also distributing profit rather than retaining funds this will reduce the capacity of shareholder equity to absorb asset value impairments, prevent insolvency and dampen financial instability.

The accounting professional bodies and accounting standards setting agencies are actors that have influence over the way in which financial information is filtered and recorded in a firm's financial statements. We have already noted that the IASB and its affiliated accounting and auditing professional bodies govern the purpose of the conceptual framework that outlines the general objectives of financial reporting. The overriding objective of financial reporting is the disclosure of information that is relevant and 'decision useful' for investors that provide capital. This is reflected in a general re-orientation in financial reporting from HCA towards FVA reporting that adjusts asset values to those based on active liquid capital markets or, in the absence of such active markets, valuation models. This 'fair value' information, it is argued, reflects the true costs of financial resources employed by firms. Gigler et al (2013) suggest that:

'While the arguments supporting fair value accounting are not based on any formal analytical models that we are aware of, the intuition underlying its support seems to be the following. The current market values of a firm's assets and liabilities are much more descriptive of a firm's financial position/wealth than their historical acquisition cost' (Gigler et al, 2013:2).

As we have already noted, a range of extant IFRS now permit mark to market adjustments to the asset side of the firm's balance sheet including: Business Combinations (IFRS3), Financial Instruments (IAS32 and 39, superseded by IFRS9), Property, Plant and Equipment (IAS16), Intangibles (IAS 38), Agriculture (IAS41). This change in orientation to FVA modifies the asset structure of firm balance sheets inflating intangible and financial assets in total assets. A significant share of these intangible and financial assets are subject to an on-going process of re-capitalization using valuation data obtained from active secondary asset markets or modelling exercises that mimic asset pricing in active markets.

The fair value determination of identified intangible assets relies on a number of important assumptions as well as forecast data, both of which introduce subjectivity into the valuation process. Many acquiring companies have used these areas of discretion to allocate a high percentage of the purchase consideration to goodwill in order to reduce the future amortisation charge associated with the identified intangible assets purchased as part of the transaction (KPMG, 2010:12-13)

Thus the asset side of a firm's balance sheets contains accumulating market values but the health risk is that they can become impaired and the system of double entry book-keeping will transmit any financial disturbance to maintain assets \equiv liabilities. This aggregate identity disguises the fact that line items on the asset / liability side of a balance sheet may (or may not) have an equivalent capacity to absorb financial disturbance (Andersson, et al 2014). Lazonick also reminds us that US firms have financialized strategy, that is, they are distributing more of their profits in the form of dividends and share buy-backs rather than reinvesting in productive capacity. Lazonick (2014) observes that:

The allocation of corporate profits to stock buybacks deserves much of the blame. Consider the 449 companies in the S&P 500 index that were publicly listed from 2003 through 2012. During that period those companies used 54% of their earnings—a total of \$2.4 trillion—to buy back their own stock, almost all through purchases on the open market. Dividends absorbed an additional 37% of their earnings. That left very little for investments in productive capabilities or higher incomes for employees Lazonick, 2014:4.

The importance of relatively high dividend pay-out ratios coupled with share buy-backs is that both these transactions are accounted for as a deduction from shareholder equity in the balance sheet. These distributions to shareholders act independently on the accumulation of shareholder equity such that this line item could be moving along a completely different trajectory than that of the fair value accumulating in intangible and financial assets. In chart 3 we show that for firms listed in the major European stock markets intangible assets are accumulating ahead of shareholder equity.

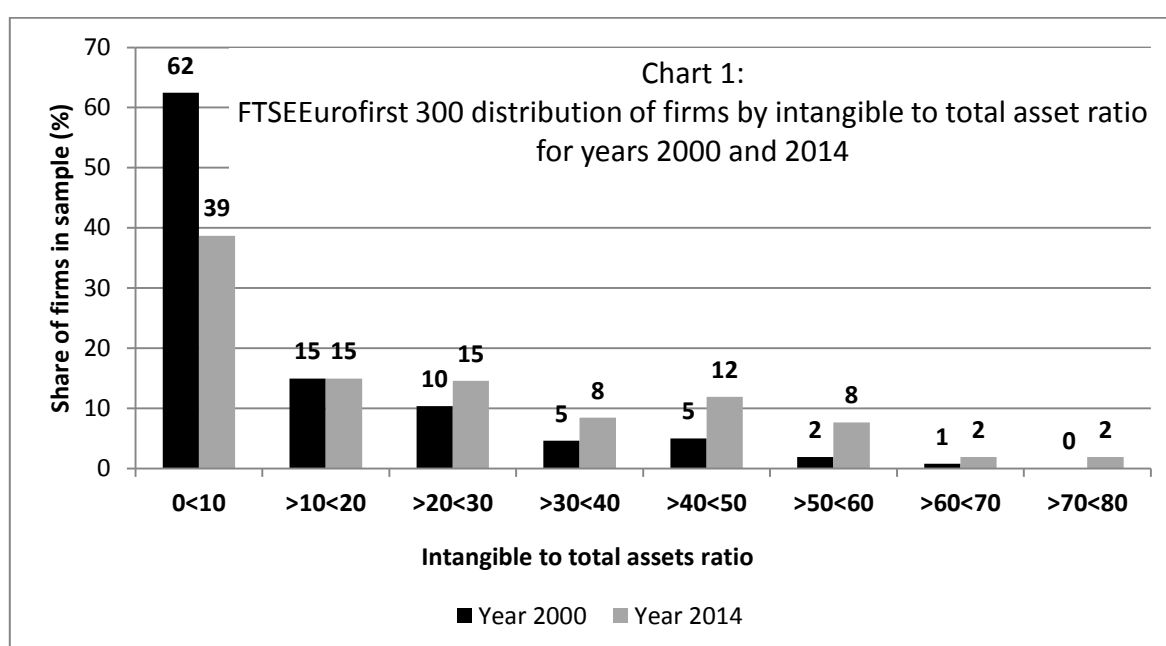
The IASB's reorientation from HCA to FVA in extant IFRS is motivated by the need to satisfy the information demands from investors and capital market institutions (see Ryan, 2008; Biondi, 2011). But the risk is that relatively small changes in valuation assumptions about future cash flows and discount rates will amplify asset impairments in current time. Small changes to asset values could have a material impact on shareholder equity funds undermining financial stability because leverage ratios, credit ratings and solvency tests are compromised. Financial disturbance also modifies resource stewardship and governance arrangements because accounting is also a control and accountability device (Biondi 2011). In this way changes to IFRS and the way in which financial information is constructed and disclosed becomes a moral hazard to society.

4. Stress testing IFRS in a Financialized World

In this paper we have argued that IFRS need to be stress tested within the context of the financialized firm. The analysis in this section therefore reveals the extent to which balance sheet asset structures are changing, whether firms are distributing a higher share of their earnings and extent to which shareholder equity funds have been hollowed out relative to

intangible assets for firms listed in the FTSEurofirst300 index⁷. Financial data is employed to construct three key indicators: first the ratio of intangible (including goodwill) to tangible assets, second the ratio of income distributed (dividends and share buy-backs) out of total income and third the ratio of intangible assets to shareholder equity.

Starting with the ratio of intangible to total assets we find that this averaged 12 percent in the year 2000 and by 2014 this had moved up to an average of 22 percent. This overall average conceals a material adjustment in the distribution of firms with an increased share of intangible to total assets (see chart 1). For example in the year 2000 thirteen percent of firms surveyed had an intangible to total assets ratio of more than 30 percent but by the year 2014 one-third of firms surveyed had an intangible to total assets ratio of more than 30 percent.



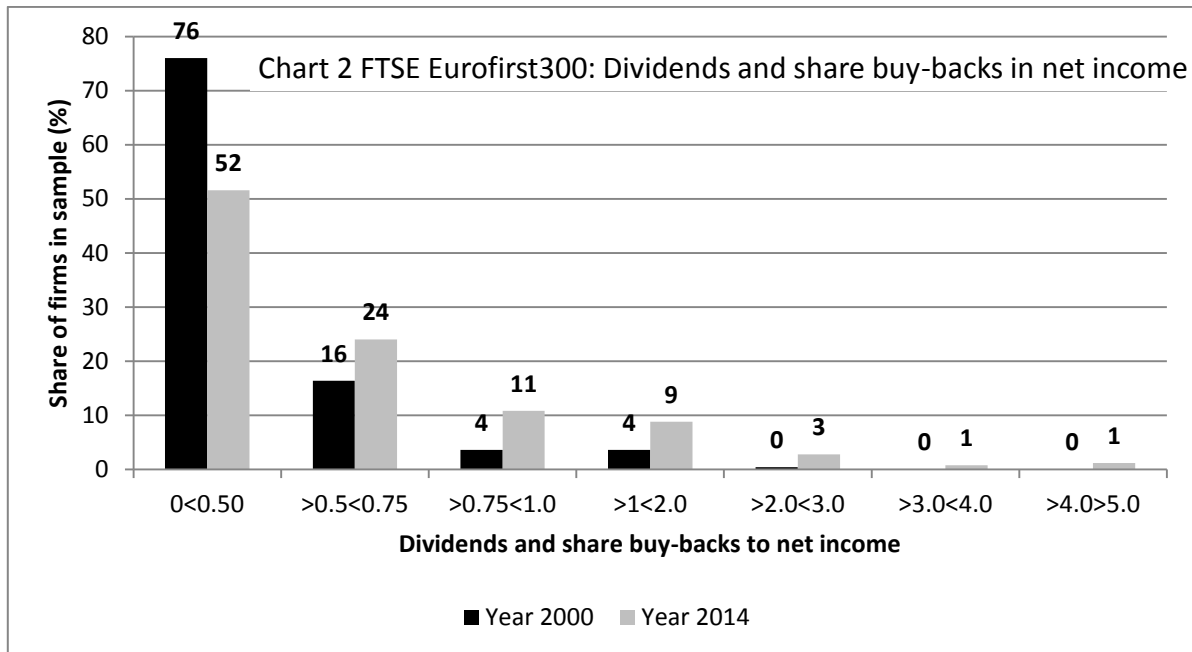
Source: Data obtained from Thomson Reuters FTSE Eurofirst 300.

Notes: A sample of 261 companies out of 300 listed in the FTSEurofirst 300 report valid matched data in 2000 and 2014 for intangibles and total assets. The ratio for intangibles to total assets is computed and then firms are independently ranked for each year 2000 and 2014. Our objective is to establish the extent to which more firms in 2014 have a higher intangible to total assets ratio than in the earlier year 2000.

In chart 2 we describe the share of net income distributed as dividends and share buy-backs for a matched set of firms listed in the FTSEurofirst300. This chart shows that an increasing number of firms are distributing more than 75 percent of their net income and more firms are financing distributions to shareholders from externally sourced funds. In the year 2000 approximately 8 percent of firms distributed more than three quarters of their net income. In 2014 the proportion of firms distributing more than three quarters of their net income

⁷The FTSEurofirst 300 Index comprises the 300 largest companies ranked by market capitalisation in the FTSE Developed Europe Index.

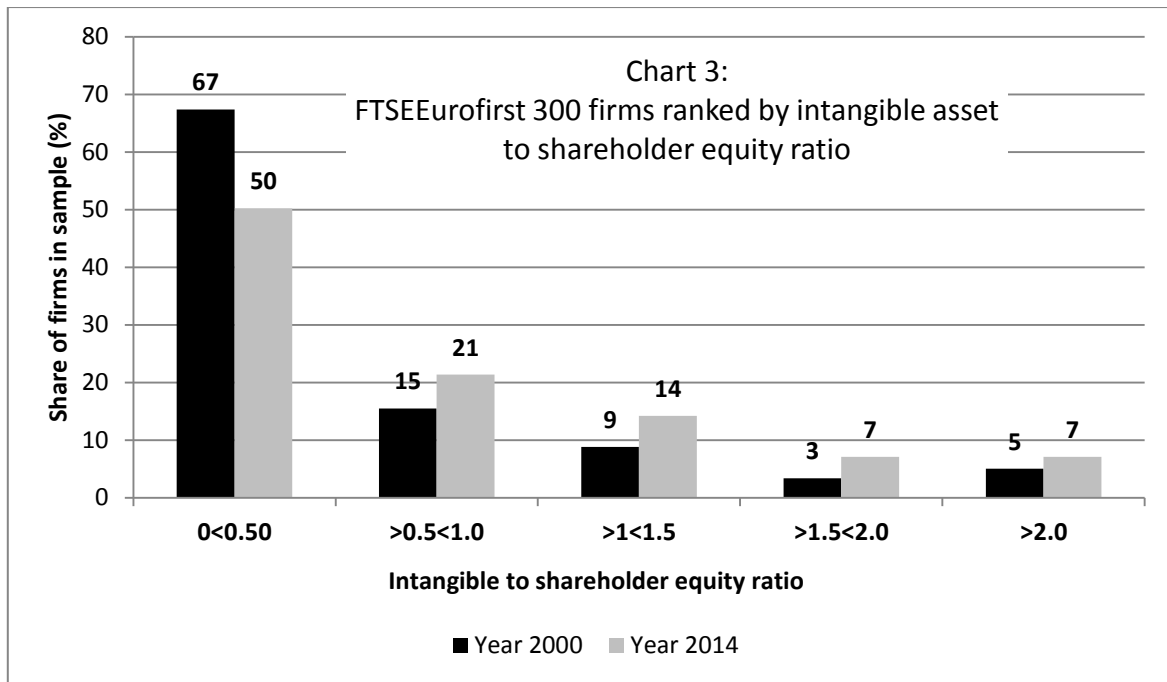
has risen to 25 percent and roughly half of all firms surveyed distributed more than fifty percent of their net income.



Source: Data obtained from Thomson Reuters FTSE Eurofirst 300.

Notes: Notes: 250 companies surveyed out of 300 listed in the FTSEurofirst 300 report valid matched data in 2000 and 2014 for dividends, share buy-backs and net income. The distribution ratio is computed and then firms are independently ranked for each year 2000 and 2014. Our objective is to establish the extent to which more firms in 2014 have a higher distribution ratio than in the earlier year 2000.

In combination a higher ratio of intangible assets in total assets and increased distribution of earnings contributes to an increasing intangible asset to shareholder equity ratio for firms listed in the FTSEurofirst300 group. In 2014 some 28 percent of firm’s surveyed reported intangible assets with a value that exceeded shareholder equity funds compared to 17 percent of firms surveyed in the year 2000 (see chart 3). Over the period 2000 to 2014 an increased number of firms in the FTSEurofirst300 group have a higher intangible to shareholder equity ratio.



Source: Thomson Reuters

Notes: Sample comprises 239 companies out of the FTSEurofirst300 reporting valid matched data in 2000 and 2014 for intangibles and shareholder equity. The ratio for intangibles to shareholder equity is computed and then firms independently ranked for each year 2000 and 2014. Our objective is to reveal the extent to which more firms in 2014 have a higher intangible to shareholder equity ratio than in the earlier year 2000.

In figure 1 we outline a stylised stress testing model for IFRS in a financialized world. This model captures the interrelationship between line items and how these are subject to variable influence. For example, a higher distribution of earnings will slow down the growth of retained earnings in shareholder funds relative to asset values that crystalize future earnings potential into their current valuations. These variable properties set line items on different trajectories such that the accumulation of asset value at risk runs ahead of shareholder funds. In the final section of our analysis we have selected nine European firms which collectively account for 1.1 million employees (see table 1). This group of firms have been chosen using the filter described in figure 2 which represents the model depicted in figure 1 but now in the form of a set of interrelated key financial ratios. These nine firms are selected because they have a shared experience, that is, over a period of time, they have migrated from a low to high intangible to total assets ratio, a low to high income distribution ratio and higher intangible assets to shareholder equity ratio.

Figure 1: A stylised stress testing model for IFRS in a financialized world

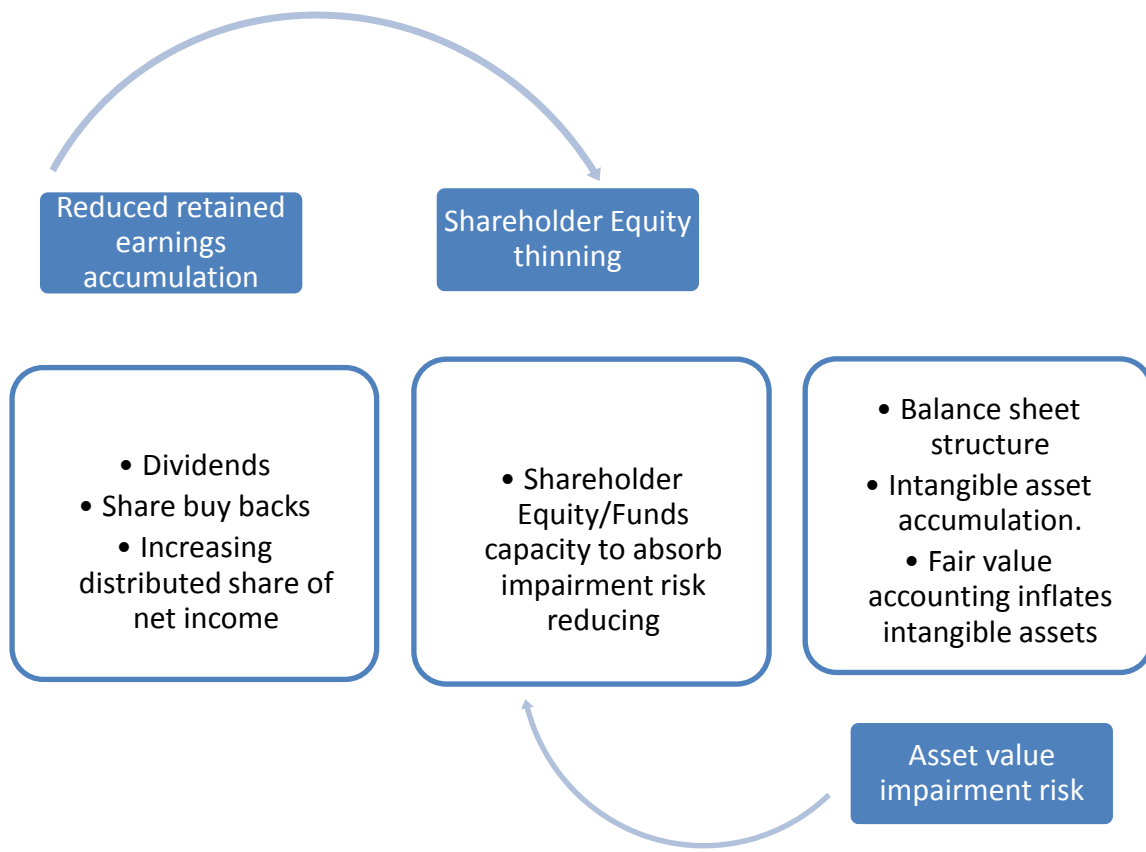
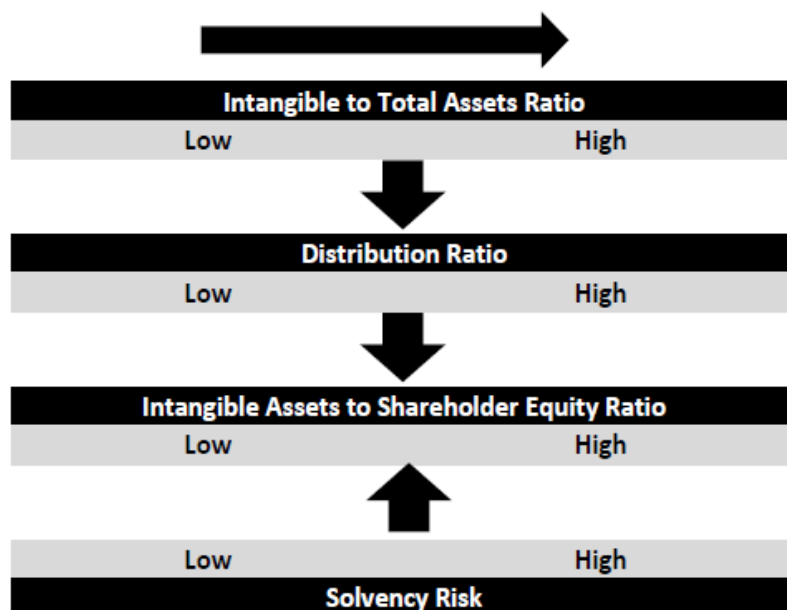


Figure 2: Case study choice filter

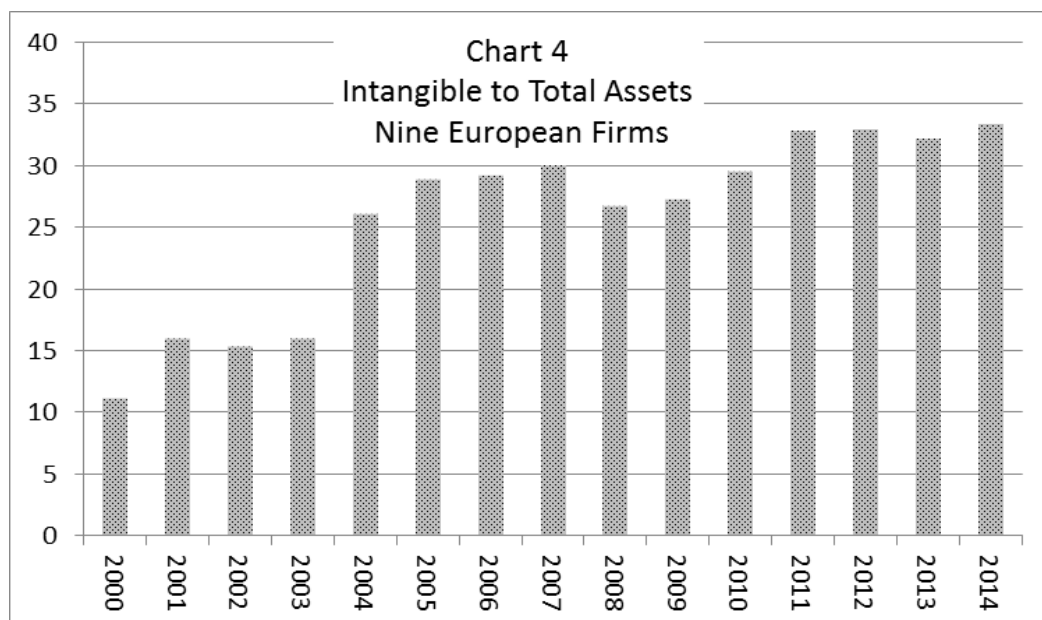


Over the period 2000 to 2014 the nine European companies listed in table 1 have experienced changes to the structure of their balance sheets with intangible assets (including goodwill) increasing relative to total assets (see Chart 4). Surprisingly this chart reveals that during the recent financial crisis the intangible to total assets ratio remained reasonably steady suggesting that intangible assets were not being heavily impaired. Biondi (2013: 152) observes that so far preparers and auditors have been reluctant to impair goodwill but that ‘this accounting choice appears questionable’. For this group of nine firms intangible assets continue to accumulate relative to total assets after the financial crisis.

Table 1: Financialized accounts for nine European firms

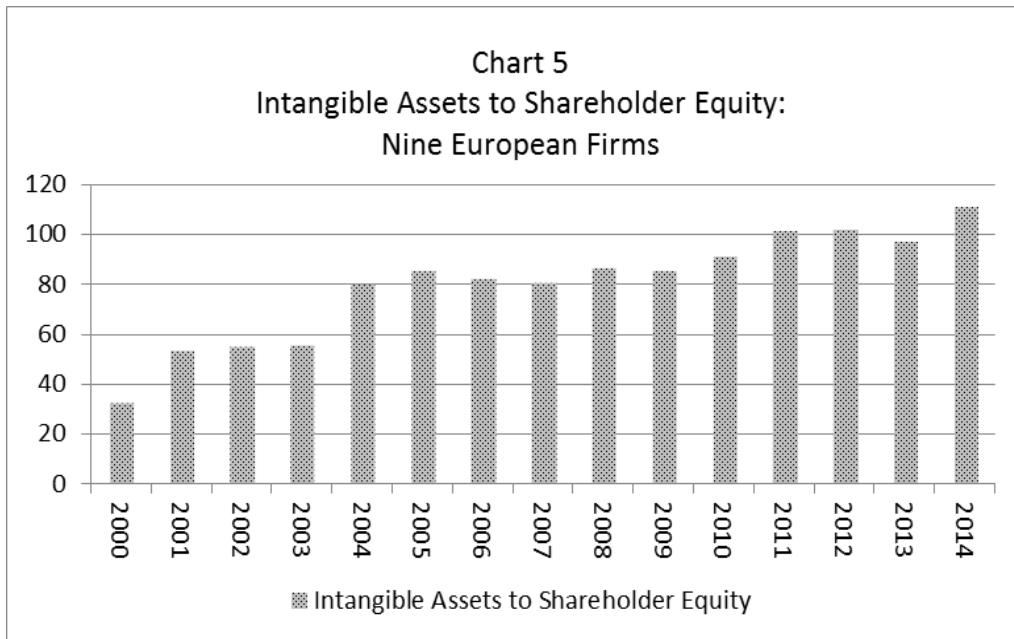
Firm	No of Employees (2014)
GlaxoSmithKline (UK)	98,792
BT Group (UK)	87,800
BAE Systems (UK)	76,000
Bayer (Germany)	118,888
E-on (Germany)	58,503
Siemens (Germany)	343,000
Sanofi (France)	113,496
Schneider Electric (France)	185,965
Legrand (France)	33,556
Totals	1,120,270

Source: Thomson Reuters



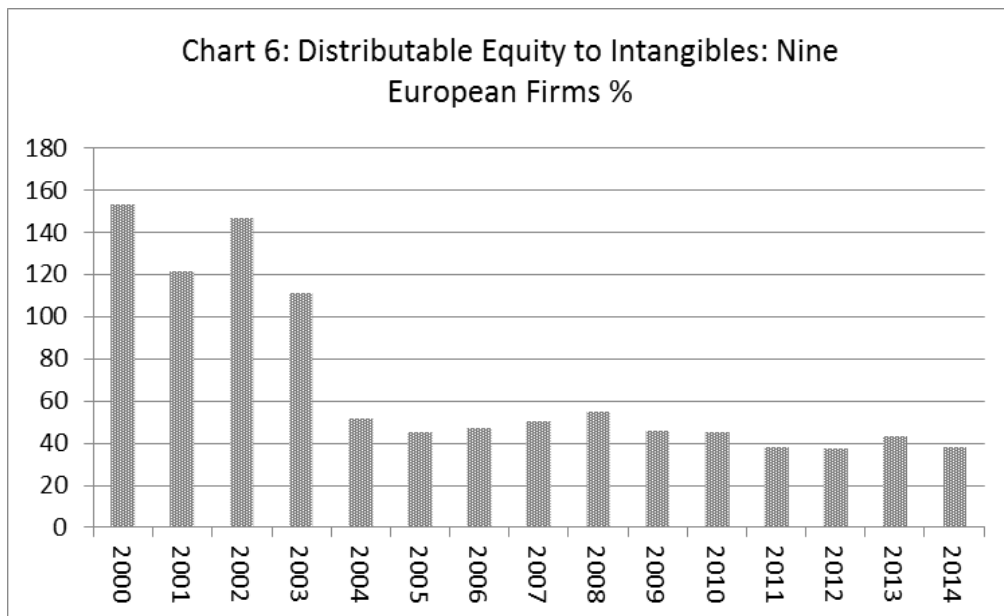
Source: Data obtained from Thomson Reuters

Chart 5 shows that for this group of nine firm's intangible assets were equivalent to one-quarter of the value of shareholder equity funds in the year 2000 but by the year 2014 the value of intangible assets, on average, exceeded shareholder funds.



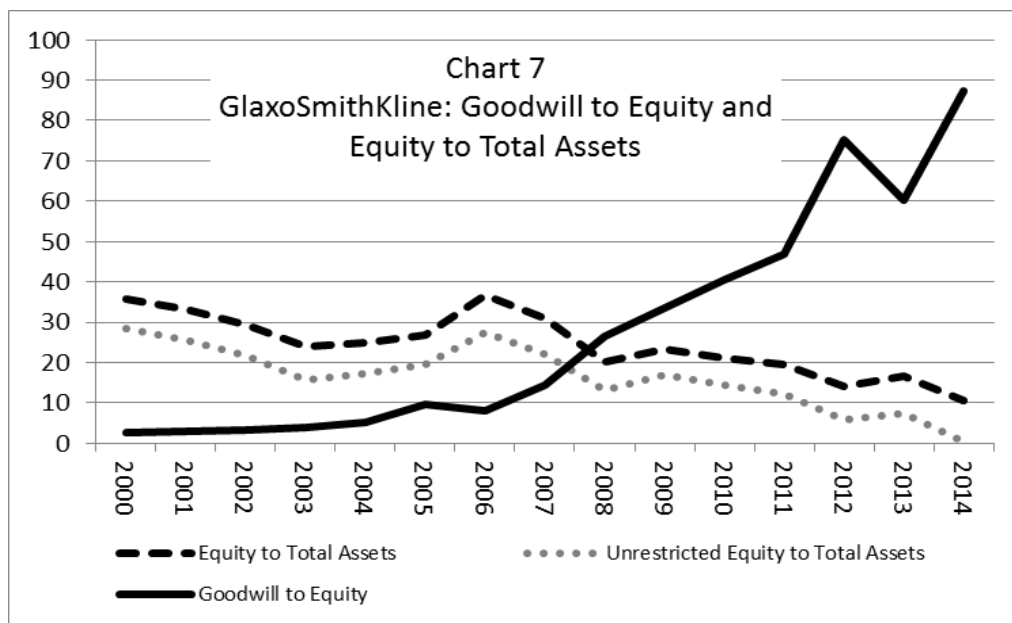
Source: Data obtained from Thomson Reuters

Chart 6 describes the ratio of distributable shareholder funds (retained earnings) to intangible assets. This ratio describes the extent to which distributable shareholder funds can cover holding losses that might arise from the impairment of intangible assets.



Source: Data obtained from Thomson Reuters2

Our analysis for the nine European firms shows that the ratio of distributable shareholder equity to intangible assets has fallen over the period 2000 to 2014 with the majority of the adjustment taking place between the years 2002-2004. Thereafter there has been a gentle further decline in the distributable equity to intangible asset ratio from around 50 percent to below 40 percent coverage. Even more fragile scenarios are possible. Some firms might deplete unrestricted equity funds (retained earnings and other reserves) and erode restricted shareholder equity (original capital and share premium). In these circumstances there is very little headroom to absorb intangible asset impairments such as that arising out of goodwill impairments as chart 7 reveals in the case study of GlaxoSmithKline.



Source: Data obtained from Thomson Reuters

Since 1995 GalxoSmithKline (GSK) generated £73.6 billion of net income and distributed £67.3 billion, that is, distributions accounted for 90 percent of net income. Shareholder equity (retained funds) in GSK were also further eroded by the need to account for market value losses on defined benefit (DB) pension schemes because the fair value of scheme assets, have in recent years, been valued below the value of liabilities. In 2014 GSK's accumulated goodwill arising out of business combinations is equivalent to 90 percent of its total equity funds and if we add to this the value of all other intangibles this would equate to three times the value of total shareholder equity funds. BT Group, another of our nine companies, has reported negative shareholder equity in the financial years 2013 to 2014 but still records intangible assets and goodwill to the value of £6bn on the asset side of its balance sheet. Our argument is that firms are increasingly exposed to potential holding losses, for example, in 2015 Tesco PLC a UK grocery retailer announced fair value impairments to its property portfolio and other one-off other impairment valuation adjustments totalling £6.2bn. This change to its asset values triggered a substantial 42

percent decline in reported shareholder equity and a significant deterioration in the debt to equity ratio from 0.6:1 to 1.24:1

5. Summary/Discussion

Philippe Maystadt's (2013) report challenged the European Parliament to reform the governance process associated with the endorsement of IFRS and issued a broader requirement that IFRS promote financial stability in the public interest. A follow-on European Commission working paper (2015) reviewed the impact of IFRS on financial market stability and concluded that, as part of the endorsement process, IFRS do need to be evaluated holistically in terms of their cumulative effects.

The central objective governing the IASB's role in setting IFRS is that of providing relevant information to investors so as to promote the efficient functioning of capital markets. The IASB's mission statement conflates the public interest with the information needs of investors and an efficient functioning of capital markets. The Maystadt report implied that accounting information can modify behaviour and impact upon the stability of capital markets. An on-going debate has focussed on the extent to which the adoption of FVA in IFRS contributed to financial market instability during the last financial crisis against the public interest. The Maystadt report was therefore concerned to integrate financial stability and the public interest element into the endorsement process for IFRS.

It is necessary to differentiate between IFRS as an information feed to 'users' and how IFRS disclosures impact upon the structure of financial statements and line items in ways that could potentially undermine the financial stability of firms, modify resource stewardship and generate a moral hazard to society. IFRS need to be stress tested to assess their impact upon the financial stability of firms. In this paper we have employed the literature on the financialized firm to construct an alternative framework for stress testing IFRS. This framework describes changes to the composition of total assets where fair value reporting crystallises future earnings into current asset valuations. These valuation adjustments are by their nature speculative and can become impaired. The potential for asset impairments is accumulating at the same time as shareholder equity funds are being hollowed out. The analysis in this paper finds that large firms listed in the main European stock markets are accumulating intangible assets that contain mark to market adjustments in their total assets. It also concludes that, for an increasing number of firms in Europe, the shareholder equity buffer is being hollowed out. The potential for asset impairments to undermine shareholder equity, damage credit ratings, solvency and the financial stability of large firms in Europe has increased.

EFRAG and the ARC (representing European political interests) continue to evaluate IFRS in relation to the costs and benefits of accounting standards for preparers and users of

accounting information. The primary objective of IFRS issued by the IASB is with the provision of information to investors so as to promote capital market efficiency. In this paper we argue that changes to IFRS also impact upon the structure of a firm's financial statements and modify the relation between line items. Changes to individual IFRS have compounding effects which can increase the potential for financial instability in firms and because accounting informs governance and resource stewardship this can translate into a moral hazard for society.

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