EU Federalism and the Governance of Financial Reporting

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The European Union (EU) is built on the federalist principle of subsidiarity, which we consider in the policy field of financial reporting. We attempt to answer the question, whether the current accounting regulation in Europe is sensibly balanced between centralized and decentralized decision making. Drawing on comparative accounting research to identify criteria for "local preferences," we conclude that local solutions currently remain preferable for small and medium-sized companies. For them, a centralized solution would result in additional costs for at least some member states and their residents. Large international firms, in contrast, face an increasingly integrated capital market and rather need a central solution as currently implemented by the EU. However, recent developments in corporate finance may align local preferences on accountancy in the future.

In the EU, accounting standards are becoming increasingly harmonized. This is a result of political attempts to create a common capital market, and it curtails the member states' latitude in setting their own financial reporting[1] rules. This harmonization can be interpreted as centralization within a federal system. As the European Union (EU) is built on the principle of subsidiarity, any centralizing political initiative warrants justification. We will therefore investigate the opportunities and difficulties of establishing a single set of European accounting rules for a common capital market, taking into account the heterogeneity of EU member states.

Issues of centralizing and decentralizing government functions are suitably discussed in connection with the concept of federalism. Federalist theory provides a normative framework for assigning different governmental functions to executive levels to maximize welfare (e.g., Musgrave 1959). Subsidiarity as core principle implies that problem solving should first be attempted on the local level. Only in the case of failure (or foreseen failure), is regulation to be moved to a more centralized arrangement. In economics as well as political science, it is commonly accepted that central governments are responsible for tasks such as macroeconomic stabilization or income redistribution (e.g., Gramlich 1987). For the majority of

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other fields, it is argued that local politicians are closer to their constituencies' needs, and that they are therefore better capable of meeting them.

For the purpose of our analysis we will treat the EU in the remainder as a federal construct with the member states being the "local" jurisdictions. Political science remains discordant on the question of whether it is appropriate to treat the European Union as a federal construct (see Kelemen 2003 for this discussion). We follow scholars who referred to "EU federalism" from a relatively early stage of integration (e.g., Dehousse 1992), and more recent political science studies that analyze Europe as a federal construction (Harbo 2005; Obinger 2005).

Generally, European accounting regulation distinguishes between financial reporting of large listed groups and all others. The latter includes the majority of firms in Europe, which are small and medium-sized enterprises (SME). Listed groups are required to apply International Financial Reporting Standards (IFRS), which are set by a transnational body, the International Accounting Standards Board (IASB), and endorsed by the EU to become community law. All other companies are still subject to national regulation, which is influenced by more general EU directives leaving wide scope for specific national solutions. This current balance may tip when the presently discussed IFRS for SMEs arrive or when the existing arrangements for large groups are extended to cover smaller firms.

The article is organized as follows. In the following section we review key concepts of federalist theory and their application in the EU. Section 3 provides a short introduction to the regulatory field of financial reporting. In this context we extract criteria for evaluating European accounting governance. In Section 4 we assess costs and benefits of the present regulation and plans for change. We summarize our findings in Section 5.

Federalism as a Framework for European Governance

In political science, the theory of federalism is a subject of political philosophy and can be described in short as an anti-centralist concept of society, encouraging bottom-up ideas rather than top-down approaches (Burgess 2000). In a policy-making perspective, federalism addresses the vertical structure of (multi-level) governments and deals with the optimal allocation of authority to different levels of government; be it local, regional, national or international (Newton and Van Deth 2005, 83–96).

The Principle of Subsidiarity

The central paradigm of federalist theory is the subsidiarity principle. The subsidiarity tenet presumes that policy-making should be settled at the lowest level of government, where the relevant benefits exceed the associated costs

(Oates 2004). It can also be described as the principle that a shift of competencies to a higher jurisdictional level is justified only if the jurisdictions' capability to act adequately cannot be assured, not even with assistance of the higher authority (Becker 2003).

The economic theory of federalism is traced back to Tiebout (1956), who introduced normative principles for the optimal distribution of responsibilities, expenditures and income to different levels of government (Becker 2003). In Tiebout's model, highly mobile households "vote with their feet": they choose for residence a jurisdiction of the particular locality that provides the (fiscal) package suited best to the households' tastes and needs. In the ideal case, the Tiebout solution generates a first-best result that mimics the outcome of a competitive market. Decentralized (federal) constitutions thus have some advantage over centralized ones if heterogeneity between local preferences subsists. In addition, the existence of distinctive regional goods opens a door to competition between jurisdictions.

The main reason for an efficiency gain in decentralized systems is the assumption that local governments usually know best the specific preferences of their local constituencies and other conditions (e.g., cost conditions), and can therefore better target the provision of public goods and services to these appeals (e.g., Musgrave 1959, 179–80). The resulting match between the supply and demand of public goods in federal systems (as compared to the single uniform level provided by a single central government) should thus lead to Pareto-superior levels of consumption in each jurisdiction. Creating several economic and political centers also makes it easier to balance the levels of regional development (Lenk 1999). Finally, local participation in decision making processes has the appealing feature of being more democratic (legitimate) than central decision making (Ischia 2004).

Decentralization is not compelling in all cases. Negative cross-border externalities or economies of scale militate against decentralization (Oates 2005). Negative externalities arise from local policies that have negative effects on other jurisdictions. Hence, centralizing such policies is efficient, as spill-over effects are internalized (Ischia 2004). Moreover, it is argued that decentralized policy making can cause macroeconomic co-ordination failures (Føllesdal 2003; Oates 2004). These lead to extra co-ordination costs and the loss of economies of scale, because lower level governments do not hold the right means to provide a certain good efficiently. Apart from that, the free-rider problem may cause an under-provision of public goods. Depending on the specificities of public goods, such problems may be overcome at least partially by joint production of neighboring local providers or by financial compensation between the provider and the users so that the externalities are internalized. Where this is impossible, a more centralized provision is preferable.

The process of finding an appropriate distribution of competencies to executive levels is, on the one hand, about balancing the trade-off between preference matching and negative externalities as well as economies of scale. On the other hand, it is a weighing up of the often competing demands of efficiency and democracy, and also systematically depends on different variables that are often specific to the policy field under consideration.

EU Federalism and its Regulative Consequences

While the principle of subsidiarity appears in the United States often informally as an aversion to the "one size fits all" regulatory approach (Oates 1999), it is explicitly enshrined in the 1992 Maastricht Treaty of the EU as one of its foundations. In Article G of the Maastricht Treaty the contracting parties state that "In areas which do not fall within its exclusive competence, the Community shall take action, . . ., only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community."[2]

In the recent stage of the European integration process, the concepts of federalism and subsidiarity are used in an institutional way to address the process of integrating a territory of different (here: nation-) states that claim to remain "Unified in Diversity" (Burgess 2004). Unlike other federalist systems, e.g., the United States or the Federal Republic of Germany, the EU does not possess a constitution, but is built-on contracts among its member states. The Maastricht Treaty signed in 1992 provides the basis for the EU and pooled previous treaties of the European Community (Hitris 1998). Since then, the Maastricht Treaty was amended by the Amsterdam Treaty in 1997 and the Nice Treaty in 2000.

Strengthening the subsidiarity principle, the Maastricht Treaty affirms the supreme sovereignty of the contractual parties (Hitris 1998), and curtails sovereignty through explicit delegation of responsibilities to the federal level of government (EU). Competencies assumed by the EU can be differentiated in exclusive competencies, shared competencies and complementary competencies (Leskinen 2008). While the first and last category determines an unambiguous competence allocation, the second category is in some measure hybrid. In this context it is noteworthy that the EU does not have competence-competence, i.e., the allocation of competencies needs a stipulation of the contracting parties (Herdegen 2007). This implies that competencies not articulated in the treaties belong to the nation-states, and thus the sovereignty of the EU is bound by contract to exclusive competencies. However, comparable to the United States "commerce clause," the EU is capable to extend its responsibilities to non-articulated competencies to accomplish the principle objectives of the treaties (Bungert 2001, 6–8; Leskinen 2008, 3–4).

The Maastricht Treaty furnishes the EU with several legal instruments for policy-making in its fields of competence (Maastricht Treaty 1992: Article G). These instruments largely differ in their binding effects, sphere of application and implications on national legislation (Lenaerts and Desomer 2005). For our purpose, the focus is on regulations and directives, as these modes of governance are extensively used to harmonize national legislation.[3] Regulations bind in their entirety all nation states, and they are directly applicable (Jaag 2003, 214–215). Thus, regulations do not have to be transposed into national law and are useful whenever uniformity between jurisdictions is desired. In contrast, directives have binding effect only for those to whom they are addressed (Lenaerts and Nuffel 2005, 766). Moreover, directives have to be transformed into national law to be effective. Procedural methods to achieve the articulated aims are left to national governments, granting them a certain amount of discretion, and therefore reflecting the idea of subsidiarity (Prechal 1995).

Looking at developments since the signing of the Maastricht Treaty, a tendency is observable that nation states sacrifice their regulatory power in favor of centralized policies (e.g., the extension of qualified majority voting in Amsterdam 1997 and Nice 2000). This is partly justified by the argument that the scope of nation states has become too narrow for solving transboundary problems in particular, and thus federal solutions have been regarded as more efficient than national solutions. Examples—besides those previously mentioned—are infrastructure, regional development, tax competition (e.g., Goodspeed 2002), budgetary transfers (e.g., Deltas and van der Beek 2003) or capital market regulation, which also has a bearing on accounting.

The debates surrounding policy decisions show a tension between the advantages of Europeanization on the one hand and the benefits of decentralization on the other. Opponents of central solutions see a growing risk that the principle of subsidiarity has lost its power and that EU institutions assume responsibilities that would be more efficiently handled by national authorities (Ischia 2004). Despite the setbacks of the European Constitution movement (e.g., Boscheck 2006), it appears to them that a dynamic towards centralization currently dominates the Union (Salmon 2002; Robinson 2004), which disregards its avowal to subsidiarity (Goucha Soares 2005). However, many interpret the results of the respective referenda as a clear signal against further empowerment of the central organization that interferes increasingly into national politics (as for France, where the referendum on the constitution failed: Franck 2005; Jerome and Vaillant 2005). Hence, it may be understood as a call for more subsidiarity.

With respect to accounting, European policy makers need to decide (i) whether policy-making is necessary in the first place and (ii) whether a measure is best undertaken at the national or the European level. To determine, which of the possible choices is the most effective and efficient, decision-makers need to consider the interests of the respective market in which the various rules are to be established. Moreover, they need to concern themselves with the questions of whether there is sufficient competition between member states, and whether there are homogeneous preferences with respect to accounting information in *all* capital markets. The resulting degree of (de-)centralization will then reflect the different preferences for a federal structure in accounting regulation.

In the following sections, we therefore discuss in detail the different needs and traditions in accounting policy among European member states in order to facilitate an evaluation of costs and benefits of a centralized/decentralized accounting regulation. We use categories from comparative accounting literature to point to national differences and outline both the ensuing regulatory costs for the legislator and the resulting costs for the affected subjects. We will evaluate the drivers: (i) legal systems, (ii) provision of finance and (iii) taxation with respect to their backing or disclaiming of a more central mode of accounting regulation in Europe.[4]

Accountability and Accounting: Economic and Policy Issues

Accountability can be defined as an obligation to give an account. Following Perks (1993, 24), one can distinguish its four dimensions: (i) subject of accountability (who is accountable), (ii) the receiver of an account (to whom), (iii) the means of accountability (how) and (iv) the object of accountability (for what). The contractual (Anglo-Saxon) model of accountability, e.g., implies that managers are accountable to the shareholders (owners) for the firm's financial performance by means of financial reports. Other approaches such as the stakeholder model (e.g., Roberts and Mahoney 2004) or Corporate Social Responsibility Accounting (e.g., Yongvanich and Guthrie 2006) widen the perspective in respect of receivers, means or objects.

Following the contractual accountability model, accounting renders a report of a firm's financial history and maps ongoing business activities into the future. In doing so, the accounting process transforms a firm's economic trajectory into specific financial numbers (e.g., net assets and earnings) and gives third parties an idea of how the company has performed during the reporting period, how it is actually doing, and how it is possibly going to continue in the future (Demski and Christensen 2003). This Anglo-Saxon model thus focuses on the management of a (joint stock) company giving account to the shareholders.

The above-described contractual approach to accountability is, however, just one particular view of what accountability means and what accounting is supposed to deliver. Accountability, though, can also be construed in a much broader fashion. Accounts can have other objectives in addition to informing shareholders. Take the stakeholder model: accounts can be used for creditor protection, serve as a basis for taxation, or play a role in solving conflicts among owners, between owners and managers, or conflicts between other interested parties. The main addressees of an account can therefore vary from small shareholders, through large banking corporations, to state authorities. Accountability and accounting reflect a general societal discourse about firms: what is to be expected from them and by whom. In many countries, e.g., the accounting system is connected to the legal and taxation system (e.g., Roberts *et al.* 2002). Accounting regulation can also extend into the capital market and company law in order to provide particular corporate governance mechanisms. This extended concept of accountability thus makes accounting not only a matter of market efficiency, but also a policy field in its own right.

From the policy-makers' point of view, the setting of accounting rules necessarily implies redistributive effects: (i) Firms bear costs in order to benefit/protect outside stakeholders, distributing from firms to stakeholders. (ii) Informational endowments of individual stakeholders are balanced, distributing from better- to worse-informed stakeholders. (iii) Insider knowledge about firms is made public, distributing from managers to outside stakeholders. (iv) Capital maintenance rules are established, distributing from residual claimants to lenders. The magnitudes of these redistributive effects must be assessed so that a policy initiative such as new accounting rules implies a higher level of social welfare.

A Cost-Benefit Analysis of Federal Structures in Accounting Standard Setting

While the idea of harmonizing accounting in Europe has been discussed from the Union's beginnings, major steps towards Europeanized accounting regulation were only taken in 1978 and 1983, when two important European Council Directives on Company Law were passed. The fourth Directive of 1978 established minimum requirements for company accounts with respect to contents and presentation (78/660/EEC). The seventh Directive of 1983 adopted rules for group accounts, aiming "to achieve the objectives of comparability and equivalence in the information, which companies must publish within the Community" (83/349/EEC, 2), an argument also forwarded in 1978. As the EU tried to harmonize accounting by using the vehicle of company law, the directives applied to all firms operating in the member states, regardless of their size or transboundary scope of activity. It is therefore understandable that the ultimate decisions on the most contentious issues in European accounting were left to national parliaments. Substantial differences in accounting remained; the goal of achieving comparative statements all over Europe was not fully achieved.

A popular example for prevailing national peculiarities in the case of directives is the acceptance of the "true and fair view" (TFV) concept as general standard for financial reporting. It was enshrined in Article 2 (3) of the fourth Directive, and its prevalence was substantiated with Article 2 (5), which allowed a true and fair override when application of specific accounting rules conflicted with the TFV objective. Both provisions have their origin in the British tradition and were expected to move accounting closer to the Anglo-Saxon approach of accountability. But most continental European countries were unfamiliar with the stipulations, and the EU legislator had not provided a definition of the TFV in the directive, which could have helped in understanding (Dragneva and Millan 2003). Member states used their administrative discretion to define circumstances, which qualified for the true and fair override. Belgium, for instance, limited the overriding property only to valuation rules. Germany even went further: the legislator adjusted the TFV concept to its own accounting tradition that is even contradictory to the British spirit (Ordelheide 1996). In other member states, the overriding property was simply not transposed into national law.

A decisive step towards harmonization of European accounting practices, sometimes seen as "…the largest and most complex accounting conversion in history…" (e.g. Brackney and Witmer 2005) came with Regulation (EC) No. 1606/2002. The so-called "IAS Regulation" requires listed groups to publish financial reports in accordance with the International Financial Reporting Standards[5] (IFRS) from 2005 onwards. This time, a distinctive capital market oriented argumentation was applied (Regulation (EC) No. 1606/2002, 4). Here, the EU harnessed the objective of a unified capital market to establish a fully harmonized accounting by means of regulation, but it could only do so for a subset of companies, namely listed groups.

Financial reporting is thus currently regulated on both levels—the federal and the national level. While group accounting of firms traded on capital markets is fully regulated on the central level, all other accounting is governed by national legislation within the framework of the respective directives. Until now there are no initiatives to harmonize company accounts further: "The work of the Contact Committee should focus on consolidated accounts. A more general approach including individual accounts would be more likely to run into controversy…" [European Commission COM 95(508), 5.6].

The nation states' regulation is not influenced by the fourth and seventh Directives alone. The Commission communication of 28 October 1998 entitled "Financial services: building a framework for action" [COM 1998 (625)] has set out an ambitious plan aiming at a centrally set solution for a wide range of issues—among them accounting, prospectuses, investment opportunities for insurers and pension funds, corporate governance and supervision. Specifically, there is an increasing activity of the European Commission observable in the regulation of enforcement and disclosure of accounting information, both due to the Lamfalussy Process {e.g., "Implementing the framework for financial markets: action plan" [COM 1999 (232) final]}, and the reactions to corporate accounting scandals. Taxation, being closely linked to accountancy, remains another issue of harmonization attempts, although there are only few significant achievements so far (e.g., VAT regulation; discussion on the harmonization of the tax base, see Oestreicher and Spengel 2005).

The European Commission has furthermore indicated that it will consider adopting "IFRS for SMEs" that are currently under development. After the IASB published its preliminary views for comment in 2004, this project began to be discussed more intensely again, as the board attempted to accomplish the project in 2007. With regards to its contents, the IASB considers significant deviations from "full IFRS," especially with regard to the users of financial reports. Still, the current plans are based on the same conceptual framework, which focuses clearly on equity investors. Also a "fall-back" on "full IFRS" is considered for issues that remain unsolved in the SME standards. The European Commission takes active part in the IASB's deliberations. In its comments on a proposal of the IFRS in 2004, the Commission points out that, especially medium-sized firms are its focal interest with regard to further centralization (European Commission 2004). Hence, a tendency towards further EU intervention can be observed in the field of accounting—and decision-making competencies seem to become increasingly centralized.

Institutional Differences as Cost Drivers

The Legal System

Although finer taxonomies do exist, legal systems are traditionally classified into two fundamental groups in accounting research: the continental-European "code law" jurisdictions, and the "common law" systems of "Anglo-Saxon" countries (e.g., Nobes and Parker 2004). While code law seeks to provide answers to specific cases and court decisions are based on interpretations of codified law, common law (or case law) tends to rely on precedents rather than formulating general rules for practical use in the future.

The nation states of Europe show a distinct variety regarding the legal system. Table 1 shows a selection of European countries, considering not only the legal families, but also commonly considered sub-groups (see La Porta *et al.* 1998). The sub-families can be traced back mostly to historical paths. The French family includes legal systems that go back more distinctively to the "Code Napoleon," while the German family incorporated changes from Bismarck's times. The Scandinavian family represents a class of its own but also possesses a clear code law tradition.

Although the legal system is an important factor consistently cited in comparative accounting literature, there is actually very little enquiry into the

Table 1 Legal families and their members within the EU (selection)

Family	Sub-family	Country
Common Law	English Origin	United Kingdom
		Ireland
Code Law	German Code Law	Germany
		Austria
	French Code Law	Belgium
		France
		Italy
		Netherlands
		Spain
		Greece
		Portugal
	Scandinavian Origin	Finland
		Denmark
		Sweden

Source: La Porta *et al.* 1998.

conceptual relationship between the legal system and the accounting system. This is important, though, as accounting regulation is always embedded in a country's legal system. There are important differences in the extent, to which laws and court decisions are the primary source of accounting regulation. In common law countries, accounting is traditionally a subject of law to a lesser extent. In these countries, accountants themselves establish rules that turn into recommendations or standards (that is, accounting practice). In countries using codified law, rules for financial reporting are established as company law or commercial codes. In Germany, e.g., company accounting is to a large extent a branch of company law (e.g., Gebhardt 2000). Consistent with its legal tradition, France has the oldest laws on accounting (Nioche and Pesqueux 1997), which makes it in this regard a stricter code law country than Germany. However, the dichotomy of two legal families cannot explain all the variance: the financial reporting structure in the Netherlands is rather similar to the accounting regulation in the UK, although it is classified as code law country (Parker 2004).

A major difficulty for a standardized European accounting regulation is that in most code law countries company accounts serve as basis for further legal consequences, and accounting and other legal rules make up a complementary system. Changing national accounting regulation would thus require changing the interrelated parts of the legal environment simultaneously. In Germany, e.g., the information function of company accounts is only of subordinated importance

(Leuz 1996, 3). Based on principles of the corporate law, their main purpose is the computation of distributable corporate income (dividends), which in other jurisdictions is tied to separate solvency tests. To prevent an excessive distribution of profits, for the sake of capital maintenance and for creditor protection objectives, Germany's company accounts are prepared under prudent recognition and measurement rules (Haller 2003).

A departure from the prudence principle would therefore, threaten the current regime of dividend distribution (Küting 2004), and with new rules the capital base of German firms may be narrowed. Consequently, the regulators would have to implement new corporate law mechanisms to govern capital maintenance and income distribution to assure creditor protection, e.g., future-oriented solvency tests which are well-established under the U.S. corporate law (Sellhorn and Gornik-Tomaszweski 2006). Another example for an interrelationship of accounting with other corporate law is bankruptcy. A uniform accounting regulation may have unwanted effects for the determination of insolvencies (Kirsch 2003). The structural fact that accounting regulation in "code law" countries affects its general legal environment more strongly could therefore cause significant switching costs.

Additionally, common law countries are able to use societal actors (such as professions) more easily, as they have a long standing tradition. Their accounting regimes will be at the same time more flexible and ready to absorb changes. Code law countries will more likely have a tendency to turn to legislative procedures, with fewer innovations and less regulatory reaction to changes in the business environment. Accountants will tend to search for guidance in existing rules. A "one size fits all" perspective of a central European regulation will therefore very likely favor one of the country clusters. The diverse nature of legal systems would therefore indicate a need for a local (decentralized) decision making; otherwise constituents in different local jurisdictions will have to bear different costs for the same type of regulation.

Micro- and Macrostructure of Capital Markets

The micro- and macrostructure of capital markets is another decisive factor behind international differences in accounting. Two issues need to be considered here: the microstructure, i.e., the distribution of supply and demand of funds within the economy, and the macrostructure, i.e., the overall importance of capital markets (compared to raising funds via banks, insurance companies, etc.; see e.g., Leuz and Wüstemann 2004). Determinants of the microstructure are also the pension system and the general saving behavior of the public (Boersch-Supan and Winter 2001). In societies with a high acceptance of stock-ownership as a means of saving or a high importance of private pension schemes, capital markets play a much more important role, and they require more information disclosure and stronger enforcement of standards. This is, for instance, the case in the UK, while other economies such as Germany, France or Italy traditionally do not need extensive market-driven information about the performance of an individual's investment. Even listed public companies differ across countries with regard to their ownership structure. The distinction between countries where companies tend to be owned by large blockholders and other countries, in which free float is much more common, is also useful in this context. The first set of countries tends to establish a system of "insider control," making market-based mechanisms such as disclosure and enforcement less important.

From a microstructure perspective, capital provided by banks is very significant for those countries that have relatively few listed companies (i.e., with the dominance of small and family-owned businesses; see, e.g., Roberts *et al.* 2002). This prevalent type of business organization is then translated into different financing structures: economies with "small" capital markets allocate savings via banks through debt vehicles, whereas economies with "big" capital markets tend to have businesses with a high share of equity financing (Doupnik and Salter 1995). Hence, one can distinguish between "equity financing" and "debt financing" countries, or "outsider" and "insider" economies respectively (Franks and Mayer 2001). Banks can even act as equity holders, when the demand for equity vehicles by individuals is particularly weak. In Germany, for instance, banks and insurance companies have been important owners as well as providers of finance to companies; but this role is fading (Lütz 2005).

In "insider" countries such as Germany, France or Italy, banks will often nominate directors and be able to obtain information and influence the decision-making of a company. In this case, with its additional opportunities of obtaining inside information or exercising influence, the need for disclosed information or for conflict-resolving mechanisms is thus not so manifest, if not almost superfluous. At the other end of the spectrum, one can easily see the usefulness of disclosure in an "outsider" economy such as the UK, where individual equity investors tend to have a too-small share to be influential.

The varieties in the organization of the economies do not apply uniformly across all firms. Large(r) companies, especially listed groups, tend to organize themselves according to the conventions of "outsider" economies: they provide in-depth disclosures, reduce blockholdings and follow corporate governance codes that no longer favor insiders such as banks. Consequently, it is largely the sector of SMEs that stand for the differences. Their importance and composition will have a major impact on how costs and benefits of a changing regulation accrue. The varying structure can be observed by the importance of SMEs in their economies as displayed in table 2 (similar Evans *et al.* 2005). We observe significant differences between the 10 largest EU economies with respect to the role of their SME sector. In total 99.8 percent of businesses in the EU-27 are SMEs with less than 250 employees. In 2005, the share of workers employed by these companies averaged

Table 2 Key indicators for SME in the EU's ten largest economies

Country	SMEs share in employment (in percent)	SMEs share in GDP (in percent)	Employees per enterprise
Italy	81.3	70.9	3.2
Spain	78.7	68.5	4.1
Poland	69.8	48.4	3.8
Netherlands	67.3	61.5	6.4
Austria	67.4	60.0	5.8
EU-27	67.1	57.6	4.3
Belgium	66.6	57.8	4.1
Sweden	63.2	55.6	3.2
France	61.4	54.2	3.9
Germany	60.6	53.2	7.5
United Kingdom	54.0	51.0	6.2

Notes: Companies employing less than 250 workers, data from 2005. *Source*: Eurostat 2008.

67.1 percent, employing on average 4.3 persons and contributing 57.6 percent to the gross domestic product (GDP). The share of workers ranges from 54.0 percent in the UK to 81.3 percent in Italy. The share of SMEs in their respective GDP varies from 48.4 percent in Poland and 51.0 percent in the UK to 68.5 percent in Spain and 70.9 percent in Italy. Similarly, the average size of an enterprise measured in number of employees differs considerably (from about 3.2 in Italy and Sweden to 7.5 in Germany). As these dissimilarly clustered firms are successfully embedded in their respective socio-economic system, including the legal framework, the need for different optimal accounting regulatory modes is rather likely.

Unsurprisingly, SMEs react with skepticism towards possible centralized rules applying to them, especially when they are expected to follow an Anglo-Saxon tradition. Particularly in "insider economies" such as Germany it is argued that less conservative and less prudent financial reports may cause higher economic pressures from (non-managing) owners, employees and customers. It is also expected that conversion costs are high for many SMEs due to the complexity and the lacking competencies in dealing with conceptually novel accounting standards, for instance IFRS. SMEs would be forced to strengthen technical and vocational skills in their accounting departments or to make use of costly consultancy services. Frequent changes in IFRS compared to national legal frameworks (Kahle 2003) may spill over to IFRS for SMEs and exacerbate the problem. Consequently, the relative implementation and compliance costs for SMEs will be considerably higher (Veerle 2005, 9) than for larger firms. Likewise, accounting costs per user will be higher, as the potential user group of the disclosed information tends to be smaller (Bollen 1995, 39).

Another critical factor is the increased transparency through extensive disclosure requirements. Information about strategic objectives, R&D projects or price calculations could be abused by domestic and foreign competitors, which may have a negative impact on the competitiveness of SMEs (Kajüter *et al.* 2008). Especially companies which traditionally shied away from greater transparency, such as German SMEs, would be affected by additional disclosure requirements (Mandler 2003).

Uniform SME standards for company accounts are discussed less controversially in the UK (e.g., Sharp 2004), where the Accounting Standards Board has been setting separate standards for SMEs since 1997. The (continental European) resistance against a uniform solution is often believed to dissipate in the context of changes in SME financing (e.g., Oehler 2006). Three general trends are observable:

- SMEs (even smaller ones) expand their business increasingly over national borders. Particularly, the eastern European expansion of the EU enhanced the degree of internationalization of SMEs (European Commission 2003). Hence, SMEs will experience that foreign customers, suppliers and banks will demand comparable financial data. Centralized standards would eliminate the comparability problem of different accounting data *a priori* and enable foreign stakeholders to better evaluate the performance between firms, which may cut transaction costs.
- Basel II, a set of rules by the Basel Committee on Banking Supervision on equity and risk management passed in 2004, is expected to change accounting. The agreement requires credit institutions to align their core capital more strongly with the borrowers' creditworthiness. For this reason banks will need a comparable base for risk assessment, which is likely to be based predominantly on international standards. Furthermore, banks may request accounts based on international standards due to their (supposedly higher) informative value to allay the risk of error (Böcking 2001).
- Refinancing of SMEs is currently undergoing significant changes. The classical financing of SMEs with debt or equity capital is decreasing, while bonds or hybrid financing instruments such as mezzanine capital gain in importance. Mezzanine capital is subordinated to creditor claims and senior to equity claims in case of liquidation or insolvency (Brealey *et al.* 2007). Therefore, bond holders and providers of mezzanine have more sophisticated information needs compared to equity financiers of SMEs.[6] They will appreciate uniform financial reports, which present a TFV of the company's economic situation for assessing and comparing the risk of investment opportunities.

All of these drivers are supposed to foster a rather Anglo-Saxon model of accountancy, especially when taking the consolidation of the banking market into account. The Anglo-Saxon model of accountancy might prevail in the future if a new financing structure will have emerged. In that case, diminished national peculiarities would no longer call for decentralized solutions: the same reasoning as for listed groups would apply.

Taxation

Accounting literature treats taxation issues frequently as a question of legal systems (e.g., La Porta *et al.* 1998). Nevertheless, taxation may be a separate driver for costs and benefits. In many continental European countries (e.g., Germany and Spain) tax accounts are based on the commercial accounts (e.g., Eberhartinger 1999). The alternative approach (e.g., Netherlands and the UK) designs financial statements mainly as performance indicators for investment decisions, with commercial accounting rules operating separately from tax rules. In such countries, the taxation authorities exert at best a minor influence on financial reporting. The reverse is true when financial and tax accountings are closely aligned. Table 3 provides an overview of the European differences in this regard.

When tax and commercial accounts are closely connected, the influence of tax accounting reduces the information content useful to financial investors (e.g., Cummins *et al.* 1994). Nevertheless, since taxation generally relates to the taxable income of corporate entities rather than that of groups, potential investors can use consolidated accounts to obtain missing information. The EU-wide transition in

Table 3 Alignment of tax accounting with financial accounting in Europe (examples)

Country	Separate tax accounting	Combined tax and financial accounting
Belgium	–	X
Denmark	X	–
France	–	X
Germany	–	X
Ireland	X	–
Italy	–	X
Netherlands	X	–
Norway	X	–
Spain	–	X
Switzerland	–	X
United Kingdom	X	–

Notes: Flower, 2004; Nobes and Parker, 2004, 306–7, 327–28.

group accounting (for listed companies) towards IFRS did not result in any resistance from tax authorities. This highlights the importance of the international capital market in group accounting on the one hand, and the national sovereignty over company accounts—particularly if linked with tax accounts—on the other.

Breaking up the operational linkage between tax accounts and company accounts by a centralized solution would exert pressure on national tax authorities to reform the national tax system. Otherwise, the computation of taxable income and therefore the tax inflow of the regarding nation-states would depend on principles, which cannot be defined by the states (Haller 2002). In addition, the information objectives of tax authorities differ from those explained in the IASB framework (Veerle 2005).

From a firm's perspective, affected companies would have to bear additional costs. In place of one account for reporting and fiscal purposes, companies would have to prepare two separate accounts, or engage in a cost-intensive reconciliation of company accounts (if based on international standards) to tax-compliant accounts (Böcking 2001). National tax systems that use financial accounting for fiscal purposes therefore impede a central approach to general (taxation) reporting standards as long as the tax systems are not aligned. However, projects for broader European tax harmonization are not to be expected in the near future (e.g., Rädler 2004). Such refusal notwithstanding, individual attempts of national regulators to scale down the impact of tax accounting can be observed in some countries, e.g., France, Italy and Germany (Kajüter *et al.* 2008). In 2008, the German legislator published a first draft for an Act to Modernise Accounting Law, in which the relevance of tax rules for reporting purposes is abandoned.

Evaluation and Outlook

The current EU accounting policy as well as the considerations to take over "IFRS for SMEs" can be evaluated by considering the cost and benefits of transitions that accrue for the affected economies and the constituents (businesses) in different proportions. It is necessary to distinguish between firms which are relatively alike in their financing behavior and ownership structure, i.e., largely listed groups and firms that overwhelmingly display features specific to the national economy, which is true for the vast majority of SMEs. For the latter group, the comparison of European accounting regulations, using three distinctive features of national configurations (legal system, capital market structure and taxation), leads to the inferences summarized in table 4. The various cost categories are to be assigned to different cost-bearers: regulation costs relate to national regulators, compliance costs concern firms as generators and application costs pertain to addressees of financial statements. Legitimacy, in this particular case, does not reflect a summation of the cost categories to an overall benefit justifying either a centralized

Table 4 Costs and benefits of decentralized accounting

	Regulation costs	Compliance cost	Application costs	Legitimacy
National regulation	−	−	−	+
Centralized regulation	+	+	+	−

Notes: "+" = comparatively higher, "−" = comparatively lower.

or decentralized accounting approach. Legitimacy rather describes the willingness of the regulated parties to acknowledge the regulating authority. Hence, it has to be seen in its causal relationship with the credibility and confidence constituents ascribed to standard-setters.

In all three fields it is reasonable to assume that regulation costs would significantly increase for some member states, if standards were set centrally. This argument is especially backed in the field of tax accounting and the legal system due to the functional importance of company accounts for these policy fields in some member states. A single set of standards would require new arrangements, which impose costs on national regulators. Such a cost increase can also be expected for compliance costs. This conclusion is supported by the evidence of switching costs that listed groups in continental Europe had to bear, when they started to apply federally set IFRS. Costs further result from the possibility that SMEs in some member states would have to bear additional expenses for preparing separate statements for fiscal and reporting purposes.

Furthermore, SMEs are on average not yet overly Europeanized with regard to their suppliers of funds so that there is no demand for a set of accounts, which is comparable across borders. A single set of standards also raises application costs, when the reports are different from the national ones previously used. Critics question the functional ability of the drafted "IFRS for SMEs" to serve creditors with relevant information and to facilitate the stewardship function that focuses on the management's accountability against the owners (e.g., Baetge 2006). Others see the risk of "financialization" of the firms in question causing a style of management that focuses rather on short-term performance than on corporate responsibilities (P. Berés, chairwoman of the EU parliament's Economic and Monetary Affairs Committee, as in Anonymous 2006).

The overall evaluation of a standardized set of accounting standards for SMEs therefore lets us conclude that a centralized regulation will cause comparatively higher costs for the affected constituencies than a decentralized regulation. According to the approach of subsidiarity, the heterogeneity of preferences over jurisdictions that tie in with company accounts argue for leaving the competence to design accounting and accountability of SMEs at the member state level. It is also reasonable to assume that the different local interest groups of SMEs hold national regulators for more responsive to their local needs. In this case, national regulations may therefore originate higher credibility or rather reliance than decentralized regulations leading to a comparatively higher legitimacy of national regulations.

A different picture emerges for companies relying mainly on the capital markets for their funds (listed companies). In the EU, the capital markets have become increasingly international (see e.g., Frankel 1995). The speed of this process has increased in recent decades, especially due to the effects of information technology. The internationalization of capital markets is well documented (Claessens *et al.* 2003; The United States Mission to the European Union 2004), and regarded as beneficial. Researchers observe, among other effects, decreasing costs of capital (Stulz 1999).

While the literature sometimes lacks a clear differentiation between the internationalization of equity markets and the internationalization of firms, both effects counterbalance the issues arising from institutional differences. Not only is it desirable from the investor's perspective to be able to compare accounting information with low processing costs across different countries; internationalized companies lower the preparation expense, when they no longer need to apply different standards for different markets. In fact, European groups affected by the "IAS Regulation" are often listed on several stock exchanges. For this reason, the argument is supported that compliance costs for (cross-listed) firms and application costs for (international) investors of a centralized approach for group accounting are comparatively lower. The same is true for regulation costs, as group accounts compared to company accounts do not have such significance for the local regulatory system.

Effectively, national regulators are relieved of the challenge to set internationally accepted and comparable standards lowering regulatory costs. The inferences are summarized in table 5. The more homogenous preferences that tie in with reporting of listed firms and realizable economies of scale allow the conclusion that national solutions are not favorable for this particular group of constituents. This is also pointed out in the Lamfalussy report of 2002, in which it is argued that a de-central regulation causes high transaction costs.

Table 5 Costs and Benefits of Centralized Group Accounting for Capital-market Oriented Firms

	Regulation costs	compliance cost	Application costs	Legitimacy
National Regulation	+	+	+	o
Centralized Regulation	–	–	–	o

Notes: "+" = comparatively higher, "–" = comparatively lower, "o" = equal.

Besides having the desired effect of providing comparable information, a federal solution contains another benefit: worldwide, a tendency of regulators to prescribe or at least to allow the application of IFRS is observable. More than 100 countries either permit or require listed companies to apply IFRS, which results in an increasing number of companies applying the same set of accounting standards. Taking this agglomerating effect into account, it seems reasonable to join the system rather in a larger union than individually.

Using the collective bargaining power of the EU, member states can exercise not only more influence in the IASB's standard setting process, but the federal decision for the International Standards also provides an opportunity to select and screen third-party regulation (similarly to the capital requirements standardization in the banking sector; as in Genschel and Plümper 1997). The so-called endorsement process, necessitating deliberations before accepting a standard, demonstrates possibilities of shaping the accounting rules directly. Furthermore, European constituencies are given an opportunity to express their views and concerns by means of lobbying during the endorsement process.

The endorsement process produces technical legitimacy, but as considered here, legitimacy defines also the willingness of the regulated parties to accept the regulating authority. It is reasonable that listed firms put stronger trust in the EU to represent pan-European interests to the IASB due to their bargaining power. This argument is becoming reinforced as the EU currently increases its attempts to gain more influence on the private standard-setter's decision making procedures (e.g., House 2005). By contrast, it is questionable that the endorsement process produces the desired acceptance. Since the same argument as for SMEs is also valid for listed companies, and perhaps in particular because lobbying for specific solutions might be easier on the national level. This bifocal perspective allows the conclusion that legitimacy neither on the national nor on the federal level seems to be comparatively higher or lower.

Summary and Conclusion

In multi-level systems, such as the EU, policy decision on allocating competencies to different levels of government should follow the functional approach of subsidiarity. This applies also for the decision, as to which level should be responsible for setting accounting standards. If preferences for accounting are homogeneous, a decentralized solution incurs higher costs, and brings about opportunity costs by foregoing economies of scale. These costs are justifiable if there are welfare gains arising from competition between jurisdictions or by "regional" peculiarities that lead to benefits for constituents. Both of these assumptions hold partly in the European context. The analysis has shown that a differentiation between SMEs and large(r) listed companies is helpful due to the divergent demands for accounting across the EU.

Preferences attached to accounting procedures as well as institutional settings vary widely and not only between outsider and insider economies. The differences in raising funds constitute an important difference, followed by regional distinctions of the tax system and other elements of the legal system such as bankruptcy law or dividend distribution. These evident varieties are reflected by the existing models of accounting and accountability.

For the majority of firms in Europe (SMEs), a centralized standard-setting would incur comparatively higher costs than national solutions. Depending on the accountability approach, either insider economies will disclose more information than needed or outsider economies will disclose too little information, or both, since a compromise would produce a non-optimal level of disclosure. National tax systems might also be affected, as in some member states company accounts are partially the basis for company taxation. In some countries centrally set standards would have disruptive effects on the problem solving capacities of accounting arising from the material embeddedness of financial accounts in the legal system. National regulators would have to restructure the legal system, e.g., the dividend distribution or insolvency determination. Besides, procedural problems would arise in the way, in which accounting is governed. While continental European economies rely usually on legislative actions, the Anglo-Saxon model implies professional bodies to draft accounting standards, resulting in a more dynamic process.

The above argument does not apply to large, capital-market oriented firms, even in insider economies. They are structurally similar to firms in outsider economies so that increasingly homogeneous preferences exist in the integrated European markets (e.g., Grahl 2006). A pan-European or internationally accepted level of standards is therefore advisable for capital-market oriented firms. Hence, a federal solution is favorable for them and their constituents as it serves their requirement for accounting best. Moreover, economies of scale are realizable due to joint standard-setting. Thus, national jurisdictions have allowed listed companies to prepare their accounts using internationally accepted standards. Holding on to local rules would have increased the cost of capital and would have devalued firms, the capital market would have functioned more poorly, and the amount of capital raised would have been less than optimal.

However, the current evaluation may have to be reassessed in the future as national peculiarities, which are the various cost drivers, might diminish. If, for instance, SMEs increasingly mimic the financing behavior of listed firms, the preference for accounting will change subsequently. The needs of outside investors and rating agencies will come to the fore, making a central European solution (e.g., a mandatory application of the evolving "IFRS for SMEs") a favorable option in the future.

Our conclusions extend to other policy areas. Corporate law is a good example. The EU legislator has attempted to harmonize corporate laws, but despite all efforts made by the EU national laws still differ significantly. Some convergence was achieved for the corporate law of listed companies; for most other firms national solutions prevail. The European Court of Justice recently paved the way for regulatory competition, which might lead to market-driven changes and a harmonization process of corporate laws comparable to the United States. Regulatory competition among national accounting regulations may also be an opportunity for SME accounting instead of enforcing harmonization by directives or regulations on the central level of government.

Notes

1. The terms financial accounting, accounting and financial reporting are used interchangeably in this article.
2. In Article A of the Maastricht Treaty the principle of subsidiarity is defined slightly different and appears somewhat wider "This Treaty marks a new stage in the process of creating an ever closer union among the peoples of Europe, in which decisions are taken as closely as possible to the citizen" (Schilling 1995, 2). But in the present context, the definition in Article G of the Maastricht Treaty seems to be more precise as the relationship between the EU and the contracting nation states is explicitly highlighted.
3. Other legal instruments are decisions, recommendations and opinions (Wessels 2008, 654). Decisions develop a binding force in its entirety upon those to whom they are addressed. In contrast to regulations, decisions have an individual scope as they are always addressed to specific persons. Recommendations and opinions are without obligation and therefore, they do not unfold any legal impact on specific persons or member states.
4. Although discussed in empirical studies (e.g., Ashiq and Hwang 2000; Jaggi and Low 2000), we intentionally omit cultural factors because of the difficulty of tracing cultural influences on accountancy precisely and describing the cultural variance quantitatively. Many path-dependent institutional arrangements such as traditional scarcity of equity capital in German SMEs are not dependent on culture, but a result of incentive structures (stemming from factors such as taxation and the microstructure of the capital markets). Inflation is not considered because price levels have become rather stable throughout the EU, mainly with the introduction of a common currency via the Economic and Monetary Union in 1999.
5. Formerly International Accounting Standards (IAS).
6. Unlike listed companies, a qualitative characteristic of SMEs is that ownership and control mostly do not diverge (Schorr and Walter 2006, 16). SMEs either have one proprietor, who manages the firm at the same time, or consist of a small group of

persons, who tend to have a close relationship to each other and to the management. The informational role of financial accounts is therefore supposed to be of minor importance for such equity financiers compared to hybrid instrument investor's.

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