

# *Sources of authority: the rise of international standards*

## OVERVIEW

Given the globalisation of capital markets and the intention of the European Union (EU) to create an integrated capital market, international developments in accounting have assumed a much greater importance than they did in the past. In this chapter, we examine the contribution of the International Accounting Standards Committee (IASC) and its successor from April 2001, the International Accounting Standards Board (IASB), as well as that of the EU.

We look at the way in which international standards have been set as well as some of the difficulties the IASC faced in both introducing and enforcing them. We outline the agreement between the IASC and the International Organisation of Securities Commissions (IOSCO) under which the IASC worked extremely hard to prepare a set of core standards but which IOSCO failed to endorse wholly for cross-border listing purposes.

We then examine the EU Accounting Directives, that is the Fourth Directive on company accounts and the Seventh Directive on consolidated accounts, and explain why they have achieved much less harmonisation than had initially been hoped. We then go on to explain the change in policy of the EU under which it has rejected the use of new Directives and supported International Accounting Standards, which will, in future, be issued as International Financial Reporting Standards.

We explain the EU Regulation of June 2002, which requires all publicly traded companies incorporated in the EU to prepare their consolidated financial statements using International Accounting Standards/International Financial Reporting Standards by the year 2005. This gives an enormous boost to those standards but the timescale is extremely tight and, as we explain, there are many problems to be faced.

## International standardisation

### Introduction

It seems reasonable to suggest that, if standards have merit within the boundaries of one country, there would be merit if they were applied more generally.

In a period in which investors based in one country choose between investments in many countries, a lack of comparability between financial statements drawn up in different countries may well lead to incorrect decision taking and thereby to an inefficient allocation of scarce resources. As individual countries have pursued a policy of standardisation, so too a number of bodies have become concerned with international standardisation. Both the United Nations (UN) and the Organisation for Economic Co-operation and Development (OECD) have been concerned with the regulation of accounting and, as might be expected, these bodies have been primarily concerned with the regulation of disclosure by multina-

tional companies. In the more recent past, we have seen the formation and subsequent disbandment of the 'G4+1' which was an international group of standard setters that consisted of the standard setters from Australia, Canada, New Zealand, the UK and the USA, together with representatives of the IASC. This group attempted to formulate a common, Anglo-Saxon approach to financial reporting issues and published Position Papers intended to influence the work of the standard setters in their respective countries.<sup>1</sup> The group disbanded in January 2001 in anticipation of the formation of the new IASB in April 2001.

For the remainder of this chapter, we shall concern ourselves with the two most important attempts at international standardisation relevant in the UK. We shall look first at the approach of the IASC and its successor, the IASB, and then at the approach of the EU. In the final section, we will examine the enormous boost given to International Accounting Standards by the EU Regulation, issued in 2002, which requires all publicly traded companies in Member States to prepare their consolidated financial statements in accordance with International Accounting Standards by the year 2005. We also examine some of the potential problems to which this Regulation gives rise.

## The International Accounting Standards Committee

Although the possibility of international standards had been debated during the first half of the twentieth century, the most successful programme began with the formation of the IASC in 1973. The founder members were drawn from professional accountancy bodies in the following countries: Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the UK, the Republic of Ireland and the USA. By the time it was replaced by the IASB in 2001, the membership of the IASC consisted of 153 professional accountancy bodies from 112 countries.

The objectives of the IASC as stated in the original 1973 agreement were:<sup>2</sup>

to formulate and publish in the public interest basic standards to be observed in the presentation of audited accounts and financial statements and to promote their worldwide acceptance and observance.

Under a revised agreement in November 1982, the reference to basic standards was removed and the revised objectives became:<sup>3</sup>

- (a) to formulate and publish in the public interest accounting standards to be observed in the presentation of financial statements and to promote their worldwide acceptance and observance, and
- (b) to work generally for the improvement and harmonisation of regulations, accounting standards and procedures relating to the presentation of financial statements.

In order to achieve these objectives, members joining the IASC entered into the following undertaking:

to support the work of IASC by publishing in their respective countries every International Accounting Standard approved for issue by the Board of IASC and by using their best endeavours:

<sup>1</sup> See, for example, the G4+1 Position Papers, 'Recommendations for achieving convergence on the methods of accounting for business combinations', subsequently published by the ASB as a Discussion Paper in December 1998, 'Reporting Financial Performance: proposals for change', subsequently published by the ASB as a Discussion Paper in June 1999, and 'Share-based payment', subsequently published by the ASB as a Discussion Paper in July 2000

<sup>2</sup> IASC Constitution, London, 1973.

<sup>3</sup> See *Preface to Statements of International Accounting Standards*, IASC, London, January 1983, para. 2.

- (i) to ensure that published financial statements comply with International Accounting Standards in all material respects and disclose the fact of such compliance;
- (ii) to persuade governments and standard-setting bodies that published financial statements should comply with International Accounting Standards in all material respects;
- (iii) to persuade authorities controlling securities markets and the industrial and business community that published financial statements should comply with International Accounting Standards in all material respects and disclose the fact of such compliance;
- (iv) to ensure that the auditors satisfy themselves that the financial statements comply with International Accounting Standards in all material respects;
- (v) to foster acceptance and observance of International Accounting Standards internationally.<sup>4</sup>

The undertaking emphasises the fact that the IASC had no direct power to implement or enforce its standards. Rather it had to rely on its members to persuade the relevant institutions in their particular countries to adopt and enforce the standards. This was no easy task given the very different ways in which countries regulate accounting; in some countries it involves persuading the relevant standard-setting bodies to comply while, in other countries, it involves the much more difficult task of persuading the government that changes to the law are necessary.

Even before the IASC had been established, Irving Fantl identified three major barriers to international standardisation:<sup>5</sup>

- (a) differences in background and traditions of countries;
- (b) differences in the needs of various economic environments;
- (c) the challenge to the sovereignty of states in making and enforcing standards.

These were enormous problems for the IASC, although it took considerable steps to try to overcome the barriers. Thus, it worked closely with the major national standard-setting bodies to ensure that it was involved before a country's position became entrenched. In addition, like the ASB, it consulted widely and formed a consultative committee drawn from a number of international bodies including the International Association of Financial Executives Institutes, the International Confederation of Free Trade Unions and the World Bank.

What then did the IASC achieve in the 28 years of its existence?

By 1990 the IASC had issued 31 International Accounting Standards and these provided a set of inexpensive ready-made standards that could be adopted by those countries which had not developed their own mechanism for standard setting. While many of the International Accounting Standards covered topics on which a UK standard had already been set, this was not always the case. For example, IAS 14 *Reporting Financial Information by Segments* (1981) was published many years before the issue of SSAP 25 *Segmental Reporting* (1990); and IAS 18 *Revenue Recognition* (1982) dealt with a subject on which neither the ASC nor the ASB has yet issued a standard.<sup>6</sup>

As might have been expected, the activities of the IASC attracted considerable criticism and, during the 1980s, it was accused of Anglo-Saxon domination and of issuing standards which were too flexible. It took action on both counts.

The Committee appointed a number of non-Anglo-Saxon Chairmen, including Georges Barthès from France (1987–9), Eiichi Shiratori from Japan (1993–5) and Stig Enevoldsen from Denmark (1998–2000).

By the close of the 1980s, the IASC recognised that it had reached a new phase in its work and its emphasis changed from the production of new standards to the tightening of its

<sup>4</sup> *Ibid.*, para. 4.

<sup>5</sup> I.L. Fantl, 'The case against international uniformity', *Management Accounting*, May 1971.

<sup>6</sup> The ASB subsequently issued a Discussion Paper *Revenue Recognition* in July 2001.

existing standards. Even now, however, many international standards specify not just one *benchmark* treatment but also an, often very different, *allowed alternative* treatment.

The work of the IASC assumed a much higher profile from 1995, when it entered into an agreement with the IOSCO to develop a set of 'core standards for cross-border capital raising and listing purposes'.<sup>7</sup> The intention was that once International Accounting Standards had been endorsed by IOSCO and accepted by the national securities regulators, this would permit quoted companies to produce their financial statements using International Accounting Standards rather than having to prepare a set of financial statements drawn up in accordance with the GAAP of the country in which the stock exchange is situated or to provide a reconciliation with the local rules of that country.

After a period of frenetic effort, the IASC concluded the development of this set of core standards with its approval of IAS 39 *Financial Instruments: Recognition and Measurement* in December 1998. In spite of this effort by the IASC, it took some considerable time for IOSCO to endorse these core standards. The main reason for the delay was opposition from the powerful US Securities and Exchange Commission (SEC) for, if the IASC set of core standards were to be accepted, this would mean that foreign companies quoted in the USA would be able to prepare their financial statements in accordance with international standards rather than in accordance with what the SEC sees as being the much more rigorous and voluminous rules of the SEC and the (American) Financial Accounting Standards Board (FASB). Such an approach would be unlikely to find favour with US corporations still subject to US GAAP and might have serious implications for the subsequent development of that US GAAP itself. It is pertinent to suggest that the US perceptions have probably been changed somewhat by the Enron and other crises of 2001 and 2002, which have cast serious doubt on the alleged superiority of the US accounting standards!

When the IOSCO endorsement did come in May 2000,<sup>8</sup> it came in the form of a recommendation to members of IOSCO to accept financial statements prepared in accordance with thirty core International Accounting Standards. However, the sting in the tail was that it also permitted members, if they so wished, to require reconciliation to the local GAAP or to require supplementary disclosure. This permitted countries like the USA and Canada to continue requiring a reconciliation, which imposes enormous costs on the companies concerned. Not surprisingly, such a limited endorsement came as a disappointment to the members of the IASC and to others who had worked so hard to achieve international harmonisation.

## The International Accounting Standards Board

The completion of the core international accounting standards provided a suitable opportunity to address the rather anachronistic structure of the IASC and, in 2001, a new IASC Foundation was formed as a not-for-profit corporation. This is the parent company of the new IASB, which assumed responsibility for setting International Accounting Standards from 1 April 2001.

The IASB consists of 14 members, 12 full-time and 2 part-time, and its first Chairman is Sir David Tweedie, the distinguished first Chairman of the UK Accounting Standard Board for its first ten years of operation.

<sup>7</sup> Joint press release, IASC Board and IOSCO Technical Committee, Paris, 9 July 1995.

<sup>8</sup> 'IASB Standards – Assessment Report', Report of the Technical Committee of the International Organisation of Securities Commissions, IOSCO, Montreal, May 2000. See the IOSCO website at [www.iosco.org](http://www.iosco.org).

The constitution of the new IASB provides the following objectives:

- To develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world's capital markets make economic decisions.
- To promote the use and rigorous application of those standards.
- To bring about convergence of national accounting standards and International Accounting Standards to high quality solutions.

The focus of the IASB is now clearly on the global players and it is quite clear that, in order to achieve its objectives, the IASB must work very closely with national standard setters. To this end, seven of the IASB members have been appointed as liaison members with their respective national standards setters.<sup>9</sup>

At its first meeting in April 2001, the IASB adopted all the existing International Accounting Standards but decided that future standards that it issues will be described as International Financial Reporting Standards (IFRS). A list of International Accounting Standards extant at 1 January 2003 is provided in Table 3.1.

The IASB is supported by a large Standards Advisory Council, available for consultation and advice, as well as an International Financial Reporting Interpretations Committee,<sup>10</sup> concerned with the publication of interpretations of International Accounting Standards and International Financial Reporting Standards.

## Harmonisation in the European Union

### The use of Directives

When the European Economic Community (EEC) was established by the Treaty of Rome on 25 March 1957 one of the objectives to be achieved by member states was 'the approximation of their respective national laws to the extent required for the common market to function in an orderly manner'.<sup>11</sup> To achieve this objective a number of programmes of law harmonisation have been undertaken. One of these is the company law harmonisation programme under the provisions of Article 54(3)(g) which calls for 'the co-ordination of the safeguards required from companies in the Member States, to protect the interests both of members and of third parties'.

When the EU Commission has obtained agreement on a set of proposals on a particular topic, it places a Draft Directive before the Council of Ministers. If the Directive is adopted, governments of member states then have a specified period to enact legislation and incorporate the provisions of the Directive into their national law.

In practice, many countries were unable to keep to the timetables imposed by the early Directives and, for the Seventh Directive, the time limits set were much longer than for previous Directives. This was, however, to a large extent necessary to accommodate fundamental changes that have been required in some member states.

<sup>9</sup> Countries which have this liaison arrangement are (1) Australia and New Zealand, (2) Canada, (3) France, (4) Germany, (5) Japan, (6) the USA and (7) the UK.

<sup>10</sup> This IFRIC replaces the Standing Interpretations Committee formed in 1997 under the previous structure.

<sup>11</sup> Treaty of Rome, Article 3(h).

**Table 3.1 International Accounting Standards at 1 January 2003**

	<i>Most recent version</i>
IAS 1 Presentation of Financial Statements	1997*
IAS 2 Inventories	1993*
IAS 7 Cash Flow Statements	1992
IAS 8 Net Profit or Loss for Period, Fundamental Errors and Changes in Accounting Policies	1993*
IAS 10 Contingencies and Events Occurring After the Balance Sheet Date	1999*
IAS 11 Construction Contracts	1993
IAS 12 Income Taxes	2000
IAS 14 Segment Reporting	1997
IAS 15 Information Reflecting the Effects of Changing Prices	1994
IAS 16 Property, Plant and Equipment	1998*
IAS 17 Leases	1997*
IAS 18 Revenue	1993
IAS 19 Employee Benefits	2000
IAS 20 Accounting for Government Grants and Disclosure of Government Assistance	1994
IAS 21 The Effects of Changes in Foreign Exchange Rates	1993*
IAS 22 Business Combinations	1998*
IAS 23 Borrowing Costs	1993
IAS 24 Related Party Disclosures	1994*
IAS 26 Accounting and Reporting by Retirement Benefit Plans	1994
IAS 27 Consolidated Financial Statements and Accounting for Investments in Subsidiaries	2000*
IAS 28 Accounting for Investments in Associates	2000*
IAS 29 Financial Reporting in Hyperinflationary Economies	1994
IAS 30 Disclosures in the Financial Statements of Banks and Similar Financial Institutions	1994
IAS 31 Financial Reporting of Interests in Joint Ventures	2000
IAS 32 Financial Instruments: Disclosure and Presentation	1998*
IAS 33 Earnings per Share	1997*
IAS 34 Interim Financial Reporting	1998
IAS 35 Discontinuing Operations	1998
IAS 36 Impairment of Assets	1998
IAS 37 Provisions, Contingent Liabilities and Contingent Assets	1998
IAS 38 Intangible Assets	1998
IAS 39 Financial Instruments: Recognition and Measurement	2000*
IAS 40 Investment property	2000*
IAS 41 Agriculture	2001

Notes: (1) IASs 3, 4, 5, 6, 9, 13 and 25 have been superseded.

(2) As we shall see later, Standards marked with an asterisk are being revised in 2002–2003.

While a number of Directives have been adopted, the two of most concern to accountants are the Fourth Directive on company accounts and the Seventh Directive on consolidated accounts.<sup>12</sup> The former was adopted on 25 July 1978 and implemented in the UK by the Companies Act 1981. The latter was adopted on 13 June 1983 and implemented by the Companies Act 1989. In this section of the chapter we look briefly at these two Directives.

## The Fourth Directive

The original draft of the Fourth Directive was published in November 1971, some time before the UK became a member of the EEC. Not surprisingly, the draft was heavily influenced by the current law and practice in France and Germany. When the UK joined the EEC in March 1973, it pressed for certain changes to the draft and, as a result, an amended draft was issued in February 1974. Although not all of the changes suggested by the UK were accepted, the requirement to give a ‘true and fair view’ was admitted as an overriding objective of accounts and the Directive was eventually adopted by the Council of Ministers on 27 July 1978.

As we have explained in the previous chapter, the major changes prescribed by the Fourth Directive were as follows:

- (a) limited companies have to adopt compulsory formats for both the balance sheet and the profit and loss account;
- (b) defined methods of valuing assets, the so-called ‘valuation rules’, must be followed.

In addition, the Directive provided definitions of small and medium-sized companies and permitted member states to offer such companies exemptions from complying with certain requirements of the Directive.<sup>13</sup>

We have already seen how the provisions of the Fourth Directive have been implemented in the UK, but it is worth spending a little time looking at the impact of the Fourth Directive in the EU as a whole.

Given the very different accounting systems which exist in member countries, it is perhaps not surprising that it took some ten years for the Fourth Directive to be adopted. Although this Directive undoubtedly moved the accounting requirements of the various countries closer together, there are two major factors which have limited its effectiveness in achieving harmonisation.

First, as we have seen, the Directive contains an overriding requirement that accounts must give a ‘true and fair view’. As we have explained in Chapter 2, although it is difficult to define such a term, accountants in the UK have long experience of working with it and are familiar with what it means. In many EU countries the term was unknown and, although it has been translated and included in their respective national legislation, it is certainly not interpreted or applied in the same way in all of those countries as it is in the UK.

Second, in order to be able to obtain agreement, it was necessary to include a large number of options in the Fourth Directive and there are over 60 points on which countries were able to exercise a choice.<sup>14</sup> Member states had to decide whether or not to incorporate

<sup>12</sup> These directives may be found in the *Official Journal of the European Communities*. The text of the Fourth Directive is in Volume 21, L222, 14 August 1978, while the text of the Seventh Directive is in Volume L193/1, 18 July 1983. They may also be found on the Europa-Internal Market-Accounting website at [www.europa.eu.int/comm/internal\\_market/en/company/account/news/index.htm](http://www.europa.eu.int/comm/internal_market/en/company/account/news/index.htm)

<sup>13</sup> Fourth Directive, Articles 11, 27 and 47.

<sup>14</sup> T.R. Watts (ed.), *Handbook on the EEC Fourth Directive*, ICAEW, London, 1979, p. 1.



the particular options in their national legislation and could, in fact, even permit individual companies a choice from alternative treatments under the national legislation.

One example is the possible exemptions for small and medium-sized companies. Some countries, such as the UK, gave most of these, while other countries did not. As a result, the information provided by small companies in different countries is not comparable.

A second example is that countries could adopt historical cost valuation rules or either permit or require the application of alternative accounting rules. The UK, through the provisions of the Companies Acts, permits the use of such alternative accounting rules, while other countries do not. Given the requirement for the provision of information that would enable the reconstruction of historical cost accounts when alternative accounting rules are used, this means that many international comparisons are possible only on the basis of the historical cost figures.

A third example is provided by the possible choice of formats. The Directive provided two balance-sheet formats and four profit-and-loss-account formats. Although part of the choice was merely between a horizontal and a vertical format, there are differences between the information disclosed in the two pairs of profit-and-loss-account formats. Member states could either impose one balance-sheet format and one profit-and-loss-account format on all companies or they could specify all formats and permit companies to choose between them. The UK Companies Acts have given the widest possible choice with the result that, even in the UK, different companies disclose somewhat different information. Other countries have been more rigid and, hence, there is a lack of comparability.

Even if all countries were to adopt the same formats, the inability to define terms with precision means that there is a superficial comparability only. For example, the profit-and-loss-account format of Article 25 requires the disclosure of, *inter alia*, cost of sales, distribution costs and administrative expenses. Even if we ignore the flexibility of the underlying valuation rules, it is highly likely that different companies will analyse similar expenses between these three categories in different ways and, hence, although the same descriptions are used, the figures may not be comparable.

The above examples are not given to belittle the efforts that have been made to try and achieve harmonisation in the EU but rather to ensure that readers do not overestimate their impact.

## The Seventh Directive

Although a proposed Seventh Directive was first issued in May 1976 and an amended proposal was issued in December 1978, it was not until June 1983 that the Seventh Directive was actually adopted.<sup>15</sup> As with the Fourth Directive it was a long and difficult task to reach agreement on when consolidated accounts should be prepared and what they should contain. This should not surprise us when it is realised that some EU countries had no legal requirement for consolidated accounts at all.<sup>16</sup> One of the major difficulties was defining the circumstances in which consolidated accounts should be required and a large part of the Directive was devoted to this problem.<sup>17</sup>

In the UK the basic legal position was that group accounts were required when one company owned more than half of the equity share capital in another company or had the legal power of control over that other company, irrespective of whether the investing company

<sup>15</sup> *Official Journal of the European Communities*, Volume L193/1, 18 July 1983.

<sup>16</sup> Examples were Greece and Luxembourg.

<sup>17</sup> Seventh Directive, s. 1, 'Conditions for the preparation of consolidated accounts' (Articles 1–15).



actually exercised that power. The proposed Directive was initially concerned to ensure that information was provided about concentrations of economic power and, as a consequence, consolidated accounts were required when companies were managed in practice by a 'central and unified management'. Ownership was only important to the extent that it led to a presumption that such central management might exist.

A criterion based on the existence of an economic unit is much more difficult to apply than one based on the legal power of control, and accountants in the UK were relieved to find that the Directive came down in favour of a definition based on the existence of this legal power of control.<sup>18</sup>

Some other problems which had to be resolved in this connection were whether or not consolidated accounts should be required when an individual or partnership controls companies; whether consolidated accounts should be required for subgroup holding companies where the ultimate parent company is in another EU country or non-EU country; and whether horizontal consolidations should be required for companies in the EU where, for example, two French companies are both under the control of a US company. We will examine accounting for groups of companies in Chapter 14.

The second part of the Directive is concerned with the preparation of consolidated accounts. As is the case for the accounts of individual companies, there is an overriding requirement that consolidated accounts give a 'true and fair view' as well as the requirement that they give the information specified by the Directive using the valuation rules and formats specified in the Fourth Directive as far as appropriate.

There is no doubt that the Seventh Directive has had a much greater impact on accounting in other EU countries than it has had in the UK, where many of its provisions were already established by existing law and accounting standards. However, this is not to say that it has had no impact at all in the UK. As in the case of the Fourth Directive, rules previously set by accounting standards are now a part of the law and the introduction of new definitions has widened the coverage of consolidated accounts to include certain off-balance-sheet finance schemes as well as certain partnerships and joint ventures. We deal with these topics in Chapters 9 and 15.

As in the case of the Fourth Directive, member states were given a large number of options in the Seventh Directive. The different ways in which they have exercised these options has inevitably limited the degree of harmonisation achieved.

## The EU Regulation of 2002 and the problems that it poses

### The EU Regulation of 2002

It is now recognised that, in spite of all the efforts which led to their development, the Accounting Directives have achieved much less harmonisation in the EU than was originally anticipated. Perhaps not surprisingly, they have been found to be an inflexible source of rules, difficult to change in a business world which is constantly changing.

The European Commission has explored the way forward on accounting harmonisation in the EU.<sup>19</sup> It has rejected both the use of new Directives and the establishment of a

<sup>18</sup> Seventh Directive, s. 1. As we shall see in Chapter 14 it is still possible for member states to require consolidated accounts where there is unified management but no legal power of control (Article 1, Para. 2).

<sup>19</sup> See, for example, *Accounting Harmonisation: A new strategy vis-à-vis international harmonisation*, Communication from the Commission, COM 95 (508), November, 1995, *EU Financial Reporting Strategy: the way forward*, Com. (2000) 359, June 2000 and *Proposal for a regulation of the Parliament and of the Council on the application of International Accounting Standards*, COM (2001) 80, February 2001.

European standard-setting body. Instead it has opted to support the work of the IASB, accepting that there will be a consequent need to amend the existing Accounting Directives where necessary to enable companies to comply with International Accounting Standards (IASs) and International Financial Reporting Standards (IFRSs).

The way that it has done this is by the issue of a Regulation in June 2002.<sup>20</sup> Unlike a Directive, which requires legislation by member states, a Regulation takes effect throughout the EU without the need for member states to incorporate its provisions in their own national law.

This rather short Regulation will have enormous impact upon accounting in the EU. It requires that, with minor exceptions, all publicly traded companies governed by the law of a member state of the EU must prepare consolidated financial statements in accordance with IASs and IFRSs and related Interpretations for all accounting periods starting on or after 1 January 2005. Although the Regulation only requires that **consolidated** financial statements comply with international standards, it also gives member states the option of permitting or requiring the use of international standards in the single entity financial statements of the publicly traded parent company. It also gives member states the option of permitting or requiring the use of international standards in the single entity financial statements and/or the consolidated financial statements of European companies that are not publicly traded. It remains to be seen how member states will use these options although, as we discuss below, the way in which they do so may give rise to considerable difficulties in practice.

In order to permit consolidated financial statements to comply with both international standards and the Directives, it has already been necessary to amend the valuation rules included in the Fourth and Seventh Directives. This was done by means of a Directive in May 2001<sup>21</sup> and this opens the way for companies in EU countries to use fair values for certain financial instruments in accordance with the requirements of IAS 39, *Financial Instruments: Recognition and Measurement* (revised 2000 and under revision again in 2002). Unlike the use of a Regulation, the use of a Directive does, of course, require legislation by the individual member states and the deadline imposed for implementation of this Directive is 1 January 2004. It is clear that further amendments to the Directives will be necessary to permit international standards to be applied.

The Regulation is very clear that international standards are to be imposed on publicly traded companies by 2005. It is estimated that some seven thousand companies in the EU fall within this category and, of these, less than three hundred have used international standards in the past. A large number of companies will therefore be applying international accounting standards for the first time and to help them, as well as companies elsewhere in the world, the IASB issued an exposure draft (ED 1) of an IFRS entitled *First Time Application of International Financial Reporting Standards* in July 2002. The UK ASB issued a Consultation Paper, which reproduced the IASB ED 1, at the same time.<sup>22</sup>

ED 1 would require that, when companies first adopt international standards by making an explicit and unreserved statement of compliance, those statements should comply with the international standards and interpretations effective at the reporting date. However it does provide some exemptions, in particular where the cost of obtaining the relevant information would be out of proportion to its benefits.<sup>23</sup>

<sup>20</sup> Regulation PE-CONS 3626/02, EU, June 2002.

<sup>21</sup> EU Directive PE-CONS 3624/01. See the Europa website given in n.12 above.

<sup>22</sup> Consultation Paper, *IASB proposals for first-time application of International Financial Reporting Standards*, ASB, July 2002.

<sup>23</sup> For details of these exemptions, interested readers are referred to the Exposure Draft or, in due course, to the IFRS based on ED 1.

The timescale allowed for so many companies to make this major change is extremely short and the requirement to use international standards gives rise to a considerable number of potential problems with which we will deal under five headings in the following section.

## **The EU Regulation – some problems**

### **Lack of understanding**

While there is a considerable similarity of approach between UK standards and international standards, there is a much greater difference between the rules of some other member states and those international standards. It will be necessary for directors and accountants in all EU countries to understand these international standards and how to apply them well before 2005 because of the need to provide comparative figures. These directors and accountants will usually have been raised on a very different set of rules and may therefore find it difficult to understand and assimilate international accounting standards.

There is a considerable amount of evidence that, although companies state that their financial statements comply with international accounting standards and have been given a clean audit report, the financial statements do not, in fact, do so. One example of such evidence is a piece of research published in July 2001 by the UK Association of Chartered Certified Accountants<sup>24</sup> which concludes that compliance is more problematic for companies domiciled in some Western European countries, notably France and Germany. It appears that even the members of large international accountancy firms in some countries do not really understand how international standards should be applied. If this is the case, then clearly a large education programme is needed before 2005 to familiarise accountants throughout the EU with the requirements of IASs and IFRSs.

### **Considerable differences and the need for convergence**

There are considerable differences between the national accounting rules of individual countries in Europe and the international standards and this must be bridged if there is to be European standardisation. The new term used is ‘convergence’ and, as a first step towards this end, several countries have conducted studies of the differences between their own rules and the international standards. For example, the UK ICAEW published a study in 2000 entitled *The Convergence Handbook* prepared by David Cairns and Christopher Nobes.<sup>25</sup> Even though the UK standards are relatively close to the international accounting standards, Cairns and Nobes identify an enormous number of differences between them and make suggestions for resolving those differences. However, sometimes they favour the UK approach and, at other times, they favour the international approach. Other countries that are studying the difference between their national rules and the international standards are not necessarily coming to the same conclusions on the appropriate way forward.

The IASB is working hard with national standard setters to resolve differences and has embarked on an improvements project to revise international standards to bring them into

<sup>24</sup> Donna Street and Sidney Gray, *Observance of International Accounting Standards: Factors explaining non-compliance*, ACCA Research Report No. 74, July 2001.

<sup>25</sup> David Cairns and Christopher Nobes, *The Convergence Handbook: A comparison between International Accounting Standards and UK financial reporting requirements*, ICAEW, 2000. An update to this has subsequently been published: David Cairns, *The Implications of IAS for UK Companies: An Update to the Convergence Handbook*, ICAEW, 2002.

line with current best practice and to remove options. To this end, it issued an exposure draft of proposed 'Improvements to International Accounting Standards' in May 2002, which proposed changes to the twelve IASs listed in Table 3.2.

**Table 3.2 IASs to be revised in 2003 under the IASB Improvements project**

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IAS 1	Presentation of Financial Statements*
IAS 2	Inventories+
IAS 8	Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies*
IAS 10	Events after the Balance Sheet Date+
IAS 16	Property, Plant and Equipment+
IAS 17	Leases*
IAS 21	The Effects of Changes in Foreign Exchange Rates+
IAS 24	Related Party Disclosures+
IAS 27	Consolidated Financial Statements and Accounting for Investments in Subsidiaries*
IAS 28	Accounting for Investments in Associates*
IAS 33	Earnings Per Share+
IAS 40	Investment Property*

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+ Separate FREDs on these topics were issued by the UK ASB in May 2002. See FREDs 24 to 29.

\* A Consultation Paper on these six topics, entitled 'IASB Proposals to Amend Certain International Accounting Standards' was also issued by the UK ASB in May 2002.

These twelve IASs are not the only ones scheduled for improvement for there are major revisions in train for IAS 22 *Business combinations*, IAS 32 *Financial instruments: Disclosure and presentation* and IAS 39 *Financial instruments: Recognition and measurement*.

At the same time that the IASB issued its proposed improvements in May 2002, the UK ASB issued seven Financial Reporting Exposure Drafts (FREDs) designed to move us towards convergence on the six topics marked + in Table 3.2, the seventh draft being concerned with 'Financial Instruments: Hedge Accounting'. At the same time it published a Consultation Paper, 'IASB proposals to amend certain international accounting standards', outlining its plan to implement changes in respect of the other six topics in Table 3.2, each marked with an asterisk, in 2005 but not before. Even after these changes, there will remain major differences between UK standards and international standards, which we will discuss in the context of the relevant chapters.

There is no doubt that the period until 2005 is likely to be extremely confusing for accountants, both in the EU and elsewhere, as they try to understand IASs which are constantly changing. Even keeping up with national standards will be difficult as individual countries attempt to change their own rules to bring them into line with the constantly changing international accounting standards. At the present time, attempts to achieve convergence involve shooting at a moving target!

## Differential enforcement

If international standards are to be effective throughout the EU then it is essential that there is some enforcement mechanism to ensure that they are properly applied. Clearly the IASB does not have this mechanism at the present time but must rely on auditors of publicly traded groups throughout the EU. As we have explained in the previous chapter, the

standards structure in the UK does have the Financial Reporting Review Panel to enforce UK standards and this panel could no doubt turn its efforts to the enforcement of international, rather than UK, standards. However, other EU countries do not have such a mechanism and hence we may arrive at a situation where international standards are enforced much more rigorously in some countries than in other EU countries. This can only diminish the effectiveness of a European capital market.

### **The endorsement mechanism**

In order to ensure political acceptance of IASs in the EU, the Regulation requires that they be endorsed by an Accounting Regulatory Committee. This committee, composed of representatives of member states, is supported by a technical committee, the European Financial Reporting Advisory Group (EFRAG). EFRAG reviewed all IASs (1–41) and Standing Interpretations (1–33), that were extant in 2002, and recommended endorsement en bloc. However, even if this recommendation is accepted by the Accounting Regulatory Committee on this occasion, there are many who have concerns about this endorsement mechanism. The question they would pose is what happens if the Accounting Regulatory Committee fails to endorse an IAS or proposes changes to such a standard for use in the EU? If this were to happen then it could lead to one set of IASs for the EU and a slightly different set for the rest of the world, hardly ideal for a global capital market!

### **One or two sets of standards in each member state**

As we have seen above, publicly traded companies are required to use IASs in their consolidated financial statements but, until relevant rules are introduced in member states, we do not know whether such companies will have to use national standards or international standards in their single entity financial statements. Nor do we know what the position will be with regard to companies that are not publicly traded. Whatever the outcome, there will be problems to be addressed.

If member states were to require non-publicly traded companies to use national standards, then countries would be faced with the cost and confusion of having two sets of standards applying to their companies. There is even the possibility, in the short term, that the non-publicly traded company would have to comply with certain national standards which are more stringent than the corresponding international standard. This would seem to be quite bizarre.

If member states were to require all companies to use IASs, then national standards will become redundant and, so too, may national standards setters. Why would it be necessary to finance a body of national standard setters if standards are being set by the IASB?

### **Conclusion**

While the requirement of the EU 2002 Regulation is extremely clear, that Regulation gives rise to enormous problems. Implementation is likely to be difficult, painful and costly, especially within the very tight timetable that has been laid down and, in the view of the authors, it will be many years after 2005 before there is real standardisation within the EU.

## Summary

Given the globalisation of capital markets and the desire of the EU to establish an integrated capital market, international and regional standardisation is now of fundamental importance to the development of accounting, both worldwide and in the EU. We have therefore examined the structure and work of the IASC and, in particular, its agreement with IOSCO to prepare a set of core international standards and the disappointing IOSCO recommendations to its members. Next we considered the structure and objectives of the IASB, which opened its doors to business in April 2001.

We then considered the attempts of the EU to harmonise accounting practice in Europe by the use of the Fourth and Seventh Directives and explained why such Directives have not been as successful as was once hoped and why the EU has gradually changed its approach to standardisation in Europe.

In 2002, the EU adopted a Regulation requiring all publicly traded companies in the EU to prepare their consolidated financial statements using International Accounting Standards (IASs) and International Financial Reporting Standards (IFRSs) for accounting periods beginning on or after 1 January 2005. This very clear focus on publicly traded companies seems eminently sensible but the Regulation gives rise to a number of difficult problems, which we have discussed at some length. Given the magnitude of the task, 2005 is uncomfortably close, and much remains to be done, especially in the field of education and training. In addition, member states must decide whether or not single entity financial statements and the consolidated financial statements of non-publicly traded companies should comply with international standards as well. If they decide against this approach, we face the prospect of having two sets of standards operating side by side in various countries of the EU. If, however, member states decide in favour of the universal application of the international standards, then the future for national standard setters seems rather bleak.

## Recommended reading

- D. Alexander and S. Archer, *Miller European Accounting Guide*, 4th edn, Aspen Law and Business, New York, 2001.
- J. Blake and M. Hossein (eds), *Readings in International Accounting*, International Thomson Business Press, London, 1996.
- D. Cairns, *International accounting standards survey 2000 – an assessment of the use of IASs in the financial statements of listed companies*, International Financial Reporting, Henley-on-Thames, 2001. See also Updates to this survey.
- D. Cairns and C. Nobes, *The Convergence Handbook: A comparison between International Accounting Standards and UK financial reporting requirements*, ICAEW, 2000. Also *The Implications of IAS for UK Companies: An Update to the Convergence Handbook*, David Cairns, ICAEW, 2002.
- B. Carsberg, *The role and future plans of the International Accounting Standards Committee*, in *Essays in accounting thought: A tribute to W.T. Baxter*, Irvine Lapsley (ed.), ICAS, Edinburgh, 1996.
- F.D.S. Choi, C.A. Frost and G.K. Meek, *International Accounting*, 4th edn, Financial Times Prentice Hall, Harlow, 2002.
- J. Flower with G. Ebberts, *Global Financial Reporting*, Palgrave, Basingstoke, 2002.
- J. Flower and C. Lefebvre (eds), *Comparative Studies in Accounting Regulation in Europe*, Acco, Leuven, 1997.

- A. Haller, 'Financial accounting developments in the European Union: Past events and future prospects', *The European Accounting Review* 2002, 11:1, 153–90.
- S. McLeay (ed.), *Accounting regulation in Europe*, Macmillan, Basingstoke, 1999.
- C. Nobes and R. Parker, *Comparative International Accounting*, 7th edn, Financial Times Prentice Hall, Harlow, 2002.
- L.H. Radebaugh and S.J. Gray, *International accounting and multinational enterprises*, 5th edn, Wiley, New York and Chichester, 2002.
- C. Roberts, P. Weetman and P. Gordon, *International Financial Accounting: A comparative approach*, Financial Times Prentice Hall, Harlow, 2000.
- P. Walton, A. Haller and B. Raffournier (eds), *International Accounting*, International Thomson Business Press, London, 1998.

### Some useful websites

[www.europa.eu.int/comm/internal\\_market/en/company/account/news/index.htm](http://www.europa.eu.int/comm/internal_market/en/company/account/news/index.htm)

[www.iasb.org.uk](http://www.iasb.org.uk)

[www.iosco.org](http://www.iosco.org)

## Questions

- 3.1** It is a requirement of the Companies Acts that the accounts of limited companies must show a true and fair view of the state of affairs at the end of a period and the profit or loss for the period.

#### Requirement

- (i) Explain the role that the Companies Acts have in the preparation and presentation of published accounts;
- (ii) explain the relationship between accounting standards, the Companies Acts and European Union Directives; and
- (iii) provide two examples of how accounting standards extend the requirements of the Companies Acts and one example of an accounting standard that differs from the Companies Acts.

*ICAEW, Financial Reporting, September 2002*

(15 marks)

- 3.2** 'In recent years, there has been growing interest in, and efforts directed towards, the harmonisation of international accounting.' (*Advanced Financial Accounting* by Taylor and Underdown (CIMA/Butterworth Heinemann)).

You are required to explain this statement.

*CIMA, Advanced Financial Accounting, November 1993*

(15 marks)

- 3.3** You are the chief accountant of Britain plc. Britain plc has a number of subsidiaries located in various parts of the world. One of these subsidiaries is Faraway Ltd. Faraway Ltd prepares its financial statements in accordance with local Accounting Standards. The accountant of Faraway Ltd has prepared the financial statements for the year ended 30 September 2001 – also the accounting reference date of Britain plc. The profit and loss account for the year



ended 30 September 2001 (together with comparatives) drawn up in local currency (LC) was as shown below.

	Year ended 30 September	
	2001 LC000	2000 LC000
Turnover	56 000	53 000
Cost of sales	(34 000)	(32 000)
Gross profit	22 000	21 000
Other operating expenses	(10 000)	(9 800)
Operating profit	12 000	11 200
Interest payable	(4 000)	(3 800)
Profit before tax	8 000	7 400
Tax	(3 000)	(2 800)
Profit after tax	5 000	4 600
Dividends paid	(2 500)	(2 400)
Retained profit	2 500	2 200
Retained profit 1 October 2000 (1 October 1999)	10 000	7 800
Retained profit 30 September 2001 (30 September 2000)	12 500	10 000

The local Accounting Standards that are used in preparing the financial statements of Faraway Ltd are the same as UK Accounting Standards with the exception of the following:

1. Faraway Ltd values its stocks using the LIFO basis. This valuation is acceptable for local tax purposes. Relevant stock values are as follows:

Date	Stock value under LIFO	Stock value under FIFO
	LC000	LC000
30 September 2001	9 500	10 000
30 September 2000	7 700	8 000
30 September 1999	8 600	9 000

The stock levels of Faraway Ltd often vary from year to year and prices do not rise evenly. The rate of local corporate taxation is 36%.

2. On 1 October 1993, Faraway Ltd acquired an unincorporated business for 50 million units of local currency. The fair value of the net assets of this business on 1 October 1993 was 30 million units of local currency. The resulting goodwill was written off to the profit and loss reserve as permitted by local Accounting Standards. At the date of acquisition, the directors of Faraway Ltd ascertained that the useful economic life of this goodwill was 10 years.

The accountant of Faraway Ltd has sent the financial statements to you with a suggestion that consolidation would be much easier if all group companies used International Accounting Standards to prepare their individual financial statements.

#### Required

- (a) Restate the profit and loss account of Faraway Ltd in local currency (both the current year and the comparative) so as to comply with UK Accounting Standards. (14 marks)
- (b) Evaluate the practicality of the suggestion that all group companies should use International Accounting Standards. (6 marks)

- 3.4** 'Now that the EU has decided to harmonise financial reporting by Regulation rather than by the issue of new Directives, the financial statements of all companies in Europe will be comparable by the year 2005.'

**Discuss.**

*University of Buckingham, Advanced Financial Accounting, December 2002* (25 marks)