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The European Union's Financial Reporting
Strategy: Lessons for New Zealand?
by
Alan Roberts**

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Address for correspondence

**AFIS Department, University of Canterbury,
Private Bag 4800, Christchurch, New Zealand.
Tel: 64 3 364 2651
e-mail: a.roberts@afis.canterbury.ac.nz**

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Abstract

In June 2000 the European Commission published proposals for a new EU financial reporting strategy; these marked a radical departure from the previous Accounting Directives of the EU company law harmonisation programme. The proposals were overwhelmingly endorsed by the European Parliament in March 2002. The proposed requirement for all EU listed companies to use standards issued by the International Accounting Standards Board (IASB) for the preparation of their consolidated financial statements, starting no later than 2005, is a major step along the way to achieving truly global accounting standards.

This paper traces the history of this financial reporting strategy and analyses the factors which led the EU to move away from the approaches of the Fourth and Seventh Company Law Directives. The paper also examines what difficulties would arise for New Zealand if it were to adopt a similar strategy. The paper suggests, *inter alia*, that the EU stance throws up unresolved political and technical problems; these and further problems would apply if New Zealand were to follow the same approach as the EU.

Key words: EU, IASB, ASRB, Directives, harmonisation, accounting standards.

The European Union's Financial Reporting Strategy: Lessons for New Zealand?

by

Alan Roberts¹

National Centre for Research on Europe

1. Introduction

On 12th March 2002 the European Parliament approved the European Commission's proposed Regulation on financial reporting: all EU listed companies should prepare their consolidated financial statements in accordance with standards issued by the International Accounting Standards Board (IASB), starting no later than 2005. The approval was by 492 votes to 5, with 29 abstentions. The Commission's proposals were based upon a Communication of 13th June 2000 entitled *EU Financial Reporting Strategy: The Way Forward* (EUFRS). This, in turn, was derived from a Communication of 1st November 1995, *Accounting Harmonisation: A New Strategy vis-à-vis International Harmonisation*.

In fact, the Parliament's approval was more modulated than the previous paragraph suggests. For example, Members of the European Parliament (MEPs) approved an amendment to the proposals which extends the common financial reporting deadline to 2007, at the option of Member States, for companies that are listed both on an EU and a non-EU exchange (eg. the New York Stock Exchange) which applies another set of internationally accepted standards. The 2007

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exemption would apply also to companies that have only publicly traded debt as opposed to equity securities.

Overall, though, it seems very likely that the proposed Regulation dealing with this matter will be adopted by the European Council of Ministers at its next meeting. An indication of this likelihood can be seen from the reaction of the European Council of Finance Ministers (ECOFIN) to the issues raised by the Enron collapse: at a meeting of April 12-13th 2002, the Ministers urged a speedy adoption of the Commission's proposals, in line with the conclusions of the European Barcelona Council of 15-16th March 2002.

The high probability that the proposals will be adopted into EU law by way of a Regulation which will be directly effective and binding on the 15 Member States (and, in the future, on up to 12 successful candidate countries) is, in many ways, remarkable. European Community law will, it could be argued, delegate responsibility for the creation of rules governing financial reporting requirements for listed EU companies to a non-governmental third party (the IASB) which is not an EU institution nor a body of any Member State.

What train of events led to this current situation in the EU? What difficulties might there be for NZ in adopting a similar approach to international harmonisation? This paper is directed at exploring these two central questions. To this end the paper is organised into three further sections. The first considers the background to the, then, EC's concern for accounting matters across the Community; it then goes on to review the programme for company law harmonisation up until 1990 and the beginning of doubts about its future. This is followed by an analysis of events in the 1990s against the backcloth of developments internationally, leading up to the publication of the EUFRS. By way of conclusions, the last section analyses the issues which would arise if NZ were to adopt the EU's financial reporting strategy. After a brief review of the regulatory framework for financial reporting in NZ, the paper suggests that there are three particular difficulties for NZ in this regard.

2. The Development of the EU's Company Law Harmonisation Programme, 1957-1989

The harmonisation of accounting and financial reporting was not specifically mentioned in the founding treaty of the European Economic Community, the *Treaty of Rome 1957* (Van Hulle and van der Tas, 2001). Instead, this area of European harmonisation has proceeded as part of the company law harmonisation programme under Articles 44(2)(g) and 54(3)(g) of the Treaty. This programme has, as its central aim, the establishment of “a level playing field” for all companies (Haller and Walton, 1998, p.14) wherever based in the Member States; this is in terms of freedom of formation and equivalent levels of protection for shareholders, employees and creditors across those states. Such an overall aim could be seen as one which facilitates intra-Community trading and financial transactions thus contributing to free trade and free movement of capital within the Communities. The company law programme used the Directive primarily as the legal instrument through which harmonisation was to be achieved. A Directive is an instrument which is directly binding following adoption by the Council of Ministers (since 1994, together with the Parliament): it requires Member States to enact into national law the provisions of the Directive within a given period of time. Member States have a free choice as to how they decide to bring those provisions into national law and, in many cases, the provisions offer a variety of options from which the states can select treatment to suit their national circumstances. The Regulation, by contrast, is an instrument which, after it has been adopted, is directly binding and effective on the states; this has been far less used for company law harmonisation.

Table 1 provides a summary of company law Directives relevant to accounting and financial reporting adopted by, successively, the EEC, EC and EU.² Some draft Directives proposed by the Commission have not so far been adopted, and this accounts for the missing numbers in the

sequence. The most significant Directives from an accounting perspective are the Fourth and Seventh.

Directives	Date Adopted	Areas Covered
First	1968	Company registries; powers of companies and their directors
Second	1976	Distinction between public & private companies; calculation of distributable profit
Third	1978	Company mergers (<i>fusions</i>)
Fourth	1978	Accounting formats, rules and disclosures for limited liability companies.
Sixth	1982	Company de-mergers (<i>scissions</i>)
Seventh	1983	Rules for consolidated accounts
Eighth	1984	Qualifications of, and rules for the appointment and dismissal of, auditors
Eleventh	1989	Disclosures about branches of non-EU companies
Thirteenth	1989	Takeovers
Amendments to Fourth and Seventh 2001		Fair value accounting

Source: Nobes & Parker (2000), adapted by the author

² From a technical perspective, there are important legal differences between these three terms. While the *Treaty of Rome* refers to the EEC, the *Treaty of Maastricht* established the EU (effective as of 1st November 1993) but without legal personality. For the

The Fourth Directive was finally adopted by the Council of Ministers on 25th July 1978 (O.J. No. L 222 of 14th August 1978); its first draft was published in 1971 and relied heavily on the accounting provisions of the (West) German *Aktiengesetz 1965* (Nobes, 1983). A second drafting took place in 1974 following the accession of the UK, Ireland and Denmark to the EC and reflects the input of these three countries, whose accounting traditions are very different from most others in continental Europe.

The diversity of accounting regulation and practice across the world has spawned, over the last 30 years, a variety of classifications of difference. These classifications have been of various types (Roberts, 1995), but it does seem clear that European countries can be divided into two groups in relation to individual company financial reporting: an “Anglo-Saxon” group comprising the UK, Ireland, the Netherlands and, to some extent, Denmark, and a “Continental” group which contains most other western European countries. The countries in each group exhibit what Nobes (1998a) calls Class A and Class B accounting, or what Richard (1996) terms dynamic and static accounting, respectively. Accounting in the Anglo-Saxon group has traditionally been marked by a relative freedom of choice in accounting methods; a relative disconnection between tax and financial reporting (Lamb *et.al*, 1998); regulation, for the most part, by accounting standards as opposed to law; and a concern for communicating relevant information to investors. Accounting in the Continental European group has been state-driven; tax dominated; marked by closely defined prescription in commercial codes, company law and general accounting plans; and characterised by the absence of authoritative standard-setting bodies.

The 1978 Fourth Directive, which applies to the individual accounts of limited liability companies (defined in terms of the Second Directive), represented a compromise between these two traditions. From the Continental group (and the 1971 draft) came the requirement for detailed

purposes of this paper, the terms are used informally and inter-changeably.

statutory prescription of formats for the profit and loss account and the balance sheet, derogations from the burden of financial reporting requirements for small and medium-sized companies, and an overall commitment to historical cost valuation. From the Anglo-Saxon group came the requirement for extensive disclosures in the notes, accounting principles, an option to choose current values for asset valuation and an overriding requirement for the annual accounts as a whole to show “a true and fair view”. By 1995 all 15 Member States has enacted the Directive into their national laws.

It is worth emphasising that this harmonisation was through the medium of company law. In many continental countries the Fourth Directive was used to amend commercial codes which applied to all business entities, whether incorporated or not, with or without limited liability. In the UK and Ireland, on the other hand, the bulk of accounting regulation was, and is, through the promulgation of accounting standards, not company law, and is focused exclusively on limited liability companies. In addition, the Directive contained a variety of options in its provisions which weakened the potential extent of harmonisation, an approach which was underlined in the Directive’s objective of bringing about “ minimum equivalent legal requirements” (Preamble to Fourth Directive). A further point concerns the coverage of accounting issues in the Directive: its minimalist stance meant that it was silent on a variety of reporting matters such as accounting for construction contracts, pensions and unsettled foreign currency transactions. There have also been substantial difficulties in translating the “true and fair” concept into the various languages of the EU Member States (Alexander, 1993; Nobes, 1993) with the effect that its Anglo-Saxon sense has been considerably watered down in some continental countries, for example, Italy and Germany.

Given these and other limitations, it might be suggested that this key Accounting Directive has made only a small contribution to accounting harmonisation in the EU. However, Thorell and Whittington (1994) argue persuasively that the Directive has brought about significant changes in

EU accounting and Van Hulle and van der Tas (2001) demonstrate the powerful influence that the Fourth Directive has had on countries outside the EU.

The Seventh Directive, finally adopted on 13th June 1983 (O.J. No. L 193 of 18th July 1983), is concerned with consolidated financial statements. In Europe, legislation requiring such statements to be prepared is first seen in the UK in 1947 and in West Germany in 1965. Prior to the enactment of the Seventh Directive in 1983, other EU countries had no legal requirements for such statements to be produced. The need for harmonisation in this area was, however, foreshadowed in the Fourth Directive: Articles 57-61 explicitly mention a future Directive on consolidated accounts. Indeed, many of the requirements contained in the Fourth Directive, notably, formats, accounting principles and valuation rules, and the overriding concept of a true and fair view, were incorporated into the Seventh.

The development of the Seventh Directive was marked by a controversy as to what constitutes a group, a notion which seemingly underpins the production of consolidated accounts (Roberts *et al.*, 2002). The UK's approach to the definition of a parent-subsidiary relationship was, essentially, *de jure*, based upon a majority share-holding control criterion. The German approach was to define a group (*Konzern*) in economic terms so that control was characterised in *de facto* terms. Diggle and Nobes (1994) analyse the evolution of the Directive through its various drafts and conclude that, although the final version shows clear German parentage, the Directive is close to previous UK consolidation practices. In any event, the controversy over the definition of a group was side-stepped by the Directive: Articles 1-15 avoided the use of the term, preferring instead to set out the "Conditions for the preparation of consolidated accounts". Other controversies which arose in the course of drafting were resolved through the creation of options within many of the Directive's provisions. There are many more such options (over 50) in the Seventh Directive than in the Fourth.

For the purposes of this paper, there are three key features of the Accounting Directives (the Fourth and the Seventh) which are significant. The first concerns the accounting traditions that underpin the construction of the Directives. The Fourth had a clear origin in continental European accounting laws but was substantially modified by an Anglo-Saxon input; the Seventh, despite its German origins, is much more clearly Anglo-Saxon in inspiration and in the detail of the provisions. The second point relates to the differential impact of the two directives upon continental European countries. For many of these countries the main function of individual company financial statements has always been the provision of information to the tax authorities, with the effect that accounting and taxable profit are essentially the same. The Fourth Directive, therefore, was often enacted into national law in such a way that this function was preserved e.g. France. However, for the vast majority of these countries, prior to the adoption of the Seventh Directive, there were no legal requirements to prepare consolidated financial statements and, correspondingly, no tax implications arising from accounting consolidation: the group was not, for the most part, a taxable entity. This meant that, in enacting this Directive, most continental Member States could adopt the Anglo-Saxon “style” of consolidated accounts. A third feature concerns the flexibility of the Seventh Directive, with its large number of options for accounting treatment, combined with the fact that it, together with the Fourth Directive, was silent on a number of important accounting matters (pensions, construction contracts etc).

By the end of the 1980s the company law harmonisation programme of the EU was virtually complete and the two Accounting Directives had been established in almost all of the national laws of the Member States. In retrospect, these directives could be seen as a “necessary first step” to accounting harmonisation in Europe (Alexander and Archer, 2001, p.20), but the minimalist legal approach to reducing differences could only go so far.

3. EU Accounting Developments 1990-2000: In Search of a Strategy.

That the reduction of EU accounting differences through the company law harmonisation programme had stalled by 1990 was widely recognised. Indeed, the Head of Accounting at the EC Commission, Karel Van Hulle, writing in 1993, suggested that:

“ If one leaves out the adoption of the Seventh Directive on consolidated accounts and the sectoral directives on banks and insurance companies, one must admit that nothing has happened since 1978.....The lack of dynamism at EC level could prove very dangerous.”

(Van Hulle, 1993, p.391)

In his paper, the Head of EC Accounting set out four options for the future:

- (a) Stop further harmonisation efforts in the EC
- (b) Leave everything to the IASC
- (c) Leave the work to the Americans
- (d) Become an active player in the international harmonisation debate.

Van Hulle quickly rejected option (a) but in the three remaining options recognised that the harmonisation of EC accounting had to be seen in a *global* context. Inside and outside the EC, a number of developments had taken place in the 1980s which had increased the pressure for an international convergence of accounting rules, particularly in relation to consolidated financial statements. Most obvious amongst these was the growing international capital market and the number of cross-border listings of major multinational companies. The impact of different national accounting rules upon reported results came home to the financial world with the first listing of a

German company, Daimler-Benz, on the New York Stock Exchange. For 1993, the company reported DM 602 million profit under German accounting rules, but on applying the rules of US Generally Accepted Accounting Principles (GAAP), this turned into a DM 1839 million loss (Flower, 1997).

The demand for some set of rules which would ensure international comparability, and reduce the costs involved in producing different sets of financial statements for different capital markets, grew significantly in the late 1980s and early 1990s. The EC's initial position, expressed in a preference for option (d) above, was to develop, through the creation of an Accounting Advisory Forum, the idea of European Accounting Standards. Such standards could form the next stage of EU accounting harmonisation and allow the EU to become a player in the emerging struggle between the international accounting standards (IAS) of the International Accounting Standards Committee (IASC) and US GAAP for world dominance. After some initial enthusiasm, however, this option began to look unrealistic internationally. Options (b) and (c), on their own, both looked unpalatable. It would be difficult for the EU to defer to the IASC in rule-making, given that this private sector body had no authority of its own but had to rely on that of its members, the various national accountancy professional institutes. To leave the work of accounting harmonisation to a nation state outside the EU, the US, would be politically unacceptable. For Hoarau (1992, 1995), arguing from a French perspective, both IAS and US GAAP were unacceptable for the purposes of the EU since they were essentially "Anglo-Saxon accounting models" (1995, p.217) and did not reflect the economic, social and cultural environment of other accounting systems; the best way forward was to develop a worldwide system of mutual recognition with benchmarks. Hoarau's position drew criticism from a number of quarters, for example, Haller (1995); Nobes (1995); and van der Tas (1995), but the essential point was that the US authorities had shown very little interest in a mutual recognition agreement and, in particular, were not prepared to exempt European

companies which listed in the US from having to prepare their financial statements according to US GAAP (Flower, 1997).

As it turned out, the European Commission published, on 1st November 1995, a Communication entitled *Accounting Harmonisation: a New Strategy vis-à-vis International Harmonisation*. This document (para.3.3) set out the problem facing the EU in eloquent fashion:

“The most urgent problem is that concerning European companies with an international vocation. The accounts prepared by these companies in accordance with their national legislation, based on the Accounting Directives, are no longer acceptable for international capital market purposes. These companies are therefore obliged to prepare two sets of accounts, one set which is in conformity with the Accounting Directives and another set which is required by the international capital markets. This situation is not satisfactory. It is costly and the provision of different figures in different environments is confusing to investors and to the public at large. There is a risk that large companies will be increasingly drawn to US GAAP.”

The strategy that the EU was to adopt is implicit in this quotation: the Commission would put its weight behind the work of the IASC in order to develop truly international accounting standards.

In retrospect, this decision appears to be an obvious one. The IASC, since its inception in 1973, had made great progress in the formulation of a set of standards in the Anglo-Saxon style, already in use by a number of European multinationals (Nobes & Roberts, 2000), which were investor and capital market orientated. Representatives from EU countries sat on the Board of the IASC. Unlike US GAAP, which reflects a particular national environment, IAS were specifically designed from an international perspective. Unlike US GAAP, which is voluminous and based upon detailed rules and their interpretations, IAS appears flexible and principles-based. In addition, the

IASC had, in 1989, launched an initiative, the Comparability Project, to reduce the number of alternative treatments allowed in IAS; this was linked to a developing relationship between the IASC and the International Organisation of Securities Commissions (IOSCO). In 1995 the IASC and IOSCO had reached an agreement that envisaged a time when IOSCO would recommend to its members (the major stock exchange regulatory bodies across the world) the use of IAS for cross-border offerings and listings as an alternative to national accounting rules. Whether that would happen or not was dependent upon the IASC working on a “Core Standards Programme” to ensure that IAS were acceptable to IOSCO. The programme was completed by the IASC in March 1999 with the issuing of IAS 39 *Financial Instruments: Recognition and Measurement*; in May 2000 IOSCO recommended “the IASC 2000 standards” to its members.

For the EU Member States, particularly those in the Continental Europe group, the use of IAS for the preparation of consolidated accounts posed no great technical difficulty. The Seventh Directive, upon which their national laws for consolidated accounts were based, was Anglo-Saxon in style, flexible and did not impinge upon the accounting tax relationship of individual company accounts. Also, the Seventh Directive did not contain provisions on a number of key accounting areas (pensions, construction contracts etc) which might have conflicted with IAS. Indeed, the European Commission has published a number of documents comparing the requirements of IAS to those of the Accounting Directives. The latest of these, *Examination of the Conformity between IAS 1 to IAS 41 and the European Accounting Directives* (2001), recognises that many IAS deal with issues not specifically covered by the Directives.

The 1995 backing of IAS by the European Commission soon produced results in terms of the legislation of some key countries in the Continental European group. In France, the law of 6th April 1998 amended the law of 24th July 1966 to permit listed companies to depart from French rules for consolidated accounts (based on the Seventh Directive) and to follow “international rules”

under certain conditions (Roberts, 1997). The conditions were interesting: these “international rules” had to be translated into French and comply with EU Directives; they also had to be adopted by the new *Comité de la Réglementation*, a state committee. The point here was that, although the phrase “international rules” could be interpreted to mean US GAAP or IAS, only the latter had been translated into French and, anyway, the former were, in important respects, not compatible with the EU Directives. A similar development took place in Germany: on 5th March 1998 a new law was approved by the German *Bundestag* (the *KapAEG*) which amended the German Commercial Code (*HGB*). The new law also allowed listed companies to use internationally recognised rules for the preparation of consolidated accounts provided they were in accordance with the Directives (although there was no requirement for these rules to be translated into German). Again, US rules had the problem of compatibility with the Directives. Similar developments took place in Belgium and Italy but, interestingly, not in Spain.

1998 also saw the Commission begin work on amending the two Accounting Directives so as to permit the use of fair value accounting for certain kinds of financial instruments (Nobes, 1998b). This was significant since the work recognised the growing use of complex financial instruments by large listed European companies and the importance of IAS 39 to their accounting treatment. This work culminated in a new Directive approved by the Council and the Parliament, the first in more than a decade, on 22nd May 2001. It was the first Directive to explicitly recognise the role of IAS.

The publication of the EUFRS in June 2000 marked both a culmination of the trends of the 1990s and a new stage in European and international accounting harmonisation. The Lisbon European Council of Ministers on 23 and 24th March 2000 had underlined the importance of efficient, transparent capital markets for growth and employment in the EU, and concluded that urgent action on financial reporting was necessary to ensure high levels of comparability between

financial statements and to complete a single securities market. The EUFRS set out the Commission's proposals for the modernisation of the Accounting Directives and, in particular, contained the proposal which required all listed EU companies to prepare their consolidated accounts in accordance with one single set of accounting standards, IAS. In making this proposal, the Commission recognised the difficulty of relying on the Accounting Directives in the future: they contained too many options; they had been interpreted in different ways by Member States; they were silent on key accounting issues; and they could be characterised as rigid, legalistic, over-prescriptive and over-concerned with creditor protection and the calculation of distributable income. Perhaps, most importantly, they had no standing in international capital markets.

Although the proposals dealt with consolidated accounts, the EUFRS recognised (para.17) that:

“ As far as the national statutory individual accounts are concerned, regulatory and tax requirements could make the use of IAS inappropriate or even invalid.”

This sensitivity to the tax accounting relationship in some countries in the Continental European group was well judged. However, the document went on, in the same paragraph, to encourage Member States to adopt IAS for individual accounts wherever possible. Thus it is that the UK has recently embarked upon a programme of convergence of UK GAAP with IAS for *both* individual and consolidated accounts (ASB, 2002).

But the EUFRS also identified the central problems associated with this new approach to accounting harmonisation. These problems are essentially twofold: political and technical. Para.18 makes it clear that the EU cannot simply assign responsibility for the creation and development of European accounting rules to an unelected, third party, non-EU, non-governmental body. It is true that the transformation of the IASC to the IASB in the reforms of 2000-2001 gave greater weight and stature to international standards (now known as international financial reporting standards -

IFRS), but the point made by para.18 still stands. This political problem is complemented by technical ones. The first of these is the issue of audit and enforcement of IAS/IFRS in European consolidated accounts and the use of effective sanctions for non-compliance. The EUFRS recognised, in this context, the importance of establishing audit benchmarks, professional ethics and peer-reviews of securities markets supervisors' practices.

However, it is another problem which looms largest, and it is by no means clear that the Commission's solution, embodied in the proposed Regulation recently voted upon in the European Parliament (12th March 2002), is entirely satisfactory. Para.3.2 of the Regulation makes the point that the requirement for listed companies to use IAS/IFRS will be *additional* to the Directives' requirements. The Regulation also sets out (para.3.3 and Article 6) arrangements for an EU "endorsement mechanism" of IAS/IFRS – this is to ensure the "necessary public oversight", from an EU perspective, of international standards and to confirm that these standards "provide a suitable basis for financial reporting by listed EU companies".

The endorsement mechanism is to operate at two levels. The first level is regulatory and involves the creation of an Accounting Regulatory Committee (ARC) which will include representatives of all Member States. The ARC will give its opinion to Council and Parliament as to whether or not an IAS/IFRS should be adopted by the EU and by which date adopted IAS/IFRS should apply within the EU. The second level is technical: an Accounting Technical Committee (ATC) will provide expert advice on standards and provide input to the IASB standard-setting process; the ATC will also advise the Commission as to whether or not an amendment to the Directives is "recommended" in the light of international accounting developments.

There are two central difficulties with this proposed endorsement mechanism. The first is that it is not clear whether there will be a two-way process between the IASB and the EU in standard-setting. The IASB has its own autonomy and is only accountable to the International

Accounting Standards Committee Foundation (IASCF), an independent trust. There is no EU, *qua* EU, representation on the IASB although three EU countries, France, Germany and the UK, provide members of this Board. The EU Commission is only a representative organisation on the Standards Advisory Council (SAC) of the IASCF. Thus, there is no guarantee that the IASB will adopt a “European” perspective in the creation of new standards. Indeed, the opposite may be the case, given that the politics of the IASB appears to be more focused on wooing US regulatory authorities (Alexander and Archer, 2001).

The second difficulty concerns the *cachet* of a set of financial statements being described as complying with IAS/IFRS. The IASB has published a draft *Preface to IFRS* which will be considered at its next meeting on 26-28 June 2002. Para.16 of this draft (based upon IAS 1) contains the following statement:

“...Financial statements should not be described as complying with International Accounting Standards unless they comply with all the requirements of each applicable Standard and each applicable Interpretation of the International Financial Reporting Interpretations Committee (IFRIC).”

Given this position, it is difficult to see how the ARC could usefully advise Council and Parliament as to whether the EU should adopt or not any particular IAS/IFRS. If the whole rationale for the use of international standards by listed EU companies is to ensure that the financial statements can be described as having been drawn up in accordance with those standards (so as to ensure acceptability on international capital markets), then *all* of those standards which are applicable must, seemingly, be applied. Furthermore, it is clear from the draft *Preface* that the IASB, through the work of the IFRIC, will provide the authoritative interpretations of its own standards.

4. Lessons for New Zealand?

The previous two sections have narrated the story of how the EU has arrived at its proposed stance towards international accounting standards. As mentioned earlier, the current position is remarkable: the EU, with its own political institutions and body of law, appears ready to delegate some of its powers to a non-EU, non-governmental third party. If it is prepared to do this, then it is an indication of the importance it attaches to international accounting harmonisation and the significance of such harmonisation for EU listed companies. There may be difficulties for the EU in the future in this area, but the way ahead seems well set.

If an organisation such as the EU has, effectively, abdicated from a role as a “global player” in standard-setting and deferred to the IASB, why should not a small country such as NZ follow suit? How difficult would it be, given NZ’s regulatory framework for financial reporting, to require, by a certain date, domestic NZ listed companies to prepare their consolidated financial statements according to IAS/IFRS?

The NZ accounting system, at least until relatively recently, was modelled on the UK approach to financial reporting regulation. The 1933 NZ Companies Act reflected British legislation (Zeff, 1979) and the development of professional accounting guidelines in the period 1946-65 in NZ were an “almost verbatim adoption of the English Institute’s *Recommendations for Accounting Practice*” (Perera & Rahman, 1997, p.133). The period 1966-73 saw the first appearance of NZ accounting standards; these became mandatory for the NZ accountancy profession from 1974.

The turning away from the British model occurred in 1993. The Companies Act and Financial Reporting Act of that year set out a new institutional architecture for financial reporting regulation. A new body, the Accounting Standards Review Board (ASRB) (the members of which are appointed by the Minister of Justice), was given responsibility for the review and approval of

“financial reporting standards” (FRS) for the purposes of the Financial Reporting Act 1993. Under s.24(d) of that Act the ASRB is required “to give direction as to the accounting policies which have authoritative support within the accounting profession in NZ”. This is significant since the Act in s.3 defines the meaning of “generally accepted accounting practice” (GAAP): s.3(b)(ii) makes it clear that where law and FRS do not make any provision on a financial reporting matter, GAAP shall include accounting policies which have “authoritative support within the accountancy profession in NZ”.

The NZ accountancy profession is mentioned in the Act and it too has a role in NZ standard-setting. The Institute of Chartered Accountants of New Zealand (ICANZ), the successor body to the NZSA, has its own standards board, the Financial Reporting Standards Board (FRSB). This Board is responsible for the preparation of accounting standards that are submitted to the ASRB for approval. Although other institutions can submit standards for approval, s.24 of the Act explicitly designates the NZSA, now ICANZ, as the main source of standards.

Despite these institutional arrangements being quite different from those in the UK, there is no doubt that the NZ accounting system is very firmly in the “Anglo-Saxon” group of countries. NZ financial reporting is mainly regulated by standards rather than law; it is principles-based (from the NZ *Statement of Concepts*); there is a disconnection between tax and accounting rules; and there is a concern, for general purpose financial reports, to provide relevant financial information to the users of those reports.

So far, then, it would seem at least as easy for NZ to adopt IAS/IFRS for consolidated accounts as for many countries in the Continental European group. This view can be confirmed in a number of ways. The first concerns the role that international standards currently play in NZ GAAP. Mention is made above of the ASRB’s role in determining this and, in particular, in directing which accounting policies shall be deemed to have authoritative support within the

accountancy profession in NZ. The combination of para. 8 of ASRB *Release 7: Accounting Policies that have Authoritative Support within the Accountancy Profession in New Zealand* (2000) and para. 4.5 of ICANZ's *Explanatory Foreword to General Purpose Financial Reporting* (1995) suggests that, in the absence of approved FRS or applicable law, IAS/IFRS may already be a source of NZ GAAP. A second point is that in recent years, until the G 4+1 was wound up, NZ has had an input into the development process of IAS. Thirdly, in practical terms, IAS/IFRS have increasingly influenced the detail of NZ FRS. Thus, for example, FRS-3 *Property, Plant and Equipment* (issued in March 2001) was explicitly modelled on IAS 16 (Simpkins *et al.*, 2001); and the most recent NZ exposure draft, ED-90 *Agriculture* (issued in April 2002), refers almost all of its paragraphs to those in the relevant international standard, IAS 41. This patterning of new FRS to IAS is a reflection of the policy adopted by the FRSB in 1997 to develop future standards based on either IAS or standards issued by the Australian Accounting Standards Board (AASB), the final choice being based on "a number of factors" (Deegan & Samkin, 2002, p.11).

Confirmation of the comparatively close relationship between international standards and NZ GAAP can be seen in Street (2002). In this paper the author provided some analysis of survey data on national accounting rules for consolidated accounts in 62 countries benchmarked against IAS as at 31 December 2001; the data appeared in the publication *GAAP 2001* (2002) which was sponsored by a number of large accountancy firms. The survey considered 80 key accounting measures and disclosures. Table 2 provides some detail from Street, focusing on EU countries, Australia and NZ. Comparatively, for this range of accounting differences, NZ GAAP is far closer to IAS than most EU countries.

Table 2: DIFFERENCES BETWEEN NATIONAL CONSOLIDATED ACCOUNTING RULES & IAS, BASED ON 80 ACCOUNTING MEASURES

Country	No of differences that could affect many enterprises	No of differences which could affect certain enterprises
Spain	38	2
Greece	37	4
Luxembourg	37	0
Austria	36	6
Finland	35	5
Germany	32	8
Italy	31	4
France	30	10
Portugal	28	5
Belgium	26	11
Denmark	23	4
Australia	22	6
Sweden	18	7
New Zealand	17	6
UK	15	6
Ireland	15	5
Netherlands	11	11

Source: Street (2002), adapted by the author

It would, it seems, require only a limited number of changes for NZ to adopt the EU policy with respect to international standards, and to contribute to international harmonisation as well as

ensuring that the consolidated financial statements of large NZ listed companies are internationally transparent and comparable. What problems remain?

There would appear to be three main difficulties, although none of these is insuperable. The first concerns the requirement in the Financial Reporting Act, s. 24(f), for the ASRB to liaise with the AASB so as to harmonise Australian and NZ standards. This requirement grew out of a report, published in July 1992, to both the Australian and NZ Governments entitled *Closer Economic Relations Trade Agreement Report to Governments: The Harmonisation of Australian and New Zealand Business Law*. The ASRB issued *Release 2* (ASRB, 1994) which briefly set out the arrangements for consultation between the ASRB and the AASB. It seems, therefore, that the priority in accounting harmonisation for NZ is regional rather than international. A change in the law would be required to adopt the EU policy towards IAS/IFRS, and this may not be politically acceptable. On the other hand, the AASB has itself indicated that it anticipates a convergence between Australian standards and IAS/IFRS, most recently in the form of a publication of a “Convergence Handbook”; ICANZ has also done the same. It may be, then, that the adoption of IAS/IFRS by both Australia and NZ will take place over time, without the Big Bang approach of the EU.

The second difficulty is, perhaps, more substantial. S.27 of the Financial Reporting Act sets out the requirement that an FRS approved by the ASRB shall apply normally to financial statements prepared by all reporting entities *and state sector bodies*: NZ’s accounting standards apply to entities in both the public and private sector. This fact can be seen in the provisions of certain FRS. For example, FRS-37 *Consolidating Investments in Subsidiaries* attempts in its definition of, and commentary about, “control” (paras. 4.13-37) to straddle not only the provisions of IAS 27 and of Australian standards, but also a standard of the Public Sector Committee of the International

Federation of Accountants (IFAC PSC): IPSAS-6: *Consolidated Financial Statements and Accounting for Investments in Subsidiaries*.

The problem here lies in reconciling NZ's approach to standard-setting with that expressed by the IASB in its *Draft Preface*. Para. 9 of this document contains the following statements:

“IFRS are designed to apply to the general purpose financial statements and other financial reporting of all profit-oriented entities.....Although IFRS are not designed to apply to not-for-profit activities in the private sector, public sector or government entities with such activities may find them appropriate. The IFAC PSC has issued a Guideline stating that IFRS are applicable to government business enterprises. The PSC is preparing accounting standards for governments and other public sector entities, other than government business enterprises, based on IFRS.”

Given the IASB's apparent determination to focus its standards on only profit-oriented entities and the suggestion that the standards of the IFAC PSC for not-for-profit public sector entities will be different from IFRS, it would be difficult for NZ to adopt wholly, as the EU is likely to do, IAS/IFRS for the consolidated accounts of domestic listed companies without some kind of departure from the s.27 of the Financial Reporting Act.

The two difficulties mentioned above could be seen as subsets of a larger issue: the challenge to national sovereignty which is provided by international standards. In this sense, the issue is common as between the EU and NZ. The European Union has effectively decided that the transparency and comparability of consolidated financial statements of listed companies is so important to the growth and development of the EU, that it is willing to forego some sovereignty over its own affairs. Some Member States e.g. the UK are apparently willing to go further and use IAS/IFRS for individual accounts as well. One candidate country to the EU, Romania, has already enacted IAS/IFRS into its own national accounting law, with full effect from year end 2006

(Roberts, 2001). Whether NZ, with its commitment to regional harmonisation and unitary standards for the private and public sectors, is willing to surrender some sovereignty in order to enhance the international acceptability of the financial statements of its listed companies is a matter yet to be debated fully.

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