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Financial reporting: the IAS Regulation - Frequently Asked Questions

(see also IP/01/200)

What is an IAS standard? Who decides it?

IAS are standards developed by the IASC, the International Accounting Standards Committee, set up in the 1970s by the accountancy bodies of a number of industrialised countries. There are 41 IAS and 25 Interpretations covering some 1300 pages. The standards are investor-oriented.

The IASC has its Secretariat in London. In May 2000, the International Federation of Accountants (IFAC) approved a new structure for IASC. A new Board of 14 members, including five Europeans (two from the UK, one from France, one from Germany and one from Switzerland) was appointed on 25 January 2001 under the chairmanship of Sir David Tweedie, former chairman of the UK Accounting Standards Board. The new IASC Board is expected to meet for the first time in April 2001 and will be supplemented by a Standards Advisory Council of 30 members, thus ensuring a broad professional and geographical representation. The Advisory Council will meet regularly with the IASC Board to advise it on priorities and to inform it of implications of proposed standards for users and preparers of financial statements.

Once adopted, what will this Regulation change? Surely the need to compete globally has prompted many European companies to already adopt IAS now?

The Regulation will directly concern around 7000 listed EU companies, which will have to prepare their consolidated accounts in accordance with IAS by 2005. At the moment, only 275 listed EU companies use IAS for their financial reporting.

At present, seven Member States (Austria, Belgium, Germany, France, Finland, Italy, Luxembourg) specifically allow listed companies to prepare their consolidated financial statements in accordance with IAS.

What kind of technical changes will this Regulation imply and at what cost?

The changeover from national accounting rules to IAS will entail a substantial amount of training both for the accounting profession and for the companies which will have to comply for the first time with IAS. In order to be ready in 2005, it is important for companies as well as the accounting profession to start with the preparations now.

The changeover to IAS will also mean some cost, particularly during the first year of application, but the long term return on this investment will be substantial. The increased transparency and the improved comparability of financial information will ultimately result in a reduction of the cost for companies of raising capital. This will help to enhance the competitiveness of European industry.

Why does one need an endorsement mechanism when IASC is delivering high quality work?

The establishment of an endorsement mechanism at EU level is necessary because it is not possible politically, nor legally, to delegate accounting standard setting unconditionally and irrevocably to a private organisation over which the EU has no influence. In addition, it is important to create legal certainty by identifying the standards which listed companies will have to apply in the future. The endorsement mechanism will also examine whether the standards adopted by the IASC conform with EU public policy concerns. Because the endorsement mechanism will have an important pro-active role, it can be expected that the new standards adopted by IASC will also be acceptable in an EU environment.

How will the endorsement mechanism work in practice?

The Regulation establishes a new EU mechanism that will assess IAS and give them legal endorsement for use within the EU. This mechanism will use an Accounting Regulatory Committee set up under the proposal that will operate at the political level under established EU rules on decision-making by regulatory committees. The Accounting Regulatory Committee, chaired by the Commission and composed of representatives of the Member States, will adopt or reject IAS on the basis of a proposal made by the Commission.

The work of the Accounting Regulatory Committee will be prepared by a committee of experts (the accounting technical committee) which will be set up as a private-sector initiative, named EFRAG "European Financial Reporting Advisory Group", by the main actors interested in financial reporting (including users, preparers, the accounting profession and national standard setters). The accounting technical committee, composed of highly qualified experts, will provide technical expertise concerning the use of IAS within the European legal environment. It will participate actively in the international accounting standard setting process and organise the coordination within the EU of views concerning IAS. The committee should be in place in the course of the second quarter of 2001, i.e. soon after the new IASC Board becomes operative (from 1 April 2001 onwards). The Commission will be represented in this committee in an observer capacity.

The Accounting Regulatory Committee will operate as follows:

1. The Commission will submit its proposal to adopt (or reject) IAS XYZ to the Accounting Regulatory Committee.

This proposal will be accompanied by a Commission report identifying the international accounting standard at stake and examining its conformity with the existing Accounting Directives and its suitability as a basis for financial reporting in Europe.

2. The Accounting Regulatory Committee will then have a month to deliver its opinion on the Commission's proposal. Voting rules within the Committee will be the same as in the Council (i.e. qualified majority voting).

If the Accounting Regulatory Committee agrees with the Commission's proposal, the Commission takes the necessary measures for ensuring that the standard is adopted for use within the European Union's legal environment.

3. If the Accounting Regulatory Committee has no opinion or delivers a negative opinion, the Commission might return the issue to the accounting technical committee or bring the matter before the Council.

In accordance with the normal EU procedures on decision-making by regulatory committees, the European Parliament will be informed about the work of the Accounting Regulatory Committee. The European Parliament can also intervene if it considers that the Commission has exceeded its powers.

What will happen if an IAS is felt not to be suitable for application within the EU?

The Commission has already carried out an examination of the conformity of the existing IAS and Interpretations of the Standing Interpretations Committee (SIC) with the Accounting Directives - namely the 4th Company Law Directive (78/660/EEC) and the 7th Directive on consolidated accounts (83/349/EEC). Very few discrepancies have been noted (see IP/96/1132). These will be addressed in the context of the modernisation of the Accounting Directives due to take place over the period 2001-2002.

As to future IAS or Interpretations, the likelihood that an IAS or an Interpretation will be considered unsuitable for application within the EU is very low. Indeed, one of the most important tasks of the endorsement mechanism is to ensure that the European view is heard by IASC at a very early stage in the decision making process. If there is a problem, it will first have to be addressed at the technical level.

What about SMEs and unlisted companies?

Listed SMEs, like other listed companies, will also have to prepare their consolidated accounts in accordance with IAS and hence prepare for the changeover to IAS. However, most SMEs are not listed. They will therefore be exempted from having to prepare their financial statements in accordance with IAS, unless they wish to do so and this option is allowed by their Member State.

In the longer term, SMEs that will be seeking international capital for their development are likely to see an advantage in using IAS, whether or not they are listed.

To what extent are IAS used globally?

Most stock exchanges in the world accept financial statements prepared on the basis of IAS. The International Organisation of Securities Commissions (IOSCO) recommended in 2000 the use of IAS for cross-border listings. There are however still a number of problems that need to be resolved. Financial statements prepared on the basis of IAS are not yet accepted for listing purposes in the US and in Canada.

The adoption of IAS as the European standard for financial reporting will no doubt increase the legitimacy of these standards world-wide.

How can enforcement of IAS be improved?

An equivalent level of enforcement is necessary to bring about an efficient capital market. Companies which apply IAS do not always fully comply with the standards. This needs to be corrected.

First of all, common guidance is needed about the way in which the standards are to be applied. This is first of all the task of the Standards Interpretation Committee, which develops interpretation guidelines for the proper implementation of IAS. If need be, these guidelines could be supplemented at the EU level by the endorsement mechanism.

Secondly, the financial statements must be properly audited. The audit profession is on the front line in this respect, as auditors are required to certify that the financial statements have been properly prepared. In order to ensure an equivalent high quality level of audit throughout the EU, the Commission has published a Communication in 1998 setting out the priorities for action in this area. Last year, the Commission issued a Recommendation on Audit Quality Assurance (see IP/00/1327). Further work is under way within the EU Committee on Auditing on subjects such as auditing standards, the audit report and independence.

Thirdly, external supervision is necessary in order to protect investors. Securities supervisors have a critical role in ensuring that listed companies comply with financial reporting requirements. The Commission looks to European securities markets supervisors through FESCO (the Forum of European Securities Commissions) to develop and implement a common approach to enforcement. It is FESCO's intention to set up a permanent sub-committee that will work on enforcement issues, notably enforceability of accounting standards.

What about US GAAP? Can EU companies continue to apply US GAAP?

Around 300 EU listed companies currently use US GAAP (Generally Accepted Accounting Principles) for financial reporting purposes. In most cases, they did so in the perspective of their flotation on US securities markets or to adopt a high level financial reporting to attract foreign or US capital and investors. However, beyond 2005, they will have to prepare their consolidated accounts in conformity with IAS.

IAS will offer them the same high quality level of financial information as US GAAP, with the additional advantage that IAS have been conceived in a truly international perspective and are not modelled by a particular national environment. The Commission hopes and expects that the US Securities and Exchange Commission (SEC) will accept in the near future financial statements prepared by EU issuers without requiring a reconciliation to US GAAP.