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Alexander Schaub

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The Use of International Accounting Standards in the European Union

*Dr. Alexander Schaub**

2005 is a watershed year for the application of International Accounting Standards (IASs) in the European Union. From the first of January this year, all listed European companies must prepare their consolidated accounts using IASs or International Financial Reporting Standards (IFRSs).¹ This requirement represents a quantum leap in the use of a single consistent set of accounting standards for capital markets in the European Union.

I. THE BACKGROUND OF THE E.U. DECISION TO USE IASS

A. Creation of Internal Market

The E.U. treaty does not expressly provide for the harmonization of accounting standards as a Community objective. Rather, this objective has developed organically from the need to harmonize company law requirements for the creation of an internal market.

Because of the substantial economic, social, welfare and political benefits, the E.U. treaty fixes as a common objective for Member States the

* Dr. Alexander Schaub has been Director-General for the Internal Market and Services in the European Commission since September 2002. From 1995 to 2002, he was Director-General for Competition. During that period he was also Vice-President of the OECD Competition Committee. From 1990 to 1995 he was Deputy Director-General for Internal Market and Industrial Affairs and for Industry. From 1989 to 1995 he served as Director responsible for trade-related issues in the industrial sector and EC Special Representative for Textile Negotiations in the Uruguay Round. His career in the European Commission, which began in 1973, following two years with the Federal Ministry of Economics in Bonn, also includes service in the Cabinet of Commissioner Ralf Dahrendorf, as Deputy Head of Cabinet for Guido Brunner, Viscount Etienne Davignon and President Gaston Thorn, and as Head of Cabinet for Willy De Clercq.

¹ International Accounting Standards (IASs) were adopted by the International Accounting Standards Board (IASB) in April 2001, when the IASB endorsed the body of IASs issued by its predecessor, the International Accounting Standards Committee (IASC). Accounting standards developed by the IASB are called International Financial Reporting Standards (IFRSs).

creation of an internal market—an area allowing the free movement of goods, persons, services and capital. Two of the key principles to create this internal market are freedom of establishment and freedom to provide services, both on a cross-border basis.

B. The Accounting Directives

As business moves cross-border, companies need to be subject to comparable—but not necessarily completely identical—rules to provide equivalent protection for investors, shareholders and creditors. This leads to the need to develop and adopt common rules for financial reporting within the European Union through a series of Company Law Directives.²

The Fourth Company Law Directive provides for the preparation of audited annual accounts giving a “true and fair” view of a company’s assets, liabilities, financial position and profit and loss.³ This Directive, as amended, is still in force today and applies to the five million or so limited companies in the European Union. Two other Directives provide common rules for banks⁴ and insurance undertakings.⁵ The Seventh Company Law Directive lays down common rules for the preparation of consolidated accounts.⁶

C. The Need for an International Approach

While the Fourth and Seventh Directives lifted the quality of financial reporting and had the merit of preserving different national accounting traditions within the internal market, this often came at the cost of many options which hindered comparability. Furthermore, it was recognized that in relation to investors’ needs, the Directives were capable of improvement in terms of addressing relevant issues and better reflecting economic reality.

During the 1990’s, efforts were made to address these weaknesses, but

² Adopted under the terms of Article 44(2)g of the Treaty Establishing the European Community. TREATY ESTABLISHING THE EUROPEAN COMMUNITY, Dec. 24, 2002, O.J. (C 325) 33, art. 44(2)g (2002), available at http://europa.eu.int/eur-lex/lex/en/treaties/dat/12002E/pdf/12002E_EN.pdf.

³ Council Directive 78/660/EEC of 25 July 1978 on the Annual Accounts of Certain Types of Companies, 1978 O.J. (L 222) 11 [hereinafter Fourth Company Law Directive]. For reference, E.U. accounting legislation and other official documents can be found at the following Commission website: http://europa.eu.int/comm/internal_market/accounting/officialdocs_en.htm.

⁴ Council Directive 86/635/EEC of 8 December 1986 on the Annual Accounts and Consolidated Accounts of Banks and Other Financial Institutions, 1986 O.J. (L 372) 1.

⁵ Council Directive 91/674/EEC of 19 December 1991 on the Annual Accounts and Consolidated Accounts of Insurance Undertakings, 1991 O.J. (L 374) 7.

⁶ Council Directive 83/349/EEC of 13 June 1983 on Consolidated Accounts, 1983 O.J. (L 193) 1 [hereinafter Seventh Company Law Directive].

for a variety of reasons, it was difficult to make further progress through Community legislation. For this reason, in 1995 the Commission adopted a Communication setting out a new strategy for accounting harmonization in the international market.⁷

The Communication identified that the most pressing need was the international vocation of European undertakings. The Communication recognized that the existing Directives as such were not suitable for the information needs of international capital markets and consequently large companies were increasingly being drawn to use U.S. Generally Accepted Accounting Practices (U.S. GAAP) in addition to their local Generally Accepted Accounting Practices (GAAP). This increased costs and sometimes resulted in confusion when comparisons were made to local GAAP.⁸ Furthermore, at a political level, the European Union had no influence on accounting standards adopted under U.S. GAAP, nor were the standards necessarily appropriate in an E.U. context.

For these reasons, the Commission proposed that the European Union should place its full weight behind the international standards being developed by the International Accounting Standards Committee with the objective of establishing a set of standards that would be acceptable in capital markets world-wide. Given the needs of international companies and investors, priority was placed on consolidated accounts.

D. The Financial Services Action Plan

The implementation of this policy was given a new and decisive impetus by the development of the Financial Services Action Plan (FSAP).⁹ This was a regulatory reform package, composed of forty-two separate measures, with the objective of building a fully integrated European financial marketplace. The Plan was also a response to the growing importance of capital markets for corporate finance in the European Union. It was designed to allow E.U. companies and citizens to benefit fully from the advantages of the introduction of a common currency, the Euro. One of the main thrusts of the Plan was therefore to improve the quality of financial information in the European Union through a new reporting

⁷ Accounting Harmonisation: A New Strategy Vis-à-Vis International Harmonisation, COM(95)508 final at 2, *available at* http://europa.eu.int/comm/internal_market/accounting/docs/com-95-508/com-95-508_en.pdf (last visited Mar. 31 2005).

⁸ When Daimler Benz listed on the New York Stock Exchange in 1999, the fact that its U.S. GAAP results showed a loss while its local GAAP revealed a profit became a cause célèbre.

⁹ Press Release, European Commission, Financial Services: Commission Outlines Action Plan for Single Financial Market, (May 11, 1999), *available at* <http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/99/327&format=HTML&aged=1&language=EN&guiLanguage=en>.

strategy.

In March 2000, at the Lisbon Council, the Heads of State and Governments of the Member States decided that the FSAP should be implemented by 2005 at the latest. In June 2000, the Commission published a Communication proposing that all listed E.U. companies prepare their consolidated accounts in accordance with one single set of accounting standards, namely International Accounting Standards (IASs).¹⁰ Applying a common framework for financial reporting would bring about transparency and greater comparability between financial statements of companies operating on the same (European) capital market. This would contribute to greater market efficiency and, in turn, lead to a lower cost of capital for listed companies, thus providing a spur to investment, growth and employment.

E. The IAS Regulation

The Commission introduced its legislative proposal in February 2001. On June 7, 2002, after a single reading in the European Parliament, the Council of Ministers adopted the Commission's proposal for a Regulation on the application of IASs.¹¹ The key features of the IAS Regulation are described below.

1. Legal Instrument: A Regulation

Rather than proceeding by way of a Directive (which is the traditional instrument used for the harmonization of company law, including accounting), the Commission decided to use another legal instrument available under the Treaty of Rome: a Regulation. While a Directive must be transposed into national law before it becomes effective in practice, a Regulation is directly applicable in all Member States and does not require the intervention of national legislators.

Using a Regulation provided the advantage of saving considerable time given the proximity of the 2005 deadline for FSAP completion. It also meant that maximum harmonization towards IASs would be achieved. For those companies required to apply IASs, Member States would not be allowed to impose further financial reporting requirements, restrict accounting options available under IASs, or issue new accounting standards.

¹⁰ E.U. Financial Reporting Strategy: The Way Forward, COM(2000)359 final at 2, available at http://europa.eu.int/eur-lex/en/com/cnc/2000/com2000_0359en01.pdf (last visited Feb. 27, 2005).

¹¹ Listed companies must begin to use International Accounting Standards by 2005. Council Regulation 1606/2002 of 19 July 2002 on the Application of International Accounting Standards, 2002 O.J. (L 243) 1.

2. *Scope of the Regulation*

a. E.U. Companies Listed in the European Union

Because the Regulation is primarily a capital market measure, it applies to all companies governed by the law of a Member State whose securities are admitted to trading on a regulated market in the European Union.¹² Approximately 8,000 companies are directly affected by the Regulation. However, a far greater number of companies will be indirectly affected because they belong to a group that is now required to apply IASs.

b. Excursion: Non-E.U. Issuers

Under the IAS Regulation, foreign companies listed within the European Union are not required to apply IASs, nor are they required under the IAS Regulation to reconcile their accounts to IASs. This issue has been addressed by the Prospectus Directive governing the conditions for preparing a prospectus for issuing securities on a European regulated market.¹³ Under Article 7 of that Directive, non-E.U. issuers may be exempted from a requirement to provide financial information based on IASs in a prospectus if the information provided under their domestic financial reporting standard (e.g., U.S. GAAP) is deemed equivalent to IASs.¹⁴ The same principle was laid down in Article 23 of the Transparency Directive for financial statements.¹⁵ To assist it in making this decision, the Commission has asked the Committee of European Securities Regulators (CESR) to give advice on whether U.S. GAAP, Canadian GAAP and Japanese GAAP can be considered as equivalent to IASs. CESR is expected to give this advice in June of this year. Under the existing rules, the Commission needs to make a decision on equivalence well before January 2007. Otherwise, issuers will have to restate their financial statements in accordance with the IASs.

¹² This includes both bond and equity issues.

¹³ Council Directive 2003/71/EC of 4 November 2003 on the Prospectus to be Published When Securities Are Offered to the Public or Admitted to Trading and Amending Directive 2001/34/EC, 2003 O.J. (L 345) 64, [hereinafter Prospectus Directive].

¹⁴ The prospectus is to be prepared under European Community law and not under the law of a third country. The second issue is addressed under Article 20 of the Prospectus Directive. *Id.* at 78.

¹⁵ Council Directive 2004/109/EC of 15 December 2004 on the Harmonisation of Transparency Requirements in Relation to Information About Issuers Whose Securities Are Admitted to Trading on a Regulated Market and Amending Directive 2001/34/EC, 2004 O.J. (L 390) 38.

c. Unlisted Companies

Under Article 5 of the IAS Regulation, Member States may also permit or require unlisted companies to prepare their individual financial statements in accordance with IASs. If a Member State chooses this option,¹⁶ the regime applicable to the companies concerned is exactly the same as that which applies to listed companies that are required to apply IASs under the Regulation. As a result, Member States can no longer issue accounting standards for those companies, nor can they amend IASs. Their accounting regime is entirely governed by IASs.

d. Consolidated vs. Individual Accounts

Only consolidated accounts must be prepared in accordance with IASs. The annual accounts of listed companies continue to be governed by national law derived from the Accounting Directives. This situation was unavoidable because of the close link that exists between accounting and taxation in many Member States of the European Union. To the extent that there is such a link, it would be difficult for a company to prepare its annual accounts in accordance with IASs, because doing so would significantly affect the taxation it is required to pay. For the few situations where a listed company is not a parent of a group and therefore does not prepare consolidated accounts, Member States will have to decide whether they wish to exercise the option to extend the scope of the Regulation to the annual accounts prepared by these companies.¹⁷

e. Regulated Sectors, e.g., Banks and Insurance Companies

For regulated industries, particularly banking and insurance, Member States may wish to subject all similar companies to the same accounting requirements. Accordingly, even unlisted banks and insurance companies may be required to use IASs. Member States will also come under pressure to decide if they want to keep a homogeneous accounting environment and, if so, whether they want to give up (either in part or totally) the link between accounting and taxation. Member States could of course decide to make these changes gradually. That is the reason why the Commission has also modernized the existing Accounting Directives.¹⁸ This offers an

¹⁶ European Commission, Planned Implementation of the IAS Regulation (1606/2002) in the E.U. and EEA (2005), at http://europa.eu.int/comm/internal_market/accounting/docs/as/ias-use-of-options_en.pdf (last visited Mar. 30, 2005).

¹⁷ *Id.*

¹⁸ Council Directive 2001/65/EC Amending Directives 78/660/EEC, 83/349/EEC, and

alternative to Member States that do not want to move to IASs all at once. Member States can do so gradually by using the accounting options that will become available as a result of the modernization, allowing either a gradual uptake of IASs, or on an IAS per IAS basis.

f. Member States' Choice

The general orientation across the European Union is for Member States to allow unlisted companies to use IASs for the preparation of their consolidated accounts.

3. *Which Standards Must be Applied?*

The Regulation imposes the use of IASs only. However, when the text was negotiated with Member States in the Council, some advocated allowing a choice between IASs and the U.S. GAAP. This was not accepted for two reasons:

First, the U.S. GAAP is the accounting regime of the United States. It does not constitute an international framework because it is too closely linked to the needs of one particular country and economy. Second, offering a choice would be counterproductive. It would not provide the right incentive to move in the direction of international standards.

In regards to the current E.U. undertaking to use U.S. GAAP, Member States under the transitional arrangements¹⁹ may allow those companies that are listed on the U.S. stock exchange (and thus required to use U.S. GAAP) to continue using U.S. GAAP for financial years until January 1, 2007.

II. THE E.U. PROCESS FOR THE ENDORSEMENT OF IASS

A. Commission Endorsement of Individual IASs Only

Although the IAS Regulation requires the use of IASs, each individual accounting standard has to be endorsed or adopted into E.U. law by the Commission in accordance with a specific Committee procedure, commonly referred to as "comitology."²⁰ The objective underlying adoption is to permit the endorsement or rejection of standards, but not their amendment. IASs are accordingly defined in Article 2 of the IAS Regulation as standards and interpretations adopted by the IASB. If the

86/635/EEC as Regards the Valuation Rules for the Annual and Consolidated Accounts of Certain Types of Companies as well as of Banks and Other Financial Institutions, 2001 O.J. (L 283) 28-32.

¹⁹ Council Regulation 1606/2002 of 19 July 2002 on the Application of International Accounting Standards, *supra* note 11 [hereinafter IAS Regulation].

²⁰ *Id.* at arts. 3, 6.

Commission considers it necessary for the European Union to adopt accounting solutions in areas not covered by IASs, then the Commission will have to use the normal co-decision procedure provided for in the Treaty, i.e., submission of a formal proposal to the Council and the European Parliament for adoption.²¹ Consequently, the comitology procedure is only applicable for the endorsement of IASs.

B. The Role of the European Union During the Preparation of New International Standards

Although most people supported the choice of IASs as the appropriate international standard, there was nevertheless considerable opposition to handing over accounting standard setting for listed companies to a private body that was largely self-controlled.²² This did not conform with the democratic traditions of Member States, which required that laws be made directly by Parliament or through delegation by the Parliament.

At the same time, it was unthinkable that an IAS adopted by the IASB would then need to be renegotiated at the E.U. level. Ideally, once an IAS had been adopted by the IASB, it should in principle be fully acceptable to the European Union. Therefore, efforts were undertaken to try to ensure that the standards adopted by the IASB are fully acceptable to the European Union. However, the only real safeguard put in place is the process for adopting or rejecting an IAS Standard under the IAS Regulation.

1. E.U. Role Within the IASC Foundation

It was inconceivable that the European Union would not in one way or another be represented within the structure of the IASC Foundation. Such representation became difficult after the IASC changed its structure in 2001.²³ The new Constitution no longer provides for the possibility of having observers on the standard setting Board. Thus, it was agreed between the Commission and the IASC Foundation that the Commission would have an observer seat on the Standards Advisory Council and on the International Financial Reporting Interpretations Committee. It was also agreed that close contacts would be maintained on a permanent basis between the Commission and the IASB (the accounting standard setting body of the IASC Foundation).

²¹ TREATY ESTABLISHING THE EUROPEAN COMMUNITY, *supra* note 2.

²² See *supra* Parts II.B.1-2.

²³ The IASC preceded the IASC Foundation. See Int'l Accounting Standards Bd., General Information at <http://www.iasb.org/about/general.asp> (last visited Mar. 28, 2005).

2. Upstream Technical Input from the European Union

The provision of upstream technical input from interested parties in the European Union in the international accounting standard setting process also needed to be organised. The Commission insisted that the private sector (particularly industry and the accounting profession) should take an initiative to set up a European technical group that would contribute to the work of the IASB. A good way to prevent a possible rejection of an IAS by the European Union is to ensure that there has been proper technical input from the very beginning and that all arguments have been properly aired.

The private sector reacted favorably to the Commission's suggestion by creating a new body, called the European Financial Reporting Advisory Group (EFRAG).²⁴ This body was set up by the main parties interested in financial reporting (such as industry, accounting profession, standard-setters, stock exchanges and financial analysts).

EFRAG has a Supervisory Board in which the "founding fathers" of the organization are represented. This is similar to the model chosen for the U.S. Financial Accounting Standards Board (FASB). The technical work is carried out by an independent group, the Technical Expert Group (TEG) which meets on a monthly basis. To exchange views about the work of the IASB, EFRAG has also taken the initiative of bringing together all standard setting bodies in the European Union at regular intervals. The European Commission and CESR are represented as observers on the TEG of EFRAG. This structure is presented schematically in Annex 1, *infra*.

To date, EFRAG has functioned as a de facto accounting technical committee²⁵ providing advice and expertise to the Commission in the assessment of international accounting standards. Furthermore, the role of EFRAG in the IAS standard setting process has also been recognized by ECOFIN, the Council of E.U. Finance Ministers.²⁶ Thought is currently being given to whether and, if so how, EFRAG should be granted a formal legal status under E.U. law to strengthen its role in the overall endorsement process.

3. The Safeguard: Specific Conditions to be Satisfied Before IAS Standards can be Endorsed

The real safeguard against the arbitrary endorsing of International

²⁴ Further information on EFRAG's activities can be obtained from the organization's website at <http://www.efrag.org> (last visited Mar. 28, 2005).

²⁵ Council Regulation 1606/2002 on the Application of International Accounting Standards, *supra* note 19, at 2.

²⁶ *Report of the Council of the European Union: Econ. & Fin. Affairs*, 2520th Council Meeting Sess. 11180 (July 15, 2003), available at <http://www.iasplus.com/resource/0307ecofina.pdf>.

Accounting Standards is that before an IAS can be endorsed by the Commission under the comitology procedure, three specific minimum criteria must be fulfilled:²⁷

a. The IAS Standard must not be Contrary to the True and Fair View Principle

First, the IAS standard must not be contrary to the true and fair view principle referred to in the Fourth and Seventh Company Directives.²⁸ This assessment ensures that there exists a high degree of conformity with the Accounting Directives. However, rather than requiring strict conformity with each and every provision of the Accounting Directives, the condition is satisfied when the application of the standard under consideration results in the presentation of a true and fair view in the same way as if the Accounting Directives had been applied.

In practice, this condition means that a standard will be acceptable if it corresponds to current accounting thinking as laid down in the Directives. Should a standard go too far beyond such thinking, endorsement will only be possible if the Commission can justify that the standard introduces a better accounting approach. In that case, the Commission may propose an amendment to the Accounting Directives to ensure that the Directives reflect that better approach. The general reference to the true and fair view requirement avoids the need to look for a detailed conformity assessment for each individual standard.

b. The IAS Must be Conducive to the European Public Good

Second, the IAS must also be conducive to the European public good. This condition is of a more political nature. Through its adoption of IASs, the European Union does not want to put its listed companies at a disadvantage in the global economy.²⁹ On the contrary, listed E.U. companies need to be able to compete on an equal footing for available financial resources in either European capital markets or in world capital markets. In this context, it is particularly important to achieve future convergence between IASs used in Europe for the preparation of financial statements and other globally-used international accounting standards, in particular U.S. GAAP.

This sends a strong message to the IASB: convergence, particularly

²⁷ Council Regulation 1606/2002 on the Application of International Accounting Standards, *supra* note 19, at 3.

²⁸ See Fourth Company Law Directive, *supra* note 3; Seventh Company Law Directive, *supra* note 6.

²⁹ Council Regulation 1606/2002 on the Application of International Accounting Standards, *supra* note 19, at 2.

with U.S. GAAP, is needed to ensure that E.U. companies and their competitors in the United States are subject to the same rules and that these rules are equally robust to protect investors and creditors. At the same time, it will produce a better integrated and more efficient global capital market for the efficient allocation of capital.

Under the so-called “Norwalk Agreement” of October 2002, the U.S. Financial Accounting Standards Board (FASB) and the IASB have decided to work together to achieve a balanced convergence between IASs and U.S. GAAP.³⁰ This offers good prospects for IASs to become a truly global accounting standard. This convergence process, when properly managed, can also play an important part in the SEC’s acceptance of IASs, without reconciliation to U.S. GAAP where necessary. Unfortunately, this convergence process seems to be taking much longer than originally anticipated, and renewed efforts to place this on a firm and comprehensive timetable for completion must now be seen as a priority.

Of course, the concept of European public good goes beyond convergence. A standard would not be conducive to the European public good if it introduced accounting solutions which, although technically correct, raised serious problems.³¹ For instance, there could be problems if it were to be negative consequences at a macro-economic level. There is always the risk that the concept of European public good might be used as an excuse for not endorsing a standard that European stakeholders do not want for various reasons. However, the best way to ensure that such is not the case is for the IASB to operate in a transparent way and to listen to the arguments as they are being put forward.

c. The IAS Standard Must Meet the Criteria of Understandability, Relevance, Reliability and Comparability

Third, for an IAS standard to be endorsed it must also meet the criteria of understandability, relevance, reliability and comparability. In principle, this should not prove to be a problem, since under the Conceptual Framework of the IASB, financial information for making economic decisions and assessing the stewardship of management is already required to meet these criteria.

³⁰ See Financial Accounting Standards Board and International Accounting Standards Board, Memorandum of Understanding, “The Norwalk Agreement,” available at http://www.fasb.org/intl/convergence_iasb.shtml (Sept. 18, 2002).

³¹ See Part III.C.5, *infra*.

C. The Endorsement Process

1. *The Position of the European Parliament*

Although the exercise of delegated or “comitology” powers by the Commission to take binding decisions under E.U. law is commonplace in many areas of Community policy,³² in 2001 and 2002 when the Commission proposal for the IAS Regulation was being negotiated between the Parliament and the Council, the exercise of these powers in the area of financial services was a matter of considerable political sensitivity between the Parliament, the Council and the Commission.³³

In the securities area particularly, it was widely recognized that complex E.U. financial legislation needed to be adopted on a basis that was more efficient, flexible and rapid. This led naturally to the consideration of a more extended use of existing “comitology powers” by the Commission. However, there was a major institutional difficulty. Under the E.U. Treaty, the European Parliament had no formal right³⁴ to “call back” or review secondary E.U. legislation adopted on a comitology basis.³⁵ It only enjoys a right of oversight. Consequently, the European Parliament was worried that an unbridled extension of these comitology powers, rather than using the normal procedure involving both Council and Parliament, could result in a loss of democratic control over complex E.U. financial services legislation.

2. *The Lamfalussy Process*

For securities markets, a solution was found through the Report drawn up by the Committee of Wise Men on the Regulation of European Securities Markets issued under the chairmanship of Baron Alexandre Lamfalussy.³⁶ The so-called “Lamfalussy Report” was endorsed by the Stockholm European Council, in its Resolution of 23 March 2001 on “more effective securities market regulation,”³⁷ and, following a declaration by

³² For example, in agriculture.

³³ The balance of power between the Council and the European Parliament in the exercise of delegated powers by the Commission has been hotly debated in the preparation of the proposed new E.U. Constitution.

³⁴ Council Regulation 1606/2002 on the Application of International Accounting Standards, *supra* note 19, at 3-4.

³⁵ The Commission has always supported the Parliament in its aim of securing equivalent control rights in the new Constitutional Treaty over powers delegated to the Commission.

³⁶ European Commission, Final Report of the Committee of Wise Men on the Regulation of European Securities Markets (Lamfalussy Report), *available at* http://europa.eu.int/comm/internal_market/securities/lamfalussy/index_en.htm (Feb. 15, 2001).

³⁷ Stockholm European Council, Presidency Conclusions, *available at* <http://ue.eu.int/ueDocs/cmsData/docs/pressData/en/ec/00100-r1.%20ann-r1.en1.html> (Mar. 23-24, 2001).

President Prodi to the European Parliament in Strasbourg on 5 February 2002,³⁸ by the European Parliament. This report set out the arrangements for a new four-level regulatory approach which is now known as the Lamfalussy process.

3. The Role of European Parliament in IAS Endorsement

Inspired by the success of the Lamfalussy approach for securities markets, it was possible to agree to a parallel *modus vivendi* between the Commission, the Council and the Parliament for the adoption of IASs under comitology powers. This parallel approach is specifically referred to in Recital 8 of the IAS Regulation.³⁹ It involves extensive information and reporting to the Parliament at an early stage. In particular, Parliament benefits from a three-month period to react to draft Commission proposals to endorse IASs, receiving the first draft at the same time as the Member States. It is thus possible to take on board Parliament's views at an early stage in the process. Parliament also has a one-month period in which to pass a Resolution in respect of the final Commission proposal where it considers that the Commission has exceeded its comitology powers. This process of information and consultation is set out schematically in Annex 2, *infra*.

4. Endorsement of IASs by the Commission

In practice, after an IAS has been adopted by the IASB, the endorsement process will start with the Commission formally asking EFRAG for its view on whether an IAS should be endorsed. Once the opinion of EFRAG has been received, the Commission will, where appropriate, draft a proposal for adoption of the standard. This proposal will then be discussed by the Accounting Regulatory Committee (ARC) whose members are elected by the Member States. Voting within the ARC takes place on the basis on qualified majority voting (QMV). The voting weights of each Member State are set in Annex 3, *infra*.

To be agreed by the ARC a double majority is required. That is, at least thirteen individual Member States representing at least 232 votes must be cast in favor of the Commission proposal. However, any Member State can additionally request confirmation that Member States representing at least sixty-two percent of the E.U. population have voted in favor of the

³⁸ President Romano Prodi, Implementation of Financial Services Legislation in the context of the Lamfalussy Report, Intervention by President Romano Prodi to the European Parliament's Plenary Session, available at <http://europa.eu.int/rapid/pressReleasesAction.do?reference=SPEECH/02/44&format=HTML&aged=1&language=EN&guiLanguage=en> (Feb. 5, 2002).

³⁹ IAS Regulation, *supra* note 19.

proposal. If after checking this is not the case, the proposal fails.⁴⁰ Once the ARC has voted in favour of a proposal, the Commission takes a formal decision to adopt the IAS on the basis of the text voted by the ARC. It has no right to change the standard.

Once a standard has been adopted by the Commission, it is then published in full in each of the official languages of the Community as a Commission regulation in the Official Journal of the European Union.⁴¹ The standards thus become part of Community law, which means that they will also automatically come under the jurisdiction of the European Court of Justice. This process is shown schematically in Annex 4, *infra*.⁴²

In accordance with Article 7(2) of the Regulation, the Commission must report to the ARC in a timely matter if it intends not to propose the adoption of a standard.

If the ARC does not vote in favour of a Commission proposal or has no opinion, the Commission's proposal is sent to the Council of Ministers, which may approve or reject a proposal within three months.⁴³

5. Commission Endorsement of "Carved-Out IAS 39"⁴⁴

So far the ARC has been able to agree to all IASs as proposed by the Commission. A "stable platform" of IASs, including a standard requiring stock options to be expensed in the income statement, is now part of European law.⁴⁵ However, this does not mean to say that the adoption of individual standards has been uncontroversial. Although forty-six Standards and interpretations have been adopted, the standard on the measurement of financial instruments (IAS 39) has been the subject of serious controversy.

Ultimately, it proved possible to adopt IAS 39 but, because of continued concerns voiced by the European Central Bank and supported by

⁴⁰ This additional requirement was introduced at the request of Germany, since qualified majority voting weights are not proportional to the population of a Member State.

⁴¹ European Commission, IASs/IFRSs, SICs and IFRICs adopted by the Commission, available at http://europa.eu.int/comm/internal_market/accounting/ias_en.htm#adopted-commission (Feb. 17, 2005).

⁴² Commission adoption corresponds to the process line on the right-hand-side of the diagram in Annex 4.

⁴³ This situation corresponds to the process lines on the left-hand-side and the center of the diagram in Annex 4.

⁴⁴ David S. Ruder et al., *Creation of World Wide Accounting Standards: Convergence and Independence*, 25 NW. J. INT'L L. & BUS. 513, 577 Part III.E.1 (2005).

⁴⁵ Commission Regulation (EC) No. 211/2005 of 4 February 2005 Amending Regulation (EC) No 1725/2003 adopting certain international accounting standards in accordance with Regulation (EC) No. 1606/2002 of the European Parliament and of the Council as regards International Financial Reporting Standards (IFRS) 1 and 2 and International Accounting Standards (IASs) No. 12, 16, 19, 32, 33, 38, and 39, 2005 O.J. (L 041) 1-3.

the European Parliament, the Commission was only able to adopt a carved-out version.⁴⁶ Its action was justified by very exceptional circumstances. In carving out a few provisions of IAS 39, the Commission was scrupulous to ensure that no additional text was inserted into the carved-out standard. On the other hand, it did not wish to postpone IAS 39 until the IASB was able to resolve the issue. The Commission has no intention of becoming a European standard setter. The technical difficulties with IAS 39 as adopted by the IASB are widely recognized, including by the IASB. The Commission is therefore closely monitoring and encouraging efforts by all parties to arrive at a satisfactory technical solution. It is the Commission's hope that after discussion the IASB will be able to come forward very quickly with a revised standard for IAS 39 that is acceptable to all parties concerned. This would allow the Commission to endorse the full IAS 39, so that the endorsement of the carved-out version would be seen only as a very exceptional and temporary measure.

III. SOME COMMENTS ON THE FUTURE OPERATION OF THE IASB

A. The Need for Democratic Governance and Political Accountability

If there is a silver lining to the cloud caused by the difficulties with the endorsement of IAS 39, it is perhaps the need for an extended re-think of the democratic governance and political accountability of international standard-setters. As an organization, the Commission itself is accountable for its actions to the European Parliament. Madame Berès, the current Chair of the EP Economic and Monetary Affairs Committee, has recently highlighted the political and economic importance of international accounting standards.⁴⁷ While standard setting may be a very technical subject, its impact on the economy and on the behavior of companies is simply too important to be left to standard-setters.

B. The European Union Still Has to Determine Its Definitive Position on IASC Governance

The governance, financing, membership and accountability of international standard-setters, and especially the International Accounting Standards Board, is presently the subject of public debate in Europe. In his address to the EP Economic and Monetary Affairs Committee on February

⁴⁶ This relates to specific provisions concerning the fair-value option and interest rate margin hedging.

⁴⁷ Pervenche Berès, *The Integration of European Financial Markets: What Challenges Ahead?*, Speech at the CESR Conference (Dec. 6, 2004), available at <http://www.cesr-eu.org/>.

1, 2005,⁴⁸ Internal Market and Services Commissioner McCreevy identified three key points for improving the governance of international standard-setters. These are:

1. Representation Should Correspond to the Jurisdictions Directly Applying the Standards

First, representation within the international standard setter and within a public oversight body should correspond more appropriately to jurisdictions that directly apply the standards.⁴⁹

2. Oversight Bodies Should Approve the Work Program

Second, effective oversight bodies should approve the work program of an international standard setter. The work program should take due account of E.U. priorities. If the oversight is effective, management of the organization should improve and confidence should grow. A more welcome approach and more effort to find common ground are needed from the IASB. Decision-making must be free from undue political interference but the standards drawn up by the IASB must meet the needs of users and be in touch with business reality. Broadening the geographical base of IASB members would help. The European Union also needs to encourage top quality people to put themselves forward in this regard. The European Union therefore needs to strengthen EFRAG.

3. Need to Address the Funding System

Third, the funding system must be addressed. Standard-setters are currently sponsored by voluntary contributions from a gamut of contributors ranging from central banks to listed companies. This raises potential issues of conflict of interest. The Commission, therefore, welcomes the intention of the Board of Trustees of the IASB to change the current funding arrangements.

IV. CONCLUSIONS

Five years ago the European Union opted for international, and not for European, accounting standards. About 8,000 listed European companies are now starting to prepare their financial statements using IASs for their

⁴⁸ Internal Market and Services Commissioner McCreevy, Speaking Points to the EP Economic and Monetary Affairs Committee (Feb. 5, 2005), available at [http://www2.europarl.eu.int/registre/commissions/econ/communication/2005/353610/ECON_CM\(2005\)353610_EN.pdf](http://www2.europarl.eu.int/registre/commissions/econ/communication/2005/353610/ECON_CM(2005)353610_EN.pdf).

⁴⁹ *Id.* This could perhaps also be extended to jurisdictions that consider IASs equivalent to their local GAAP.

2005 accounts. The Commission remains fully committed to this agenda because it fosters international convergence of accounting standards, keeps our capital markets attractive for overseas issuers of securities and increases the opportunities for our companies to expand their activities to other economies where IASs are accepted.

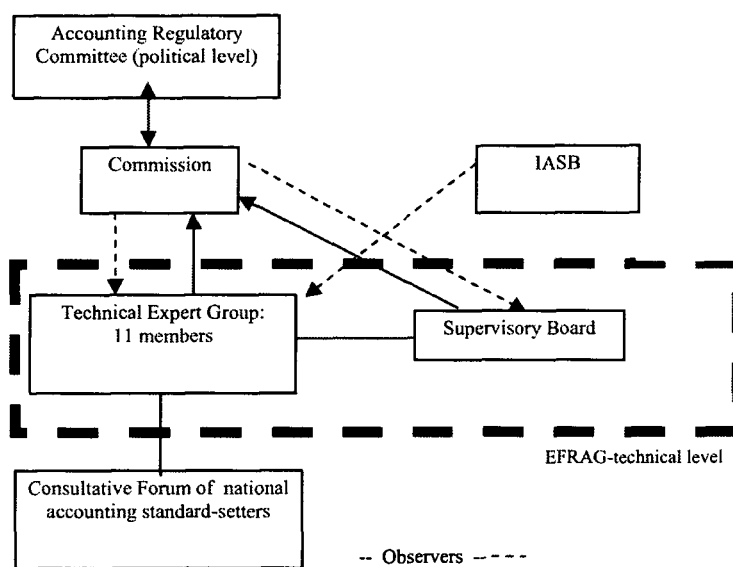
The United States remains the largest capital market in the world. The importance of achieving a balanced convergence between IASs and U.S. GAAP can only grow for businesses on both sides of the Atlantic Ocean, and it needs to be tackled urgently. At the same time, such convergence will also facilitate the mutual decisions we have to take on accounting equivalence in the European Union. Putting the current convergence program between the IASB and FASB on a firm and comprehensive timetable for completion must now be seen as a priority. This would also be a decisive step towards the creation of a single accounting standard that could be used for listing purposes at the global level—an objective to which the International Organization of Securities Commissions (IOSCO) has again recently subscribed.

Last, and by no means least, we need to improve the corporate governance structure of the IASB itself.

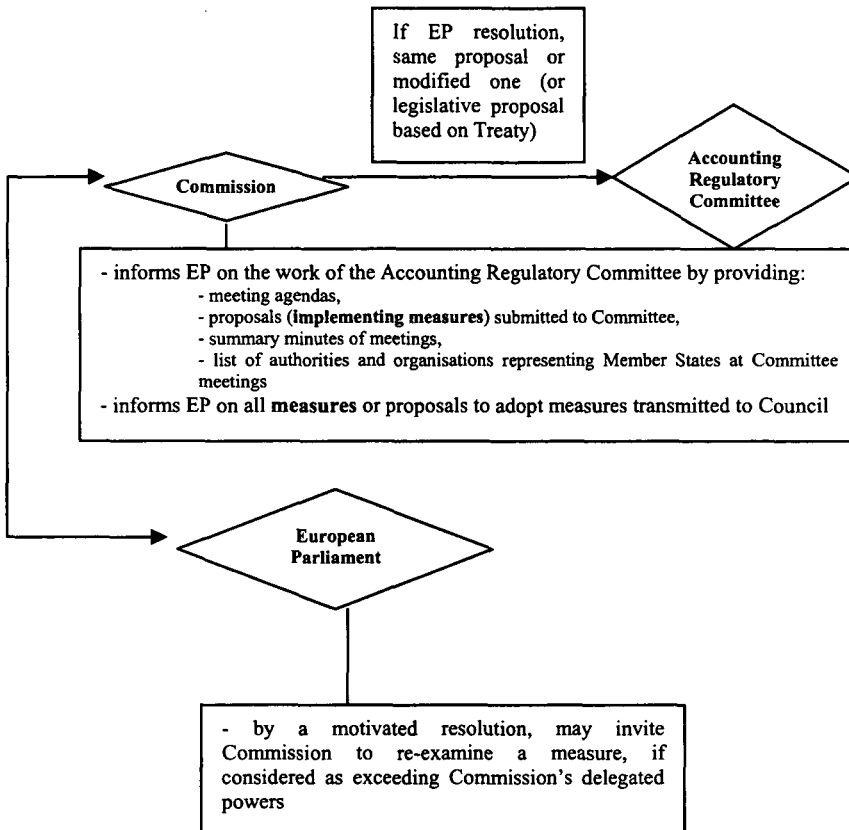
ANNEX 1: STRUCTURE OF EFRAG

EFRAG has been granted the status of liaison standard setter to the IASB by the Board of Trustees. This decision enables EFRAG to attend technical meetings organised by the IASB with a number of privileged national accounting standard setting bodies.

EFRAG meetings are usually attend by one IASB Board member or IASB staff, usually at senior level.



ANNEX 2: POSITION OF THE EUROPEAN PARLIAMENT IN THE
PROCEDURE FOR ADOPTION OF IASs



Motivated resolution means a resolution adopted in plenary session (unless a matter of urgency, in which case it could be adopted by a parliamentary committee).

ANNEX 3: QUALIFIED MAJORITY VOTING TABLE

Member State	Population (x 1000)	% of E.U. Population	Votes
Belgium	10396.4	2.27	12
Cyprus	730.4	0.16	4
Czech Rep.	10211.5	2.23	12
Denmark	5397.6	1.18	7
Espana	42345.3	9.23	27
Estonia	1350.6	0.29	4
Germany	82531.7	18.00	29
Greece	11041.1	2.41	12
France	61684.7	13.45	29
Ireland	4027.5	0.88	7
Italy	57888.2	12.62	29
Latvia	2319.2	0.51	4
Lithuania	3445.9	0.75	7
Luxembourg	451.6	0.10	4
Hungary	10116.7	2.21	12
Malta	399.9	0.09	3
Netherlands	16258.0	3.55	13
Austria	8114.0	1.77	10
Poland	38190.6	8.33	27
Portugal	10474.7	2.28	12
Slovenia	1996.4	0.44	4
Slovakia	5380.1	1.17	7
Finland	5219.7	1.14	7
Sweden	8975.7	1.96	10
UK	59651.5	13.01	29
Total	458599.0	100.00	321
Blocking minority need			90 votes
QMV – Need majority of MS and 72.3% in favour			At least 13 MS and 232 votes
A Member State can ask for confirmation – Need 62% of E.U. population; if not, proposal falls	284331.4		

ANNEX 4: COMITOLGY PROCEDURE IN THE FRAMEWORK OF
THE IAS REGULATION (1606/2002)

