

INTERNATIONAL CONVERGENCE OF ACCOUNTING STANDARDS

A COMMENT ON JEFFREY

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I. INTRODUCTION

The use of different accounting frameworks, which require inconsistent treatment and presentation of the same underlying economic transactions, creates confusion for users of financial statements. This confusion leads to an inefficiency in capital markets across the world, which are increasingly attracting investors and registrants from the global economy. This inefficiency has very real costs, both for registrants, for whom it increases both the cost of compliance and the cost of the capital raised, and for users of financial statements, who must interpret the economic reality portrayed by the particular accounting system. The situation is far from ideal, and Peter Jeffrey has written a valuable analysis of the international harmonization of accounting standards. My comments will focus more specifically on European Union (EU) efforts to harmonize accounting requirements.

II. THE ACCOUNTING DIRECTIVES

The quest for harmonization in Europe commenced in the late 1970s, when the European Community (EC) adopted a series of Directives dealing with accounting matters. The purpose of these Accounting Directives was to align, though not to wholly harmonize, accounting requirements in Europe. Harmonization started with the adoption of the Fourth Council Directive of July 25, 1978 on the an-

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nual accounts of certain types of companies.¹ On June 13, 1983, the Seventh Council Directive, dealing with consolidated accounts, was adopted.² The Council later added other Directives dealing specifically with accounting matters specific to banks³ and insurance undertakings.⁴

Since their adoption, these Directives have remained largely unchanged, and they remain largely consistent with current accounting theory and practice, forming the basis of accounting requirements in Europe today. Countries have since added national requirements, which are part of the law or are the subject of specific accounting standards issued by a national accounting standard-setting body.

III. THE IAS REGULATION

Since the adoption of the Accounting Directives, the complexity of business transactions has increased dramatically. Indeed, entire industries exist which were not envisaged in the late 1970s. At the same time, globalization has continued apace. Multinational groups operate across geographical boundaries and many companies seek funding on the international capital market, from investors both at home and abroad.

In 1995, the European Commission issued a Communication in which it advised Member States to permit global players to prepare their consolidated accounts in conformity with International Accounting Standards (IAS).⁵ The objective of this recommendation was to facilitate access by major European companies to the international capital market.

In 1999, when the national currency of eleven EU Member States ceased to exist in favor of the creation of a common currency, the euro, the European Commission issued a Financial Services Ac-

1. Fourth Council Directive 78/660 of 25 July 1978 Annual Accounts of Certain Types of Companies, 1978 O.J. (L 222) 11, 11.

2. Seventh Council Directive 83/349 of 13 June 1983 Consolidated Accounts, 1983 O.J. (L 193) 1, 1.

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

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

5. Communication from the Commission: Accounting Harmonisation: A New Strategy vis-à-vis International Harmonisation, COM(95)508 final at ¶ 5.6, available at http://europa.eu.int/comm/internal_market/en/company/account/official/acts/701195en.pdf (last visited Mar. 6, 2002).

tion Plan.⁶ The main objective of this plan was to create an internal market for financial services, which would allow European citizens and companies to benefit fully from the introduction of a common currency.⁷ The March 23–24, 2000, Lisbon Council set a deadline of 2005 to implement the Commission's Financial Services Action Plan and urged that steps be taken to enhance the comparability of financial statements prepared by EU-listed companies.⁸

On February 13, 2001, the Commission adopted a proposal for a Regulation of the European Parliament and of the Council on the Application of International Accounting Standards (IAS Regulation).⁹ The proposal sets out the mechanism for recognizing IAS in the EU: it recommends EU adoption of the standards if they are deemed suitable based on specified criteria.¹⁰ Most significantly, the proposal introduces the requirement that from 2005 onwards, all EU-listed companies shall prepare their consolidated financial statements in accordance with the adopted IAS.¹¹ The IAS Regulation also provides an option for Member States to permit or require the application of adopted IAS by unlisted companies and in the preparation of annual accounts.¹² As indicated in the Explanatory Memorandum, which accompanied the proposal for the IAS Regulation, this is an option that the European Commission hopes will be taken up by many Member States, in order to expand the use of IAS in Europe, in particular in important sectors such as banking and insurance.¹³

For European-listed companies, this harmonization is dramatic. It is envisaged that, consistent with the move toward IAS, the European Commission will propose also to add to the Accounting Directives any additional accounting treatments which are permitted under IAS and to remove all remaining conflicts between the Directives and IAS. One such change, relating to the consolidation of Special Pur-

6. Financial Services: Implementing the Framework for Financial Markets: Action Plan 3 (1999), COM(99)232 final, *available at* http://europa.eu.int/comm/internal_market/en/finances/general/actionen.pdf (last visited Mar. 6, 2002).

7. *Id.*

8. Presidency conclusions: Lisbon European Council 23–24 March 2000, ¶ 21, *available at* <http://www.europa.eu.int/council/off/conclu/> (last visited Mar. 6, 2002).

9. Proposal for a Regulation of the European Parliament and of the Council on the Application of International Accounting Standards, COM(01)80 final, 2001/0044 (COD), *available at* http://europa.eu.int/comm/internal_market/en/company/account/news/6941en.pdf (last visited Mar. 6, 2002).

10. *Id.* at 5.

11. *Id.* at 4.

12. *Id.*

13. *Id.*

pose Entities (SPEs), is relevant to the issue of securitizations. Such modifications will modernize the Accounting Directives so that unlisted companies may prepare their accounts in a manner consistent with IAS even if they are not required to do so by the IAS Regulation.

IV. CONVERGENCE WITH OTHER GAAPS

The proposals for the use of IAS and the modernization of the Accounting Directives are a sound basis for harmonization across Europe, but capital markets are global, and a global solution is required. Convergence cannot stop at the boundary of Europe. True international convergence is the responsibility of the International Accounting Standards Board (IASB) and the individual national standard setters. A decision by the EU to adopt all existing IAS would be an important signal to the standard setters in other parts of the world to move in the same direction. Convergence is the process by which standard setters across the globe discuss accounting issues, drawing on their combined experiences in order to arrive at the most appropriate solution. The resulting standards are “best of breed” and can initially be used by individual national standard setters as the bases of new or revised local standards.

Ultimately, such incorporation in local standards may become unnecessary as IAS are applied directly—as will be the case in Europe from 2005 onwards. However, such convergence cannot be a one-way street, and discovery of the best solutions will require effort and cooperation, and perhaps some compromises, from the key standard setters, notably the Federal Accounting Standards Board (FASB) in the United States and the IASB at a global level.

In this regard, the United States plays a prominent role in the new structure of the IASB. Five of the fourteen board members have a U.S. background or U.S. training. In June 2001, the U.S. Congress recognized the importance of international accounting and its importance for the U.S. capital markets.¹⁴ These developments are all positive signs that the forthcoming debates on convergence will be both open and fair.

14. *Promotion of International Capital Flow Through Accounting Standards: Hearing Before the House Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Enters., House Comm. On Fin. Servs.*, 107th Cong. 1, 7 (2001) (testimony of Mr Volcker, Chairman of the Board of Trustees of the International Accounting Standards Committee).

V. SECURITIZATIONS

Securitization is a good example of an area where a convergence debate would be a worthwhile pursuit, as the requirements in IAS are very different from those in the U.S. Generally Accepted Accounting Principles (U.S. GAAP). This debate will be a difficult one. Clearly there are valid commercial reasons for the use of securitizations, such as the transfer of certain risks and as an alternative method of raising capital.

Unfortunately, securitizations are often categorized as somehow unsavory, alongside other arrangements that may result in off-balance sheet treatment. This reputation may be undeserved, but there is more than one corporate collapse where the post mortem has unearthed liabilities that had been treated as being off-balance sheet.¹⁵ Had they been properly recorded in the balance sheet, the true financial situation of the companies concerned might have been better understood and the corporate collapse might have been averted.

A desire to mislead is probably far from the minds of the vast majority of those who use securitization, but it is only proper that standard setters should seek to protect unwary investors through transparent accounting and clear disclosure. Where true changes in the economic position of an entity arise as a result of a securitization, such changes should be reflected in some manner in its accounts. Where there has been no real change this must be clear also from the accounts.

The use of SPEs as a vehicle for securitizations is clearly open to misuse if accounting requirements are not appropriately drafted. Avoiding abuse is particularly difficult where requirements are drafted as detailed rules which the unscrupulous may seek to circumvent. The use of principles is a far more positive manner in which to prevent nasty surprises.

The Seventh Council Directive on consolidated accounts allows consolidation, in the case of effective control, if the parent undertaking holds at least a participating interest in another undertaking or subsidiary.¹⁶ A participating interest requires ownership of at least twenty percent of the share capital.¹⁷ This requirement may make the

15. For example, off-balance sheet transactions played a large role in the collapse of the Enron corporation, making its bankruptcy one of the largest in U.S. history. Daniel Kadlec, *Who's Accountable?*, TIME, Jan. 21, 2002, at 28, 30.

16. Seventh Council Directive 83/349, *supra* note 2, at 1.

17. Fourth Council Directive 78/660, *supra* note 1, at 11. This limit can be set at a lower level.

inclusion of an SPE in the scope of the consolidation difficult. The requirements of the Seventh Council Directive will be amended in the course of the modernization proposals in order to permit the consolidation of SPEs.¹⁸ As a result, consolidation of such entities will be possible where control exists, even if there is no traditional equity investment in the entity.

The approach underlying the requirements of the Standing Interpretations Committee (SIC) Pronouncement Number 12 (SIC 12) is similar.¹⁹ In accordance with SIC 12, an SPE must be consolidated if an enterprise has in substance control of the SPE.²⁰ Such control may exist even in cases where an enterprise owns little or none of the SPE's equity.²¹ Rather than listing criteria that must be fulfilled before consolidation can take place, SIC 12 states that the application of the control concept requires, in each case, judgement in the context of all relevant factors.²²

There is no doubt that the drafting of SIC 12 can be improved to explain more clearly those factors which are relevant and the respective emphasis that they should receive. This may, however, also require a rewrite of IAS 27.²³ By further elaborating the control concept underlying consolidation, such a revision should help in answering some of the questions raised by securitization.

VI. CONCLUDING OBSERVATIONS

Accounting standards should not affect the rationale for undertaking transactions. I would not agree that this objective can be qualified as "naïve." Companies should seek to make "real" profits and generate real wealth. Accounting standards should keep the score. Time and effort spent creating "accounting profits" is at best a distraction and at worst may be at the expense of real wealth creation. We should therefore seek accounting standards which are neutral—

18. See discussion *infra* Part V.

19. STANDING INTERPRETATIONS COMMITTEE PRONOUNCEMENT NO. 12: CONSOLIDATION—SPECIAL PURPOSE ENTITIES (1998), *reprinted in* INT'L ACCT. STANDARDS COMM., INT'L ACCT. STANDARDS 2001, at 1385.

20. *Id.* ¶ 8, *reprinted in* INT'L ACCT. STANDARDS COMM., INT'L ACCT. STANDARDS 2001, at 1385, 1386.

21. *Id.*

22. *Id.* ¶ 9, *reprinted in* INT'L ACCT. STANDARDS COMM., INT'L ACCT. STANDARDS 2001, at 1385, 1386–7.

23. INT'L ACCT. STANDARD 27: CONSOLIDATED FIN. STATEMENTS AND ACCT. FOR INVESTMENTS IN SUBSIDIARIES (2000), *reprinted in* INT'L ACCT. STANDARDS COMM., INT'L ACCT. STANDARDS 2001, at 673.

measuring performance without affecting it. Reflecting business reality in accounting standards is not always easy, especially when new types of transactions are taking place that are difficult to capture with traditional accounting concepts.

Particularly in the field of securitization, there is a risk that a financing technique is being misused with a view to excluding items from the balance sheet which effectively remain liabilities of the reporting entity. Recent developments in the United States concerning Enron²⁴ have shown that, if harmonization in the field of accounting for securitizations is to result in improved accounting for such transactions, the solutions presently retained in U.S. GAAP are certainly not sufficient as derecognition can be argued to occur at a point where a significant element of the risks and rewards of the underlying assets, and therefore the liability, remains with the company entering into the securitization.

24. See Kadlec, *supra* note 15, at 34 (arguing that the current Enron scandal will likely result in substantial changes for the accounting industry).