The introduction of International Financial Reporting Standards in the European Union

An interim report

"Management is central to any discussion of financial reporting, whether at the statutory or regulatory level, or at the level of official pronouncements of accounting bodies."

Maurice Moonitz, 1974

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Inaugural Lecture

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by

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Rector Magnificus,
ladies and gentlemen,

Introduction

As you have probably gathered from your invitation to this event, what I would like to present to you this afternoon is an interim report on the mandatory application of International Financial Reporting Standards (IFRS) in the European Union. I think my choice of theme will surprise none of you. After all, both in my scholarly work and in my various other activities I have been involved with the adoption of IFRS in many different ways, in particular in my capacity as a preparer of financial statements. So let me start by making a confession. My perception of the adoption process has been a very mixed one. At some points I was an enthusiastic advocate of this major step forward in European financial reporting history, but at other times I was close to desperation and felt more like a victim of a plethora of pointlessly detailed rules and incomprehensible directives, drawn up by standard-setters, supervisory bodies and auditors.

Since I will frequently speak about financial reporting in the rest of this speech, I think it is appropriate to give a brief definition of what I mean by the term. I define financial reporting as the process by which companies provide their stakeholders with information about their economic position and the course of business. This information will enable stakeholders to form a judgment on the company's past performance and make assumptions regarding its future performance. A company's financial statements are an important source of such information, but not the only one. In order to ensure that the information that the stakeholders need is included in the financial statements and that the meaning and content of this information is clear to the user, use is made of Accounting Standards, also called Reporting Standards. These are rules defining what information a company should include in its financial statements, how this information should be presented and what the various information elements express. This means that accounting rules not only secure the accessibility and comparability of financial data but also provide a framework on the basis of which an independent auditor can verify the completeness and accuracy of the information provided. One of the organizations establishing these standards is the London-based *International Accounting Standards Board* (IASB). Let me briefly summarize what I would like to discuss today.

In 2002 the European Parliament decided that from 2005 onwards all listed companies in Europe should prepare their annual financial statements on the basis of *International Financial Reporting Standards* (IFRS) issued by the IASB. First, I will briefly discuss the main drivers behind this decision, the objectives and the way in which the change process proceeded. In doing so I will also discuss the establishment of the standards and the role of the organizations involved in this process. Next, I will discuss the initial experiences. Most of the EU-listed companies have published three annual financial statements since the introduction of IFRS. I will discuss whether the initial expectations have been fulfilled and what we can learn from the transition process. In making this analysis it should be noted that the introduction of IFRS was one of the biggest changes in the accounting history of Europe. Three years is too short a period to reach a final conclusion. This is one of the reasons why I am considering this an interim report: it is too early to draw final conclusions and the change process is not over yet. In parallel with the initial adoption of the standards, over the past few years several important changes have taken place in the way the standards are implemented and in the field of international harmonization. In 2005 Europe introduced a set of core standards that formed a fairly consistent and complete package. These were regarded as a firm basis for high-quality financial reporting. Meanwhile, this package has become subject to change and the institutional framework for further development has also changed in a major way. Against this background I will discuss whether the experience gained so far indicates that Europe is capable of meeting the objectives originally aimed at with the introduction of IFRS or whether additional changes or supplementary measures will be needed. In other words, does the interim review provide sufficient confidence that the final balance will be positive, or will further steps be needed? I will discuss both the regulatory framework and the role that academic research can play in this context.

Why IFRS?

As early as the 1990s, Europe had come to the conclusion that transparent, comparable and reliable financial information was one of the necessary building blocks for an efficient and integrated European capital market. At the same time, it was concluded that European Directives were not very effective instruments to ensure international harmonization of the accounting practices in the various member states. One of the objectives of the Treaty of Rome signed in 1957 had been to ensure free movement of capital. Free movement of capital required a transparent and uniform capital market, which would bring considerable benefits: a better competitive position of the European market, a lower cost of capital for European industry and greater liquidity of the market. A second reason why comparability and harmonization were important was the fact that European companies wanting to gain access to major capital markets outside Europe were unable to use their local financial statements for this purpose. They needed to provide additional information, which in most cases had to be based on *United States Generally Accepted Accounting Principles* (US GAAP). It was thought that the introduction of IFRS might resolve this problem as well.

Before the introduction of IFRS, accounting standards were the responsibility of the individual member states of the EU. European Directives provided the framework, but within that framework every country had its own rules, usually drawn up by national standard-setters, which in some countries were government bodies and in others were based on private initiative. The objectives differed from one member state to another. In a number of countries, including the Netherlands, the primary goal was to provide information to stakeholders, while in other countries the objectives were strongly linked to the determination of profit or loss for tax purposes and the protection of creditors[1]. To varying degrees, the national standard-setters sought to comply with the standards issued by the IASC, the predecessor of the IASB. Other differences arose from the fact that a number of member states formally or informally allowed their companies to apply international standards (in particular US GAAP or *International Accounting Standards*, the predecessors of IFRS) instead of the national standards. All in all, the situation was quite complex, and it was a major challenge for investors and analysts to understand the heterogeneous data in annual reports and translate these into sensible comparisons and investment choices.

The EU only had a limited number of options to arrive at a single set of high-quality accounting standards[2]. A fundamental revision of the accounting Directives was deemed to be too politicized and time consuming. Creating an independent European standard–setter to draw

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[1] For an in-depth discussion see Nobes and Parker (2004).

[2] Van Hulle (2004) provides a good overview of the EU decision making process.

up uniform rules for European companies seemed a logical option but was not practicable because of the large differences between member states in terms of tradition, institutional setting and objectives for financial reporting. Adopting American standards was inconceivable for political reasons, because it would be tantamount to outsourcing part of Europe's legislation to the US and subjecting it to the supervision of the US Congress. The only realistic alternative was to opt for a standard-setter that was truly international and independent and in addition had a fairly complete set of standards for high-quality financial reporting: the IASB.

The IASB was established in April 2001 as the successor to the International Accounting Standards Committee (IASC). Whereas its predecessor was originally established by the auditing profession and closely associated with the International Federation of Accountants, the IASB is an independent body governed by a Board of Trustees and funded from contributions that are collected by the IASC Foundation. The Trustees are responsible for raising the required financing and for the appointment of the members of the International Accounting Standards Board (IASB), the International Financial Reporting Interpretations Committee (IFRIC) and the Standards Advisory Council (SAC). The SAC is an advisory body whose members have backgrounds in various stakeholder groups. They are expected to suggest topics for the IASB agenda and provide input on IASB proposals. The actual standard-setting and the determination of the technical agenda are responsibilities of the Board, which is supported by technical staff based in London. IFRIC deals with questions from constituents on how to interpret standards and issues interpretations in cases where the standards are not consistently applied. In setting standards the IASB applies a due process that requires as a minimum exposure of new standards for public comment and deliberation of these comments before finalization of the standards. The meetings of the Board are open to the public in order to increase the transparency of the standard-setting process. The IASB adopted the original standards of the IASC when it was established and has in the meantime issued eight new International Financial Reporting Standards (IFRSs) and amended a number of the existing IASs[3].

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[3] Camfferman and Zeff (2006) and Kirsch (2006) provide historical overviews of the work of the IASC up to the creation of the IASB. Whittington (2005) discusses the structure, role and program of the IASB.

In 2002 the European Parliament adopted Regulation 1606, which obliged EU-listed companies to prepare their annual financial statements on the basis of IFRS from the financial year 2005[4] onwards. Since European Regulations are imperative rules of law for all member states, they ensured a uniform and simultaneous introduction of this obligation for all listed companies in Europe. According to the preamble to the Regulation, the main objectives of the adoption of IFRS were the following:

1. transition to a single set of international standards for high-quality financial statements,
2. sufficient guarantees for a high degree of transparency and comparability of financial statements, and
3. creation of a level playing field for European companies on both the European and global capital markets.

It was considered important that various international accounting standards ultimately converge into a single standard applied worldwide. EU-listed companies and their auditors thus had their work cut out for them; they faced one of the biggest challenges in accounting history and could now embark on an intensive preparation process that should ultimately contribute to an efficient and cost-effective European capital market.

In one important respect, the Regulation represented a breakthrough. In most European member states, accounting rules were derived from national legislation, which was based on the fourth and seventh EU Directives, often complemented with rules issued by a national accounting standard-setter. In this way, parliamentary control over the content of accounting rules anchored in national legislation was embedded in the structure. Even in those member states where an important part of the standards had been issued by private-sector standard-setters, parliament would at all times be able to intervene in the legal framework, both at the national and at the European level (fourth and seventh Directive). By contrast, IFRSs are developed by the IASB, which is an autonomous private-sector body that wants to be independent of politics and stakeholder interests. Its objectives are:

1. to develop, in the public interest, a single set of high quality,

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[4] The Regulation offered member states a number of options to exempt certain listed companies from the obligation until 2007 (see Sampers 2004[b]).

understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions,
2. to promote the use and rigorous application of those standards, and
3. to bring about convergence of national accounting standards and International Accounting Standards and International Financial Reporting Standards to high quality solutions.

These are the objectives according to the Preface to IFRSs (IASB 2008). It will be clear that the objectives of the IASB largely coincide with those of the Regulation and that it was therefore quite logical to opt for the IASB.

The Regulation made the IASB standards into law for all EU-listed companies. However, there was no parliamentary control whatsoever over the work of the IASB. Because of this fact, a retroactive assessment was included in the Regulation. The IASB standards will only become mandatory in Europe after it has been established that they meet the requirement of presenting a true and fair view, as laid down in the fourth and seventh EU Directives, that they are conducive to the European public good and that they meet the criteria of clarity, relevance, reliability and comparability of financial information (Van Hulle 2005, Van Helleman and Van der Tas 2004). In order to be able to establish this, the so-called endorsement process was included in the Regulation. The European Commission was initially given the task of establishing whether the standards met the above-mentioned criteria, endorsing them and informing the European Parliament and the Council of this.

Retroactive endorsement does create a certain democratic guarantee but it also raises a number of questions. Is the European Commission capable of effectively assessing the quality and consequences of these standards, which are often complex and voluminous? And what should be done if the result of such an assessment is negative? After all, if a standard has already been adopted by the IASB, it can be difficult (or even impossible, given the independent status of the IASB) for the European Commission to force the IASB to make the adjustments that are necessary for endorsement. In response to the first question, the private sector in the EU has taken a number of initiatives. In 2001 the *European Financial Reporting Advisory Group* (EFRAG) was established by European organizations representing the interests of providers, users and auditors of financial statements. EFRAG's mission is to proactively contribute to the development of new IASB standards from a European perspective, to provide technical advice as a basis for European endorsement of standards and to contribute to a consistent use of the standards in Europe. In doing so, EFRAG also aims to unite the national standard-setters in Europe and thus increase their influence. At the government level in the EU, an *Accounting Regulatory Committee* (ARC) has been established as a consultative platform for endorsement decisions by the Commission. All member states are represented in this platform. Moreover, in order to have assurances that no standards will be developed that are contrary to the European endorsement criteria, Europe has concluded agreements with the Trustees of the IASB about the consultation process to be followed in the development of standards and has gained the position of *observer* within a number of IASB bodies.

However, during the approval process for the core set of accounting standards that were to come into force from 2005 onwards, it immediately became clear that this solution was less than ideal. With regard to IAS 39, the standard that deals with the recognition of financial instruments in the annual accounts, there were major doubts as to the desirability of a number of clauses of the standard. I will not discuss the technical merits of these doubts here[5], but I do want to discuss the consequences. In November 2004 the EU decided to endorse the standard only partially and to 'carve out' some paragraphs. This meant that the set of standards that became mandatory for 2005 deviated from the complete package provided by the IASB.

The year 2005 is now behind us, and more than 7,000 European companies have published their first IFRS-based annual accounts. Outside Europe, too, more and more countries are changing over to IFRS. The question is: to what extent have the original objectives been achieved?

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[5] A discussion of the debate is provided by Walton (2004).

Initial experiences

Research on the effects of the mandatory introduction of IFRS in the EU and other countries is still in its infancy. IFRS-based financial statements are available for three financial years, but a thorough analysis of these statements will take a great deal of time. In particular, it will take a few more years to study the capital markets' response to the adoption of IFRS. Still, the data gathered so far is sufficient for an interim analysis. Fairly soon after the publication of the financial statements for the financial year 2005, initial evaluations were carried out and the results published. The virtually unanimous conclusion is that the introduction has not resulted in any loss of confidence in the quality of financial reporting (CESR 2007, Ernst & Young 2006). During a symposium at the University of Kobe in Japan in March 2006, I summarized the conclusions as follows. "The changeover to IFRS brought a great deal of work for EU-listed companies and their auditors, but it has otherwise been a success. The capital markets were not disrupted, and for many companies the impact of the adoption was limited because they had timely (that is, in anticipation of the publication of their financial statements for 2005) communicated with the market about the consequences that were to be expected from the changeover to IFRS." Moreover, it is widely acknowledged that the introduction has led to an improvement of the quality of financial reporting and has resulted in greater transparency and comparability. In a study by Ernst & Young (2006)[6], for example, it was established on the basis of an analysis of 65 financial statements that the introduction had been a big success and that practically all companies involved were able to publish their first IFRS-based reports on a date comparable to the date on which they used to publish their previous annual reports under national standards. In addition, it was found that the amount of information provided had clearly increased and that the information met the requirements of the standards. Moreover, the study concluded that the financial reports still projected a national identity, in other words that the companies concerned, while complying with the IFRS rules, still remained more or less faithful to their country-specific practices and traditions. Although in itself this development can limit the comparability of financial statements, it is not by definition a bad thing. It fits in with the concept of principle-based standards and facilitates comparison with reports from previous years. It is to be expected that presentations will converge

6 Similar findings are reported in KPMG 2006 and ICAEW 2008.

in due course because companies will increasingly seek to adopt the best practices that will emerge as a result of the improved comparability.

A more fundamental question, however, is whether the introduction of IFRS has also resulted in the envisaged improvement of the liquidity of the European capital market and whether it has reduced the cost of capital for European companies. Only provisional conclusions can be drawn on this point. A limited number of studies have been published on this issue so far, and their conclusions sometimes diverge. A number of studies (Comprix et al. 2003, Armstrong et al. 2006) into the effects of decisions that increased the likelihood of the adoption of IFRS in Europe provide initial – positive – indications that the capital market will respond in the desired manner. A Study by Armstrong and others into the responses of the European stock markets to 11 events surrounding the adoption of IFRS in Europe shows that the capital markets indeed responded in a positive manner (in that the cost of capital decreased) to decisions that increased the likelihood of the adoption. It is interesting to note that the publication of EFRAG's positive endorsement advice in June 2002 was the event that made the single largest positive contribution. For the EFRAG representatives who are present here today it will be reassuring to see that the importance of their work has been recognized by the market. These are studies that preceded the actual adoption.

The results of the first studies into the actual effects of the adoption are now beginning to become available. These include studies that measure the actual impact of the adoption of IFRS on the basis of specific performance indicators or ratios (Aisbitt 2006, Knoops and Vergoossen 2006, Jaruga et al. 2007). Although interesting in themselves, these studies are primarily descriptive in nature and do not provide insight into the degree to which the adoption has actually met the original objectives of the EU. The results of studies into the opinions of preparers and users of financial reports on the adoption of IFRS present a mixed picture. A number of preparers have voiced negative opinions about the increased complexity and volatility of performance data reported on the basis of IFRS (see for example ICAEW 2007). However, the advantages regarding comparability and transparency are generally acknowledged (CESR 2007, Ernst & Young 2006, ICAEW 2007 and MEDEF 2006). In the endorsement phase there were already critical comments about the complexity aspect, and these comments keep recurring from time to time. Moreover, it remains to be explained why, despite the improved transparency, the market can apparently still be surprised by events and risks (the credit crisis being the most recent example).

One of the first studies (Daske et al. 2007[b]) into capital-market responses to the mandatory adoption of IFRS was published at the end of last year. In this study, the effect of the mandatory first-time adoption of IFRS on liquidity and market capitalization was investigated for more than 3,800 companies in 26 countries. The conclusion was that there were indeed significant improvements in market liquidity and increases in equity valuation. Although this kind of research is still in its infancy, which is only natural given the recent introduction of IFRS, first studies suggest that the adoption of IFRS has resulted in an increase in the market capitalization of listed companies, an improvement in the quality of financial reporting and a positive assessment of the information by users[7].

It would thus seem that Europe can look back on the changeover to IFRS with some satisfaction. However, this conclusion needs to be qualified. Daske et al. (2007[b]) have also established that there are considerable differences between countries and that the benefits are realized only in those countries that have a system for strictly enforcing high-quality financial reporting and where there are strong reporting incentives. With regard to the latter aspect, it is important to note that IFRS, like any other accounting standard, allows information providers considerable freedom of choice, and that the application of the standards requires estimates and choices from management. This means that management can choose to apply the standards in such a way as to strictly comply with the rules (in other words, adopt a minimal approach). But management can also choose an approach resulting in the most informative form of financial reporting for their company. In the latter case, the capital market's response can be expected to be more positive, and this is indeed found to be the case. Whether or not companies opt for the most informative form of financial reporting depends on the legal environment in which they operate, the functioning of the capital market and company-specific characteristics. Obviously, companies that frequently turn to the open capital market for funding will attach more importance to transparent reporting than companies that are

7 For an overview of these studies see ICAEW (2007).

contemplating leaving this market in order to be relieved of all kinds of obligations in the field of financial reporting and governance. So it is not the changeover to high-quality reporting standards – in this case IFRS – that generated the capital market's positive response, but a combination of this changeover with other factors. These findings are in line with other studies which have shown, for various accounting regimes, that the supervisory framework and the presence of reporting incentives influence the quality of financial reporting[8]. For the decision-makers in Europe this means that it takes more than just the adoption of IFRS to achieve the objectives of Regulation 1606/2002.

As noted earlier, one of the requirements included in Regulation 1606/2002 was the convergence of different accounting standards. In particular, it was thought to be important to reduce the differences between IFRS and US GAAP so that, in the long term, European companies producing IFRS-based financial statements would have access to the US capital market. Major progress has been made on this front. In 2002, the IASB and the American standard-setter FASB concluded the so-called Norwalk Agreement on measures to eliminate the differences between the two GAAPs. On the basis of this agreement, the two organizations have jointly developed a number of new standards and several changes have been implemented, especially in IFRS, to achieve harmonization. This step was not induced by the EU's requirements, though. At their own initiative, IASB and FASB had been looking for ways to develop a globally applicable set of accounting standards, and since it was not to be expected that either of the two would become the dominant standard in the near future, they opted for collaboration and convergence, with the joint aim of developing high-quality accounting standards. In other words, it was not a case of convergence to existing solutions but to new solutions, which were deemed to be better than the solutions existing at the time under the two GAAPs. This is one of the explanations for the large number of changes that have been made (and are still being made) to the standards. Companies are not altogether happy with this. The large number of changes and their rapid succession entail considerable implementation costs and reduce the comparability of financial information over time. Moreover, in a number of cases convergence appears to be used as a cover for realizing theoretical 'pet ideals' cherished by the IASB and the FASB. However, the steps that have

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8 See Soderstrom and Jialin Sun (2007) for an overview.

been taken so far were necessary to secure a positive assessment of IFRS reporting by the SEC, the US stock market regulator.

The ultimate result of all this was that it became easier for European companies to gain access to international capital markets. Access to the US market is particularly important, as this is a liquid market that European multinationals frequently use to obtain both equity and debt. In the past, these companies needed to prepare financial statements based on US GAAP or provide a reconciliation to US GAAP (in which equity and profit or loss under their own accounting standard were restated according to US GAAP) in order to gain access to this market. This was costly, because it meant that these companies' accounting systems needed to accommodate two standards that differed in many respects. The SEC has examined the first IFRS-based financial statements from European companies that are also listed in the United States. It established that although there were differences in the application of the standards that gave rise to questions and comments, these differences were of a similar nature and magnitude as those occurring in the application of US GAAP (SEC 2007[b], p. 26). On the basis of these and other findings, and the progress made in the convergence process, the SEC decided last year that non-US companies that prepare their financial statements on the basis of IFRS established by the IASB have access to the US market without having to provide any further reconciliation. This accommodation applied to financial statements for financial years ending after 15 November 2007, which meant that most European companies listed in the US were able to take advantage of it this spring already. This is definitely a major step forward, and a very real benefit of the introduction of IFRS. In the longer term, the SEC aims to go even further by allowing US companies to prepare their financial statements on the basis of IFRS. In the US, as in Europe, the aim is to work towards a single set of globally accepted high-quality accounting standards, and according to the SEC these standards should be IFRS (Cox 2008 and also White 2008). It can be concluded that the EU has largely achieved the objective of Regulation 1606/2002 with regard to international recognition of the financial statements of European companies, although the SEC does not acknowledge the EU carve-out and will only grant exemption for financial statements in which the full set of IASB standards has been applied.

Of course, the benefits that are being realized did not come for free. Companies have had to make considerable efforts to meet the new reporting requirements and auditors and analysts too have had to invest a great deal of time and money in training and new working methods. The ultimate cost of the entire transition process probably cannot be measured in any reliable way. According to a study into the introduction of IFRS commissioned by the EU (ICAEW 2007) the cost of the first adoption of IFRS is estimated at 0.05% of sales for companies of the size of DSM (the global Life Sciences and Materials Sciences company headquartered in the Netherlands), with the annually recurring costs amounting to 0.008% of sales. These are small percentages, but if we consider that DSM's sales in 2007 amounted to almost 8.8 billion Euros, the cost of the transition to IFRS was more than 4 million Euros and the annual extra costs amount to more than 700,000 Euros. These sums are considerable and justify the question whether all these efforts have indeed brought the benefits that the EU envisaged.

Mid-term review

Given the initial evidence suggesting that the adoption of IFRS has indeed contributed to the realization of the objectives set by the EU, one would expect the government bodies in Brussels and Strasbourg to look back on the implementation of Regulation 1606/2002 with satisfaction. However, this is only partially the case. The European Parliament acknowledges that the introduction of IFRS has increased the European capital market's transparency and strengthened its competitive position (European Parliament 2008). It notes that the consistent application of the standards in the EU is essential for securing the comparability of financial reporting in the long term. By contrast, the role of the IASB as standard-setter is viewed less positively. The fact that carve-outs were necessary to enable the adoption of IAS 39 in Europe strained the relationship between Europe and the IASB as early as the preparatory stage. And the fact that only a partial solution has been found to date certainly does not help to ease the tension. In addition, Europe is concerned about a number of interpretations of standards and suggestions for amendment. The IASB had to withdraw the IFRIC interpretation that dealt with CO_2 emission rights, following widespread criticism of the consequences that this interpretation would have for financial reporting. The parties involved were of the opinion that although the interpretation fitted in with the existing IFRS rules, the resulting accounting practices would not meet the criteria for high-quality reporting. Besides these content-related criticisms, there are also a number of governance-related issues. These include the fact that the Trustees, who supervise the Board, are self-appointed, that the Board can independently draw up its work program, that Europeans are underrepresented in the various IASB bodies and that the IASB poorly responds to the critical comments it receives in the consultation process. These points of criticism do not just come from the European Parliament (European Parliament 2008); interest groups representing the providers, users and auditors of financial reports also keep demanding better governance, greater transparency and a more open ear to stakeholder concerns.

At the European level, this constant dissatisfaction has led to a number of adjustments to the endorsement process. The roles of the European Parliament and the European Council have become more important. New standards and interpretations now need explicit approval from the European Parliament and the Council in order to be endorsed. The very first standard to be introduced under this new regime – IFRS 8, addressing *Operating Segments* – gave rise to problems. The European Parliament wondered whether it was sufficiently clear what consequences the new standard would have for European industry and for the quality of financial reporting. To remove concerns about this, the staff of the European Commission had to investigate the potential effects of the new standard in order to enable its final approval by the European Parliament. As a result, the IASB is now under increased pressure to carry out impact assessments for new standards at an early stage. In those cases where it does not carry out such an assessment, the European Commission will need to do this afterwards, in collaboration with EFRAG. Obviously, this will not facilitate a rapid endorsement. Moreover, in March 2007 the Standard Advice Review Group (SARG) was established to review the process by which EFRAG establishes its endorsement recommendations. The aim is to secure the objectiveness and impartiality of the advice provided by EFRAG – a private organization that is outside the direct control of the EU.

It will be clear that these developments have not exactly made the European endorsement process easier. Both the time required for the process and the risk of standards or interpretations being rejected have increased, and this is harming the efficiency of the European market. Moreover, there is the risk that dissatisfaction with new standards will lead to rejection or partial rejection of a standard or interpretation, as a result of which the IFRS applied in Europe would deviate even more from what can be called *full IFRS*. It seems that Europe is facing an unsolvable dilemma here. The preparation of accounting standards has been delegated to an independent organization that operates outside the control of the European Parliament and the European Council, and the standards set by the IASB can only be endorsed or rejected. To break this dilemma, Europe needs to ensure that at an early stage, when a new standard is still in preparation, it becomes clear where Europe's interests lie and what Europe's thoughts are about the issues at hand. EFRAG recognized this need at an early stage and started a number of proactive projects that are not linked to endorsement advice. In collaboration with several European accounting standard-setters EFRAG is publishing discussion papers, under the banner of *Pro-active Accounting Activities in Europe* (PAAinE), on topics that the IASB is working on or will be working on in the near future. These papers are intended to promote public discussion about these topics at an early stage of the standard-setting process before the IASB issues its first proposals. The aim is to formulate a European point of view that derives its authority from the quality of the technical arguments and public debates. In October 2006 the first discussion paper on elements of the Conceptual Framework appeared (EFRAG 2006[a]), and in the meantime another four papers have been published. The papers deal with important topics such as the recognition of pensions (EFRAG 2008[b]) in the financial statements and the distinction between equity and liabilities (EFRAG 2008[a]). It is too early to determine whether the IASB is actually using this input, but at any rate Europe cannot be accused of passively waiting for whatever the IASB comes up with.

Besides this initial thought-formulation process, it is also important that all European stakeholders (information providers, users, auditors, standard-setters and political organizations) make a contribution to the consultation process forming part of the development of new standards and interpretations. If this can be achieved, and the IASB is willing to listen to valid and technically underpinned opinions from Europe, it should be possible to avoid having to use the non-endorsement of a standard as a last-resort measure. In this context, the European Parliament has rightly urged the IASB to improve its governance structure and to be more transparent about how it deals with the outcome of the public consultation process that it is obliged to follow in setting new standards.

However, there is more to be done. The European Parliament should also ensure that Europe has a sufficiently powerful say in the early phase of standard-setting. The private sector has taken the lead in this respect, with EFRAG and the European accounting standard-setters demonstrating that they are capable of providing high-quality input in the development of new International Financial Reporting Standards. However, the quantity and complexity of the topics to be addressed are growing exponentially. Therefore, the European infrastructure urgently needs to be reinforced in order to be able to keep pace with the innovation drive of the standard-setters in London. The EU will need to participate in the financing and governance of EFRAG in order to secure the quality of the European input.

Some claim that the EU's role should remain limited to an assessment of the reasonableness of the standards set by the IASB (Vergoossen 2007, see also Kloeze 2008). I only partially agree with this. It is evident that Europe should not reject standards at a late stage, when they have already been adopted by the IASB. But such a situation can only be avoided if Europe participates in the standard–development proces at an early stage and if the IASB takes this input seriously. It is an important task of the European Council and the European Parliament to ensure that these conditions are fulfilled. It would be wrong to assume that accounting standards are just technical rules prescribing how economic phenomena should be reported. The standards influence economic decisions, and new standards lead to changes that influence the economy. Studies conducted here in Maastricht have shown that one of the factors that have led to recent changes in the pension schemes of Dutch companies was the introduction of IAS 19, which regulates how pensions should be recognized in financial statements (Hassink et al. 2007). The accounting standard was probably not the most important reason for the changes but it did play a role. Also, it has been found that many Dutch companies have changed their financing because of the way in which certain preference shares are accounted for according to IFRS (Jong, de et al. 2006). This does not mean that these standards are wrong or undesirable, but it does indicate that new accounting standards influence the economy and are therefore politically relevant. That is why parliamentary control is called for. As I argued earlier, the European Parliament should play a proactive and enabling role. Rejection of established standards is incompatible with the objectives of Regulation 1606/2002.

Another aspect requiring attention is the consistent application of the standards. As I indicated before, IFRS-based financial statements still contain elements of national reporting traditions. This is a good thing as long as the resulting differences remain within the requirements of the standards, because it enables companies to better align their reporting practices with the economic and legal environment in which they operate. After all, there are still considerable differences in this area between the various member states. Stock market regulators, including the Netherlands Authority for the Financial Markets, actively monitor the correct application of IFRS by EU-listed companies. This monitoring role is primarily the responsibility of the member states. Regulators and other stakeholders can go to a national court to force a company to modify its financial reports. Both the actions of the regulator and the rulings of the competent court in matters relating to financial statements can lead to additional interpretations of the way in which IFRS should be applied. Therefore there is a real danger of differences arising between *full IFRS* and the rules applied in Europe. The European stock market regulators recognize this danger and have set up an alignment mechanism within CESR, their European organization, to guarantee consistency and prevent local interpretations from developing. Whether this will be effective remains to be seen. It is conceivable that concerted actions by the regulators will ultimately produce a set of supplementary application rules that will lead to a European variant of IFRS. Court actions hold a similar danger. An interesting question is to what extent the ruling of the Enterprise Section of the Amsterdam Court (Ondernemingskamer 2007) in the Netherlands (and at a later stage the Dutch Supreme Court) in the proceedings initiated by the Netherlands Authority for the Financial Markets about the financial statements of Spyker Cars will be relevant to companies in other member states. Especially if these courts make argumented rulings as to whether or not certain IFRS rules were correctly applied, this will result in supplementary regulations that Dutch listed companies will at any rate have to comply with. This, too, can lead to the development of local IFRS variants, even when the EU endorses and adopts all standards and interpretations of the IASB. In the longer term, this might stand in the way of the realization of the objectives of Regulation 1606/2002. In the years to come it will definitely need to be investigated how regulatory and legal actions influence the application of IFRS. Policy makers in the EU should consider whether further harmonization of both enforcement and legal procedures is needed to avoid the development of European IFRS.

As I indicated earlier, the IASB and the FASB are working hard on the convergence of their standards. This, and the fact that the SEC has explicitly indicated that it would like to see IFRS become the world standard in the long term, raises the question whether there will be any need for accounting standard-setters other than the IASB in the long term. In Cannon Street in London the prevailing opinion is no doubt that there is no such need, while in Norwalk in Connecticut the preferred option may well be a merger between the FASB and IASB. However, both options are questionable[9]. In the first place, there will continue to be major differences between economies and markets across the world. Therefore, there will continue to be a need for local and regional input in the standard-setting process. As I have indicated earlier, EFRAG and national standard-setters have an important role to play in this respect, and the same goes for their counterparts in other countries and regions. In the second place, competition promotes innovation and efficiency. For this reason, too, other standard-setters should continue to exist alongside the IASB. A normative model from which high-quality accounting solutions can be derived does not exist, and it is very difficult for standard-setters to find out what information the users of financial statements actually need. Changes and innovations need to be evaluated in practice, and sometimes these evaluations reveal that a change or innovation does not work out in the manner envisaged. In such an environment, standard-setters who collaborate but retain their own identity can make a valuable contribution. This need not compromise the transparency and comparability of financial statements. In addition to companies that tap the open capital market, there is a large group of reporting entities that need to provide financial information even though they are not listed, for which standards are needed. Policy makers should ask themselves whether it might perhaps be necessary to deliberately limit the scope of the IASB's activities to companies that tap the international capital market, and to retain local and regional accounting expertise alongside the IASB. Accounting scholars also have a role to play in this respect. It will continue to be important to critically analyze the effectiveness of existing and new accounting standards on the one hand and investigate the needs of users of financial statements on the other[10].

Summarizing, there are a number of important questions that still need to be answered, and following the introduction of IFRS new risks have

9 See also Dye and Sunder 2001

10 For findings from the Netherlands see Hoogendoorn and Mertens (2001).

arisen with regard to the consistent application of *full IFRS* in Europe. The outcome of an interim review is positive, but this does not imply that the final balance will also be positive. To secure a positive overall outcome, a great deal of attention will need to be paid to the aspects I have discussed regarding the establishment and application of IFRS.

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