IN SEPTEMBER 2002, the Parliament and Council of the European Union (EU) introduced the biggest change to financial reporting in Europe in 30 years. They approved a new Accounting Regulation that would require all EU-listed companies to follow International Financial Reporting Standards (IFRS) in their consolidated financial statements as of 2005. This decision is now affecting thousands of companies in all 28 countries of the European Economic Area (EEA), including the 25 EU countries plus Norway, Iceland, and Liechtenstein. The compelling reason for this Regulation was the need to develop an integrated financial services market in the EU. Ultimately the change to IFRS will lead to transparency in financial statements, which should increase market efficiency, reduce the cost of raising capital, and thereby eliminate barriers to cross-border trading.

The new EU legislation has resulted in rapid change in financial reporting across the world. As of January 10, 2006, accounting firm Deloitte Touche Tohmatsu reported, 70 countries require and 25 countries permit listed companies to use IFRS for domestic reporting. As IFRS become the prevailing global accounting standard, their impact on U.S. generally accepted accounting principles (U.S. GAAP), U.S. companies, and capital markets will increase.

NEW APPROACH TO ACCOUNTING HARMONIZATION

The EU includes countries with extremely diverse economies. Even highly industrialized member states, such as Germany and the U.K., provide sharp contrasts in style and orientation when it comes to their accounting and financial reporting practices. In the late 1970s and 1980s, the quality of the financial information published by European companies increased considerably from implementing the EU Accounting Directives that were designed to align accounting requirements in Europe. But the Directives are broad guidelines and allow many

IFRS and You

What are the implications of the European accounting revolution?

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GLOSSARY

European Union (EU) Directive. Legislation of the EU that requires member states to implement its provisions nationally for the benefit of Europe as a whole. The Accounting Directives include the Fourth Directive (Council of the EC, 1978) on the annual accounting of limited liability companies and the Seventh Directive (Council of the EC, 1983) on consolidated accounts. Over time, several modifying directives were passed and became incorporated into the Fourth and Seventh Directives. In addition, special rules have been developed for banks and other financial institutions in the Bank Accounts Directive (Council of the EC, 1986) and for insurance companies in the Insurance Accounts Directive (Council of the EC, 1991). The Eighth Directive (Council of the EC, 1984) on qualifications and work of auditors is referred to as the Audit Directive. It was recently revised into the proposed Directive on statutory audit. The European Parliament voted in favor of the proposal on September 28, 2005.

EU Regulation. Legislation that requires direct implementation of EU policy in member states without the need for member states to enact their own legislation.

International Accounting Standards (IAS). Standards enacted by the International Accounting Standards Committee (IASC), the predecessor of the International Accounting Standards Board (IASB). The IASC was involved in accounting harmonization efforts during the period 1973-2001.

International Financial Reporting Standards (IFRS). Standards issued by the International Accounting Standards Board (IASB), created in 2001 with a mandate to develop a single set of high-quality global accounting standards and to encourage convergence on these standards. They include the International Accounting Standards (IAS) and their interpretations adopted by the IASB from its predecessor, the International Accounting Standards Committee (IASC).

options, so they didn't bring sufficient quality and uniformity of financial reporting within the EU.

In the 1990s, growing competition and globalization pushed EU companies to seek capital abroad. But international capital markets didn't accept financial statements prepared on the basis of the Accounting Directives. Consequently, many multinational companies in Europe had to prepare a second set of financial statements using either U.S. GAAP or International Accounting Standards (IAS) promulgated by the International Accounting Standards Committee (IASC) based in London. In the U.S., the Securities & Exchange Commission (SEC) accepts reports prepared under foreign accounting standards but requires a reconciliation of the company's net income and stockholders' equity to its net income and equity under U.S. GAAP. This costly requirement involves almost as much work as converting to a full set of U.S. GAAP statements.

Under these circumstances the European Commission, in consultation with the member states, started to develop a new accounting strategy in 1995. They considered five possible alternatives:

Mutual recognition agreement with the United States. Since the financial statements prepared by U.S. companies under U.S. GAAP were already recognized in all member states, the European Commission was in a weak bargaining position and spurred little interest in the U.S. for this initiative.

Exclusion of EU multinationals from the scope of applying the Accounting Directives. The Commission couldn't accept this option because most companies would probably choose U.S. GAAP. It was unacceptable that a foreign standards setter, over which the EU had no influence, would determine the financial reporting practices of large European companies.

An update of the Accounting Directives. Since member states implement Directives by incorporating them into national law, this solution was unworkable because of difficulties in achieving consensus among member states.

Creation of the European Accounting Standards Board. Establishing the pan-European standards-setting body was discarded as too expensive and time-consuming.

Adoption of IAS for consolidated reporting by EU multinationals. The Commission preferred this option, especially after the IASC made an agreement with the International Organization of Securities Commissions (IOSCO) to develop a set of core IAS that major securities regulators would accept for cross-border listings and offerings.

In November 1995, the Commission recommended adopting IAS for domestic and foreign reporting purposes for large EU companies seeking capital on international capital markets. Since there's a close link between accounting and taxation in many continental member states, the Commission proposed a distinction between individual and consolidated financial statements by recommending IAS for preparing consolidated financial statements only.

Several member states subsequently adopted legislation that allowed listed companies to depart from the national rules on consolidation and prepare their consolidated financial statements for domestic reporting purposes in accordance with IAS or U.S. GAAP. But most EU companies continued to use national accounting standards

Table 1: Compliance with IFRS By EU Companies from 2005

	INDIVIDUAL FINANCIAL STATEMENTS	CONSOLIDATED FINANCIAL STATEMENTS
Listed companies	Member state option to: ◆ Require compliance ◆ Permit compliance ◆ Implement only specific contents of IFRS into national accounting standards	◆ Compliance required
Unlisted companies	Member state option to: ◆ Require compliance ◆ Permit compliance ◆ Implement only specific contents of IFRS into national accounting standards	◆ Member state option to: ◆ Require compliance ◆ Permit compliance ◆ Implement only specific contents of IFRS into national accounting standards

based on EU Accounting Directives, and, in 2000, more than 70% of European companies listed on the New York Stock Exchange prepared financial statements based on their national GAAP.

THE NEW EU ACCOUNTING REGULATION

The growing importance of capital markets for corporate financing, as well as new investment opportunities arising from the fall of Communism and introduction of the euro, prompted the integration of European financial markets. In 1999, the European Commission presented its *Financial Services Action Plan* to establish a common legal framework for integrated securities and derivatives markets. In the area of financial reporting, the *Action Plan* proposed that all EU-listed companies report under the same accounting framework. Besides improving comparability of financial statements within the EU, the intention was to allow EU companies to use the same set of financial statements for listing purposes throughout the world. At the Lisbon Council in March 2000, the member states decided to set 2005 as the deadline for the implementation of this plan.

Consequently, in June 2000, the Commission adopted its Communication, "The EU's Financial Reporting Strategy: The Way Forward." This Communication proposed that all EU companies listed on a regulated market must prepare their consolidated financial statements in accordance with a single set of accounting standards, namely IAS, starting no later than 2005.

In February 2001, the Commission presented a formal proposal for the new Accounting Regulation, which was approved in July 2002 and became law on September 11, 2002, as "Regulation (EC) No. 1606/2002 of July 19, 2002, on the Application of International Accounting Standards." In practice, this Regulation directly affects about 9,000 EU-listed companies. It covers all companies listed on a regulated market, including banks and insurance companies, with two exceptions:

- Companies traded both within the EU and on a regulated non-EU market that are already applying another set of internationally accepted standards, such as U.S. GAAP, and
- Companies that have issued debt securities but not equity securities.

Member states may allow companies within these exception categories to defer implementing IFRS until 2007.

During an interview we conducted in 2003, Karel Van Hulle, then head of the European Commission's accounting and auditing unit, emphasized that this was quite a revolutionary document. Unlike a Directive, which must be incorporated into national law before it becomes effective, a Regulation is directly applicable in all member states. Member states are no longer allowed to restrict accounting options available under IAS, nor can they issue new accounting standards. He explained that the only way to achieve the timetable for establishing an internal market for financial services by 2005 was by adopting a Regulation.

Intense pressure from the international financial markets, which led to the new financial reporting strategy in the EU, also brought about a major restructuring of the IASC. In 2001, the Committee was restructured into the International Accounting Standards Board (IASB), a highly professional organization supported by industry and governments throughout the world. Modelled after the Financial Accounting Standards Board (FASB) in the U.S., the IASB was created with a mandate to produce a single set of high-quality, understandable, and enforceable International Financial Reporting Standards. The IFRS include existing IAS issued by the IASC as well as Standards the IASB issued.

After announcing the EU Accounting Regulation, the IASB undertook three major sets of projects to meet the demand for high-quality Standards:

◆ The first provided leadership to converge accounting standards and included business combinations (phase I), insurance contracts, performance reporting, and share-based payments.

◆ The second, which was designed to make existing Standards easier to apply, included the first-time application of IFRS and the activities of financial institutions.

◆ The third aimed to improve basic Standards the IASB inherited from its predecessor, the IASC.

The European Commission contributed to the process by modernizing the Accounting Directives. It removed inconsistencies between the existing Directives and IFRS and addressed the accounting issues faced by the estimated five million European companies that aren't subject to the new Regulation. Specifically, the Commission opened the Directives for accounting treatments available under IFRS. This way, member states can implement only specific contents of IFRS into their national accounting standards and make the changes gradually. Table 1 summarizes the 2005 IFRS compliance levels by EU companies.

Accounting harmonization within the EU will depend on how member states implement the available options. Most continental member states, for example, don't make IFRS compulsory for individual financial statements of listed companies because individual accounts in these countries, based on national accounting standards, are used for purposes of taxation, profit distribution, and financial services supervision. IFRS may be permitted for individual financial statements in these countries but for informational purposes only.

ENDORSING IFRS AND ENFORCING THE ACCOUNTING REGULATION

European companies may apply an IASB Standard only if the EU has endorsed and published it in the EU's *Official Journal*. This is the way the EU transforms IFRS into EU law. In June 2001, the private-sector European Financial Reporting Advisory Group (EFRAG) was established to assist the Commission in the endorsement process. Group members represent users, preparers, the accounting profession, and national standards setters who will provide technical expertise on using IFRS within the European legal environment. The Accounting Regulatory Committee (ARC), which includes member states representatives, assists the Commission at the political level and makes endorsement recommendations.

In September 2003, the Commission adopted most of the IFRS except for two Standards on financial instruments: IAS 32, "Financial Instruments: Disclosure and Presentation," and IAS 39, "Financial Instruments: Recognition and Measurement." Many European banks and insurance companies objected to the requirement to measure derivatives at market value because they believed these Standards could significantly increase earnings volatility and therefore have negative consequences for financial stability in Europe. This controversy led accounting experts in the continental European countries to want a stronger voice on the Board. After extensive due process, both Standards on financial instruments were revised and amended by the IASB, yet this didn't resolve the conflict between the Board and the European Commission. Therefore, in order to have substantive accounting guidance on financial instruments in time for application in 2005, the Commission decided to endorse all Standards and related interpretations, but with two carve-outs from IAS 39: One prohibits the fair-value option as it applies to liabilities, and the other allows fair-value hedge accounting for interest-rate hedges of core deposits on a portfolio basis. After the IASB published further amendments to IAS 39 in June 2005, the Commission decided to reinsert provisions relating to the application of the fair-value option to financial liabilities.

To ease the transition to IFRS and ensure that users were given high-quality information, in June 2003, the IASB issued its first completely new Standard, IFRS 1, "First-Time Adoption of International Financial Reporting Standards." As its title implies, IFRS 1 provides specific guidance on first-time application of the Standards and imposes overriding transitional provisions that must be applied on first-time adoption. In principle it requires retrospective application of each IFRS effective at the reporting date of an entity's first IFRS-compliant financial statements, with certain limited exceptions.

But IFRS 1 isn't the last word on the first-time adoption of the Standards. The IASB has issued new Standards in major areas such as business combinations and share-based payment, and each one contains additional first-time adoption provisions. This results in an ongoing process of amendments to IFRS 1.

New arrangements for enforcing accepted accounting standards have also been established that include a mech-

Table 2: Key FASB Initiatives to Converge U.S. GAAP with IFRS

- Joint projects between the FASB and the IASB include those that the Boards have agreed to conduct simultaneously in a coordinated manner. These projects address revenue recognition, business combinations (phase II), financial performance reporting, and conceptual framework.
- The short-term convergence project will resolve those differences in the standards in which convergence around a high-quality solution appears to be achievable in the short term, usually by selecting current practices under either existing IFRS or U.S. GAAP.
- To exchange information and increase cooperation, James J. Leisenring, a former FASB member, serves as the IASB liaison Board member to the FASB. The FASB is monitoring several IASB projects, based upon the FASB's level of interest in the topic.
- The convergence research project seeks to identify and categorize all substantive differences between U.S. GAAP and IFRS according to the Board's resolution strategy.
- All Board agenda decisions give explicit consideration to potential convergence.

anism to coordinate activities of the national enforcement bodies and public oversight of the auditing profession in the member states. In April 2003, the Committee of European Securities Regulators (CESR) published its Standard No. 1, "Enforcement of Standards on Financial Information in Europe," to develop and implement a common approach to enforcing IFRS throughout the EU. The Standard lists 21 high-level principles that define enforcement and describes principles that EU member states should adopt in enforcing IFRS. Standard No. 2, "Coordination of Enforcement Activities," addresses consistent application and enforcement of IFRS among member states.

Furthermore, the European Commission has been focusing on statutory audit and other corporate governance measures. For example, on September 28, 2005, the European Parliament approved a new version of the EU Audit Directive. The measure includes adopting International Standards on Auditing (ISA) to apply throughout the European Union and many other measures designed to improve audit quality, such as establishing an oversight system and rotating auditors.

THE EU ACCOUNTING REGULATION AND U.S. GAAP

When it was established, the IASB received a mandate to encourage international convergence on a single set of high-quality accounting standards. To achieve this goal, the Board cooperates closely with national standards setters around the world. International convergence, recommended by the Sarbanes-Oxley Act of 2002, is also a high priority for the FASB, a proponent of improved international standards and one of the most influential IASB partners. After former IASB member Robert Hertz was named FASB chair, both Boards agreed that convergence of IFRS and U.S. GAAP would be a primary objective.

So at the September 18, 2002, meeting in Norwalk, Conn., both the FASB and the IASB pledged to make existing international and U.S. accounting standards fully compatible as soon as possible and issued a Memorandum of Understanding called "The Norwalk Agreement."

The effect of the cooperation between the IASB and FASB is already noticeable (see Table 2 for some examples). The IASB has brought many international standards in line with U.S. GAAP through its improvements project and its Standard on business combinations, which eliminated the pooling method and the amortization of goodwill. In June 2005, the IASB and the FASB each published an exposure draft containing joint proposals to further improve and align accounting for business combinations. If approved, the proposed Standard would replace IFRS 3, "Business Combinations," and SFAS No. 141, "Business Combinations." The principal changes include a requirement to measure and recognize the business acquired at fair value of the acquiree, even if the business combination is achieved in stages or if less than 100% of the equity interests in the acquiree are owned at the acquisition date.

In the case of stock options, the IASB showed strong leadership by undertaking a comprehensive share-based payment project that developed a Standard on all aspects of accounting for share-based payments to employees, suppliers, creditors, and others. In February 2004, it issued IFRS 2, "Share-Based Payment," requiring companies that prepare financial statements under IASB Standards to recognize the fair value of share-based payments, including employee stock-based compensation, as an expense. Subsequently, in December 2004, the FASB issued the revised SFAS No. 123R, "Share-Based Payment," that also requires companies to account for share-based payment transactions using a fair-value method. It's also noteworthy that the FASB has recently incorporated IFRS into the GAAP hierarchy for the first time.

Furthermore, the international cooperation may contribute to a more principles-based approach to U.S. standards setting. The U.S. financial reporting model is based largely on principles but is supplemented by extensive rules and regulations. The IASB emphasizes the fundamental importance of Standards that focus on principle, drawn clearly from the IASB's conceptual framework, rather than on detailed rules. At their joint meeting in April 2004, the Boards agreed to undertake a project together to develop a common conceptual framework that improves their two frameworks. The complete and internally consistent conceptual framework is considered critical to the evolution toward principles-based accounting standards.

IMPLICATIONS FOR U.S. CAPITAL MARKETS AND COMPANIES

The EU Accounting Regulation's impact on the SEC is expected to be significant. It's estimated that more than 300 European SEC registrants who had used their national accounting standards and reconciled material differences to U.S. GAAP switched to IFRS for U.S. reporting by 2005. The SEC has supported global standards and the IFRS-U.S. GAAP convergence process, although it still doesn't accept IFRS financial statements without reconciliation. The SEC wants IFRS to be more rigorously interpreted and applied, which involves more uniform auditing procedures, enforcement mechanisms, and regulatory environments worldwide. Recently the SEC proposed a road map toward equivalence between IFRS and U.S. GAAP by showing steps it will take to eliminate the need for registrants using IFRS to reconcile to U.S. GAAP. This should happen as soon as 2007 but no later than 2009.

The Accounting Regulation will also affect the financial reporting activities of U.S. companies. D.J. Gannon, a member of the Deloitte Global IFRS Leadership Team, presents four possible situations in which a U.S. company would be required to use IFRS:

- If the U.S. company's international parent uses IFRS, the subsidiary will have to prepare IFRS statements for the parent's consolidated financial statements.
- A publicly listed European subsidiary of a U.S.-headquartered multinational corporation must comply with IFRS, and, consequently, the U.S. parent may have to convert its subsidiary's financial statements to U.S. GAAP for consolidation purposes. In this situation, the U.S. parent company may simplify its financial reporting by implementing IFRS for all its foreign subsidiaries.
- A U.S. company that has foreign operations and is seeking to enter new markets and expand operations to a foreign country may need to report under IFRS to obtain an operating license or raise capital.
- If a foreign investor in a U.S. company uses IFRS, the U.S. company may also be required to follow suit.

In addition to mandatory reporting, voluntary reporting under IFRS is expected to increase significantly for companies seeking to raise capital in international markets. U.S. companies facing strong foreign competition in such industries as manufacturing, banking, insurance, automotive, pharmaceuticals, or telecommunications may consider supplementing their current U.S. GAAP financial statements with information prepared under IFRS for foreign analysts and investors.

HOW IMPORTANT IS THE CHANGE?

Europe is embracing an entirely new system of financial reporting that will have a significant impact on companies' balance sheets and income statements, but the consequences of implementing IFRS in the EU will undoubtedly go far beyond a simple change of accounting rules. Adopting IFRS will significantly change national accounting standards in many countries and the role of standards setters, as well as affect the accounting profession and accounting education. Integrating European financial markets is also likely to change the way in which markets are regulated and the way market participants operate.

Outside Europe, the full implications of the European accounting revolution for U.S. companies, capital markets, and the accounting profession are yet to be determined. The efforts to converge IFRS and U.S. GAAP and the trend toward adopting IFRS create an opportunity to develop truly global high-quality accounting standards that will improve the consistency and quality of financial reporting worldwide. ■

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