The future of IFRSs in Europe

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Association of German Banks
All under one roof ...

Through International Financial Reporting Standards (IFRSs), the EU brings together the accounting rules applying to publicly traded companies under one roof. For this reason, the transparent roof is a fitting visual accompaniment to the content of this brochure.
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Since the adoption of the IAS Regulation (Regulation (EC) No 1606/2002 on the application of international accounting standards) in 2002, the International Financial Reporting Standards (IFRSs) have served as the authoritative accounting rules for publicly traded companies in the European Union. Disclosure of financial information is no longer conceivable for such companies without IFRSs. This is because, besides being an “admission ticket” to the international capital markets, the application of IFRSs helps to make financial statements more meaningful and comparable and to harmonise internal and external accounting. Many EU member states have therefore expanded the use of IFRSs on a compulsory or voluntary basis to cover other entities outside the mandatory scope of application.

Regardless of this success story, IFRSs have been repeatedly criticised and questioned in Europe from the outset. This indicates that the democratic process from which they gain their legitimation is working. At the same time, however, the debate on appropriate accounting reveals fears and worries that prove to be unwarranted on closer scrutiny. So it is worth taking a look at the – undoubtedly complex – standard-setting process.

Unlike the conventional legislative process with which we are familiar in Europe, IFRSs are developed by an independent international body drawing on the expertise and input of preparers, users and auditors, and not set by a government authority. The financial reports prepared by companies (annual/consolidated accounts, semi-annual/quarterly reports) are designed primarily to provide information to current and future shareholders, debt providers and partners in business such as suppliers and customers. To meet the information needs of these different stakeholders, it is important that representatives of each group are involved in the development of IFRSs.

The International Accounting Standards Board (IASB) was set up as a private standard-setting body composed of representatives from different countries. The IASB has played a major role over the past few years in creating internationally recognised accounting standards geared to the needs of addressees. Two developments have given cause for concern recently, however. Firstly, the US has turned its back to some extent on the principle of uniform global standards. The US standard-setting body FASB has, for example, withdrawn from joint work on some projects and is pursuing its own agenda. Secondly, the debate on a big enough say for Europe in the standard-setting process and on the IASB’s political legitimation has flared up again in Europe.

We take a critical view of these developments. So that it can continue to perform its job as an independent global standard-setter, the IASB should not be allowed to become a plaything of diverging national interests. Purely national interests inevitably have to take a back seat in efforts to develop an internationally accepted financial reporting convention. The IASB’s work as a standard-setter should therefore be kept largely free of political influence in the future as well. This is the only way to ensure high-quality standards and uphold the IASB’s good reputation in the long term.

Irrespective of this, the IASB, as the body responsible for setting international standards, is, of course, accountable to some degree to preparers and users of financial statements as well as to political decision-makers. Transparent structures and an understandable standard-setting process are key prerequisites for the acceptance and recognition of standards. The IASB standard-setting process, the “due process”, has been continuously improved over the past ten years to strengthen transparency and participation, so that a sound and robust process with clear-cut lines of
responsibility is in place today. One major change was undoubtedly the setting-up of a Monitoring Board in 2009. The Monitoring Board is composed of representatives of financial market watchdogs from Europe, the US and Asia, establishing a direct link to regulators.

In Europe, the linchpin of both political and technical control is the endorsement process set out in the IAS Regulation for implementation of IFRSs issued by the IASB in EU law. This endorsement process was thoroughly reviewed and partly modified in 2013.

Any European go-it-alone approach must be avoided, however. The non-recognition of individual IFRSs in Europe (carve-out) or the establishment of European accounting rules would be at odds with the target of uniform international accounting standards. The comparability of financial information would be impaired; the result would be a competitive handicap for internationally operating companies based in Europe. Different accounting standards would be problematic particularly from a supervisory perspective. Accounting capital forms the basis for regulatory capital requirements. A level accounting playing field is essential for a single European supervisory regime.

In addition to a set of globally recognised accounting standards, the correct uniform application of these standards is a key prerequisite for strengthening investor confidence in efficient capital markets. This is where the European Securities and Markets Authority (ESMA) has played an important role recently. We support ESMA’s activities as long as there is a strict separation between standard-setting and enforcement. On the other hand, setting actual accounting and valuation rules is not ESMA’s job in our view, but should be left to the IASB and the IFRS Interpretations Committee.
Significance and development of IFRSs in Europe

2.1 Function and limitations of accounting standards

Financial reporting’s primary function is enabling present and future providers of capital to assess a company’s economic performance. In this context, it is important that investors, banks and companies speak the “same language”. Capital is often provided today by investors and banks across borders. Uniform, internationally accepted accounting standards create a common language allowing presentation of a company’s net assets, financial position and earnings in an internationally comparable form. For export-oriented companies, this leads to funding advantages, e.g. a broader funding base, since international venture capital providers and investment banks are increasingly asking for IFRS-based financial information.

IFRS-based financial reporting is particularly important for internationally operating companies within a group. Different accounting systems mean considerable extra costs for preparing balance sheets. IFRS-based financial reporting also offers the chance to harmonise internal and external accounting, which can help to improve internal corporate management.

At the same time, a sense of proportion is called for when assessing accounting systems. Accounting should not create an economic reality, but simply serve to present it as realistically as possible. Ultimately, every set of financial reporting rules is based on a convention. In globally converging markets, it is therefore important to adhere to the same convention and to agree on common rules. This applies not only in Europe, but also worldwide. IFRSs have since become established as the internationally accepted language of accounting.

2.2 Accounting and regulation

The close connection between accounting and regulation should not be overlooked. Accounting figures generally form the basis for regulatory capital requirements. The leverage ratio, for example, is linked directly to total assets. Different accounting approaches hinder comparability and lead to an unlevel playing field.

It is true that the action taken by regulators and standard-setters in the area of accounting pursues different objectives or serves different purposes. But it is equally true that viewing the raft of different regulatory measures, reporting requirements and accounting standards in isolation is wrong, and creates over-complexity. A closer dialogue between standard-setters and regulators is therefore desirable.

2.3 IASB structure

To reach the target of uniform global standards, an international body is needed. For this purpose, the International Accounting Standards Committee (IASC), the forerunner of today’s International Accounting Standards Board (IASB), was founded in 1973 by representatives of professional accountancy bodies. Already then, the primary objective was harmonising
accounting across the globe and creating a uniform international accounting “language”. Substantial progress has been made in worldwide harmonisation of accounting standards in the meantime.

Virtually all of the 130 countries producing 96% of world GDP have publicly endorsed the IFRSs as global accounting standards.

In most of these countries, the use of IFRSs is already mandatory for national reporting. In the US, for example – one of the leading industrialised nations – non-US entities are allowed to use IFRSs for reporting to the Securities and Exchange Commission (SEC).

The IASC has been repeatedly restructured since its formation. Today, IFRSs are developed and published by the IASB. The IFRS Foundation, which is run by trustees, operates as the oversight body of the IASB. The Board of Trustees currently comprises 22 persons of diverse geographical and professional backgrounds.

To enhance the public accountability of the IFRS Foundation, the Monitoring Board was set up on 1 February 2009. The Monitoring Board comprises five members representing the European Commission, the International Organization of Securities Commissions (IOSCO) and various securities regulators, and provides a formal link between the IFRS Foundation and the relevant public authorities. It is responsible for appointing and overseeing the trustees.

The IASB currently comprises 16 members. It is responsible for developing and publishing IFRSs. Besides the Board,
The IFRS Foundation governance and control structures, including the affiliated advisory bodies, are regularly reviewed by the trustees and modified where necessary.

Even though the IASB and IFRSs are repeatedly criticised on some specific points, the IFRS Foundation generally enjoys broad worldwide support for its work. The progress made by the IASB in global acceptance of IFRSs with a view to creating a single global accounting language is unmistakable.

Sources: IFRS Foundation, IASB.

Three-pillar structure

1 Independent standard-setting and related activities

IFRS Foundation

International Accounting Standards Board

IFRS Interpretations Committee

IFRS Advisory Council

2 Governance and oversight

IFRS Foundation Trustees

3 Public accountability

IFRS Foundation Monitoring Board

*Accounting Standards Advisory Forum
2.4 International standard-setting process

In accordance with the IFRS Foundation’s Constitution, IFRSs are developed on the basis of clearly articulated principles (principles-based approach). Standard-setting follows a strictly defined process, the “due process”, which calls for the involvement of all accounting stakeholders at an early stage.

The standard-setting process provides for, among other things, impact analyses and the formation of expert groups on special agenda projects. The general public is explicitly called upon to comment on the discussion papers and exposure drafts issued by the IASB. Besides consultation in writing, there is an opportunity for an exchange of views with IASB representatives at public hearings on individual agenda projects. Following evaluation of the feedback received, the finalised standards are issued and published by the IASB; their application is mandatory after a transitional period.

The following diagram shows the various steps in the due process:

Strict compliance with the due process is a key precondition for ensuring transparent standard-setting and thus long-term acceptance and recognition of IFRSs. Experience shows that early involvement in the standard-setting process is vital to allow the incorporation of economically sensible positions into proposed IFRSs.
2.5 IFRSs and supervisory law

IFRSs were developed for publicly traded companies, i.e. companies whose securities are traded on a regulated market. For companies and particularly also for banks which do not use regulated capital markets, IFRSs are only of very limited importance. It is therefore right not to make IFRS-based accounting mandatory for such entities. In this context, we see the danger for banks of IFRS-based accounting being introduced “through the back door”, as it were, by the single European banking supervisor. This would be the case if all banks were to have to comply with the prudential reporting requirements on an IFRS basis and were thus to be obligated to introduce an IFRS-based shadow accounting regime. Generally requiring all banks to use IFRSs solely for prudential purposes would effectively force banks which file HGB-based accounts (i.e. accounts prepared in accordance with the provisions of the German Commercial Code (HGB)) to draw up two sets of accounts although they neither publish IFRS-based accounts nor manage their operations internally on an IFRS basis.

2.6 European accounting architecture

2.6.1 Implementation of IFRSs in EU law (endorsement)

It is neither politically nor legally possible for an IFRS adopted by a private-sector body to have direct legal effect in the member states of the European Union. For this reason, a special endorsement mechanism was built into the IAS Regulation. This mechanism requires accounting standards adopted by the IASB to first be legitimised by a legislative act before being applied in the EU. Up to now, standards have gone through what is known as a comitology process, under which the European Commission decides whether or not to adopt an IAS/IFRS and its associated interpretative guidance. The Commission does not have the power to alter the content of a standard: it can merely restrict its use in the European Union.

The main bodies involved in the endorsement process are:

- the European Financial Reporting Advisory Group (EFRAG)
- the Accounting Regulatory Committee (ARC)
- the European Commission
- the European Parliament
- the European Council

This finely balanced process involving a number of parties is about to be reorganised. First, the European

2.6.2 Reorganisation of EFRAG – Maystadt Review

EFRAG is a private-sector body established in 2001 to provide the European Commission with technical support on accounting matters. One of EFRAG’s key tasks is to advise the Commission on the question of whether individual IFRSs should be endorsed for use in Europe. EFRAG also plays an active part in developing accounting standards at IASB level: EFRAG representatives sit on IASB working groups, for instance, and comment on the IASB’s working papers and exposure drafts. It is partly funded by contributions from industry and, since 2009, around 50% of its entire budget has come from the European Commission.

From the outset, various groups and nations in Europe were critical of the endorsement process and of the way EFRAG functioned. In the eyes of these critics, the EU continues to have too little weight in the international standard-setting process. With the aim of strengthening Europe’s role, the European Commission in March 2013 appointed Philippe Maystadt, a Belgian politician and former President of the European Investment Bank, as a special adviser to review the entire institutional infrastructure for adopting IFRSs, including the governance structures of EFRAG. The findings of this review were unveiled in November 2013 in the Maystadt Report. The report’s

Parties involved in the endorsement process

Source: European Commission.
recommendations for adjusting the endorsement process have since been approved by the ECOFIN Council and are currently being implemented.

The centre-piece of the reform is a fundamental reorganisation of EFRAG. Membership is to be extended to include national standard-setters and other interested stakeholders, thus broadening EFRAG’s funding base. In addition, a High-Level Board will be established. This new body will be composed of senior representatives of private organisations (industry, banks, insurance companies, auditors, analysts) and national standard-setters. The High-Level Board’s primary focus will be less on the technical assessment of IFRSs and more on the political representation of European interests in the international standard-setting process. Individual standards will continue to be evaluated by EFRAG TEG, which will submit its findings to the High-Level Board for approval. EFRAG TEG will therefore no longer function as an independent decision-making body under the new structure, but will essentially act in an advisory capacity to the High-Level Board.

The Maystadt Report is quiet on issues such as how the High-Level Board and EFRAG TEG will interact with one another or how the desired consensus on decisions taken by the High-Level Board will be reached. It will therefore be interesting to see how its recommendations are implemented in practice.

As well as recommending the reorganisation of EFRAG, the Maystadt Report discusses further possible adjustments. These include making the endorsement process more flexible, i.e. providing not just for the adoption or rejection of an entire standard, but also for the partial modification of an IFRS (carve-in) or the drafting of alternative European standards. Ways of clarifying and supplementing the existing endorsement criteria are also explored. The report is careful to highlight the risks associated with these proposals, however. Given that the ultimate objective is to establish a single set of globally accepted, high-quality accounting standards, it would seem counterproductive to introduce further potential for creating special European rules. These options should therefore be pursued – if at all – with extreme caution and care.

The usual endorsement process

Under the current system, the Accounting Regulatory Committee (ARC) plays a major role in the endorsement process alongside EFRAG. This committee is made up of representatives drawn from the ministries or authorities responsible for accounting in member states.

The existing endorsement process can be summarised as follows. Within two months of an IFRS’s adoption, EFRAG’s Technical Expert Group (EFRAG TEG) submits a proposal to the Commission for the approval or rejection of the standard. The Commission then drafts a positive or negative recommendation. It is not bound by EFRAG TEG’s opinion. The Commission’s recommendation is subsequently presented to the ARC for approval. The ARC has three months to arrive at a decision. If the ARC agrees with the Commission, the European Parliament and European Council have a further three months to consider the proposal. The proposal can be rejected by the Parliament with a simple majority and by the Council with a qualified majority. In this case, the Commission then has an opportunity to submit a new or amended proposal. The endorsement process is concluded when an announcement about the new IFRS is published in the Official Journal of the European Union in all the EU’s official languages. In total, endorsement takes about one year to complete.
2.6.3 Role of the European Parliament

The European Parliament has always been somewhat sceptical of the comitology procedure, which places the main decision-making authority in the hands of the European Commission. As early as in 2008, the procedure was changed to give the Parliament additional oversight and consultation rights. The Treaty of Lisbon, which entered into force on 1 December 2009, further strengthened the position of the European Parliament. The endorsement process has not yet been amended to reflect the Lisbon Treaty. But the Parliament’s ability to influence endorsement will doubtless be increased. The ARC, by contrast, is likely to see its importance decline.

Since the European Parliament has to approve European funding of the IASB and EFRAG, it has an additional bargaining chip when calling for more active parliamentary involvement. In March 2014, the European Parliament voted to continue Europe’s co-funding of the IFRS Foundation and EFRAG. The funding takes the form of grants for operating costs, which have to be approved annually by the European Parliament and Council. MEPs have tied their approval to several conditions:

- The standard-setting process should be independent, transparent and democratic.
- Standard-setters should be accountable.
- The Commission should report annually on the activities of the IASB and EFRAG.
- EFRAG should analyse whether new and amended standards present a true and fair view and serve European public interests.
- EFRAG should analyse whether new and amended standards are evidence-based and meet European needs, bearing in mind the diversity of accounting rules and business models in the EU.

The precise details of how the endorsement process will work in the future are not yet clear. It is likely, however, that the time needed to complete the whole process will increase further. This is problematic, since even longer time lags could arise between the adoption of a standard by the IASB and its implementation in EU law. If a new or amended standard has already been adopted by the IASB but its use in Europe has not yet been authorised by the European Commission, this causes complications for companies which prepare IFRS-based accounts. For internationally operating companies, in particular, it is extremely important that they are able to publish full IFRS accounts prepared in accordance with the standards adopted by the IASB. It is therefore vital that the process of implementing the standards in EU law is swift and efficient.
2.7 Enforcement

A single, coherent set of accounting rules is a key prerequisite for efficient capital markets, but it is not enough in itself. To strengthen investor confidence, it is also essential that the rules are applied correctly and consistently. Enforcing accounting standards is the responsibility of individual member states and is organised on a national basis.

2.7.1 Role of ESMA

European coordination of enforcement is the responsibility of the European Securities and Markets Authority (ESMA). ESMA is the successor organisation to the Committee of European Securities Regulators and is part of the new European supervisory architecture established on 1 January 2011. The three former supervisory committees (CEBS, CEIOPS and CESR) became the European Supervisory Authorities (EBA, EIOPA and ESMA). The new authorities were given extended powers and are not subject to political instructions.

One of ESMA’s objectives is to develop uniform European standards for high-quality enforcement and to ensure the consistent application of IFRSs across Europe.
As well as promoting greater standardisation of enforcement in Europe, ESMA also publishes recommendations and guidance on individual accounting issues. In 2011 and 2012, for example, ESMA released two reports on accounting for foreign government bonds in accordance with IFRSs. It is not, in our view, the task of ESMA to issue specific accounting and valuation rules. This should be the job of the IASB and IFRS Interpretations Committee alone. Otherwise, we see a danger of “European IFRSs” developing, which would fly in the face of efforts to establish globally recognised accounting standards. We therefore consider it important to keep a close eye on ESMA’s future activities in the area of accounting.

2.8 Outlook

IFRSs have established themselves as internationally accepted standards of high quality. In Europe, they quickly became the most important accounting standards used by publicly traded companies. This approach should continue to be pursued when reorganising Europe’s accounting architecture. A uniform basis for accounting improves transparency and can play a significant part in enhancing investor confidence.

Care should nevertheless be taken to avoid prudential requirements for the disclosure of financial information imposing a de facto obligation to use IFRS accounting on companies which are not publicly traded.
Glossary

Accounting Regulatory Committee (ARC)
The Accounting Regulatory Committee is composed of representatives from member states and is chaired by the European Commission. It was set up by the Commission in accordance with the requirements of the IAS Regulation. The committee’s function is to provide an opinion on the Commission’s proposals to adopt or reject an International Financial Reporting Standard (IFRS).

Accounting Standards Advisory Forum (ASAF)
An advisory body to the IASB made up of representatives of national standard-setters or regional groups of standard-setters. The ASAF currently has 12 members. The geographical composition of the committee is fixed. The Accounting Standards Committee of Germany has one of the three European seats on the ASAF.

Due process
Process of developing and adopting new or amended IFRSs by the IASB.

Endorsement
Procedure for adopting IASB standards and interpretations as directly applicable, binding EU law.

Enforcement
Prudential term signifying national and international procedures to ensure that certain accounting and auditing requirements are duly applied. The German Financial Reporting Control Act (Bilanzkontrollgesetz) introduced a two-stage enforcement procedure to scrutinise companies’ financial reporting.

European Financial Advisory Group (EFRAG)
Technical committee for accounting which supports the European Commission in evaluating international accounting standards and recommends the adoption or rejection of new or amended IFRSs.

European Securities and Markets Authority (ESMA)
European securities watchdog established when Europe’s supervisory bodies were reorganised. ESMA’s task is to contribute to the stability of the EU financial system by ensuring the integrity, transparency, efficiency and smooth functioning of the securities markets and strengthening investor protection.

European Supervisory Authorities (ESAs)
Umbrella term for the three supervisory authorities established in the course of reorganising Europe’s supervisory architecture. The ESAs are the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA).

International Accounting Standards Board (IASB)
Independent body of international accounting experts which develops and adopts IFRSs. Members of the IASB are appointed by the trustees of the International Accounting Standards Committee Foundation (IASCF) on the basis of fixed criteria with respect to geographical diversity and qualifications. The IASB was set up by the IASCF in 2001 as the successor organisation to the International Accounting Standards Committee.

International Financial Reporting Standard (IFRS)
An IFRS is an internationally applicable accounting standard developed by the IASB with the aim of gaining the widest possible global acceptance. Publicly traded companies in the EU are obliged to prepare their consolidated accounts in accordance with IFRSs.
IFRS Advisory Council (IFRS AC)
The IFRS AC is composed of at least 30 members of various professions and nationalities. Its task is to advise the IASB and the IFRS Foundation.

IFRS Foundation
Umbrella organisation of the IASB which is overseen by a body of trustees. The foundation is responsible for monitoring the work of the IASB and appoints the members of the IASB and IFRS IC.

IFRS Interpretations Committee (IFRS IC)
Clarifies and interprets issues about which there is doubt or on which there are diverging views.

Monitoring Board
The Monitoring Board of the IFRS Foundation was established on 1 February 2009 and is made up of representatives of IOSCO, the European Commission and financial supervisory authorities (including those in the US, Japan and Australia). It is the formal link between these public authorities and the IFRS Foundation. The Monitoring Board is responsible for appointing and overseeing the trustees. The board was created with the aim of enhancing the public accountability of the IFRS Foundation without undermining the independence of the standard-setting process.
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