Accounting (Basics) - Lecture 12

INTRODUCTION TO THE EUROPEAN ACCOUNTING, HARMONIZATION OF ACCOUNTING, DIRECTIVES OF THE EUROPEAN UNION. US GAAP.

Content

- Introduction to the European accounting
- Harmonization of accounting
- Directives of the European union
- US GAAP

Introduction to the European accounting

- In most countries, it is not thought appropriate to regulate bookkeeping in any detail, although there are generally requirements that orderly books should be kept so that auditors and tax authorities could investigate them where this seems necessary to confirm the contents of financial reports.
- In a few countries, such as Belgium and France, bookkeeping is regulated in detail, as is noted below.

Introduction to the European accounting

- Financial reporting could be regulated in a number of ways, including:
  - legislation, such as Companies Acts and Commercial Codes;
  - other rules issued by departments of government (such as a Ministry of Finance) or by committees operating under their control;
  - rules from governmental regulators of stock exchanges;
  - rules of stock exchanges;
  - accounting guidelines or standards issued by committees of the accountancy profession;
  - accounting guidelines or standards issued by independent private-sector bodies acting in the public interest.

Introduction to the European accounting

- The expression 'accounting standard' is used here to mean a document containing a series of instructions on a particular topic of financial reporting (e.g. how to value inventories), where the standard is written in the private (nongovernmental) sector and is intended to be obeyed in full before an enterprise or an auditor can claim compliance with the system of rules of which the standards form part.
- For financial reporting regulation, it is important to separate the creation of rules from their enforcement.

Introduction to the European accounting

- For example, in the United States most accounting rules are to be found in accounting standards but the enforcement, for certain companies, comes from the stock exchange regulator.

Examples of regulation - Germany

- The basic source of accounting rules in Germany is the Commercial Code (*Handelsgesetzbuch*, abbreviated to HGB, and literally meaning the ‘commercial law book’).
- The HGB is amended from time to time, most notably in 1985 as a result of implementation of EU Directives.
- The HGB covers all types of enterprise in Germany, but limited companies have special rules and larger companies must be audited.
- Because of the close links between tax and accounting in Germany, the rules of tax law and the decisions of tax courts are also important for financial reporting.

Examples of regulation - Germany

- For listed companies, there are some additional disclosure requirements in a special law.
- Compliance with the rules is the responsibility of the management of an enterprise.
- Auditors will check certain features of compliance.
- The tax authorities will check matters of concern to them.
- However, the consolidated financial statements of groups are generally not relevant for tax, even though parents and certain subsidiaries can sometimes be treated together for tax purposes.

Examples of regulation - Germany

- Therefore, there may not be a fully effective enforcement mechanism, particularly for consolidated statements.
- Since 1998 in Germany, consolidated statements of listed companies have been allowed to depart from the normal requirements of the HGB if they follow 'internationally recognized rules' instead.
- There are other conditions, but US rules and International Standards are accepted.
- A number of large German companies take advantage of this permission, and it seems that there is no mechanism of enforcing the strict use of these 'foreign' rules.

Examples of regulation - Germany

- Also in 1998, a private-sector standard setter was established: the Deutsches Rechnungslegungs Standards Committee (DRSC).
- The fact that the German for ‘standards committee’ is ‘Standards Committee’ tells us that it is an imported concept.
- The DRSC can recommend to the Ministry of Justice rules designed for listed companies in their consolidated statements.

Examples of regulation - France

- The most detailed source of accounting instructions in France is the *plan comptable general* (PCG, general accounting plan).
- The PCG is a large document within the control of a governmental committee.
- Part of the PCG is a chart of accounts that regulates how double entries should be made; another part specifies the formats that financial statements should follow.
- The tax system uses the output in PCG format, so that there is detailed enforcement.

Examples of regulation - France

- An outline of the chart of accounts in the French PCG, as amended in 1999,
- The recording of each type of transaction can be specified in great detail, so that it can be standardized throughout France.
- France also has a Civil Code and several Companies Acts.
- All larger companies must be audited.
- For listed companies, there is a stock exchange regulator that exercises some enforcement powers.

Examples of regulation – The United Kingdom

- There have been Companies Acts in the UK since 1844, but the accounting content was not detailed until the relevant EU Directives were implemented in the 1980s.
- All companies are covered, and audits are required in all cases except small companies ('small' being defined).
- There are also accounting standards, which are more detailed than the present Companies Act (of 1985) on many issues.
- The standards were set by a committee of the accountancy profession until 1990 but are now set by an independent private-sector body, the Accounting Standards Board.

Examples of regulation – The United Kingdom

- The overriding requirement of the Companies Act is that financial statements must give a true and fair view.
- This requirement is given more substance in the UK than elsewhere because the standard setters make requirements that remove some of the options in law and sometimes even contradict the detail of the law.
- Enforcement of the rules is achieved because companies and auditors can be taken to court (by the Financial Reporting Review Panel (FRRP), another private-sector body) for ‘defective accounts’, and legal opinion is that financial statements that break accounting standards are likely to be defective.

Examples of regulation – The United States

- There are no general Companies Acts or Codes in the United States, and so most companies have little regulation and no audit requirement.
- However, for listed companies there is the world’s most active regulator: the Securities and Exchange
- Commission (SEC).
- The SEC was founded in 1934 as a reaction to the free-for-all in accounting that contributed to the Wall Street Crash of 1929.
- The SEC requires the use of ‘generally accepted accounting principles ’(GAAP) and also requires an audit.

Examples of regulation – The United States

- The SEC imposes serious penalties on auditors and companies that break the rules.
- The SEC makes some of the content of GAAP but mostly chooses to rely upon the private sector to do this. Since 1973, the chosen body is the Financial Accounting Standards Board (FASB), which is a private-sector body set up to act in the public interest.
- The FASB is independent but is influenced by the fact that it could be overruled by the SEC.

Examples of regulation – some other countries

- Many other countries are similar to one or more of the above.
- For example, the Nordic countries have Bookkeeping Acts and Companies Acts which have incorporated the EU Directives.
- They also have various forms of accounting standards, set by committees involving representatives of various bodies, such as the accountancy profession and stock exchanges.

Generally accepted accounting principles (GAAP)

- The term ‘GAAP’ is of US origin but is commonly used to describe accounting requirements, and so the term ‘Swedish GAAP’ might also be used, for example.
- In the United States, in the absence of company law, the term first meant the practices of large and respected companies, as recommended by textbooks and accepted by auditors.
- By the 1930s in the US, GAAP began to be codified, so that there is now also written (or promulgated) GAAP including accounting standards.
- The SEC requires companies registered with it to comply with GAAP.
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Generally accepted accounting principles (GAAP)

- In other countries, ‘GAAP’ is generally an unofficial term with no exact meaning, although there is a similar term, namely ‘good accounting practice’, in the laws of some countries, such as Denmark.
- For example, if one sees the term ‘Swedish GAAP’ it presumably includes Swedish law, Swedish accounting standards and the practices of respected companies and auditors.

Harmonization of accounting

- There are major differences in the financial reporting practices of companies in different countries.
- This leads to great complications for those preparing, consolidating, auditing and interpreting published financial statements.
- Since the preparation of internal financial information often overlaps with the preparation of published information, the complications spread further.
- To combat this, several organizations throughout the world are involved in attempts to harmonize or standardize accounting.

Harmonization of accounting

- ‘Harmonization’ is a process of increasing the compatibility of accounting practices by setting bounds to their degree of variation.
- ‘Standardization’ appears to imply the imposition of a more rigid and narrow set of rules.
- However, within accounting these two words have almost become technical terms, and one cannot rely upon the normal difference in their meanings.

Harmonization of accounting

- Harmonization is a word that tends to be associated with the supranational legislation promulgated in the European Union, while standardization is a word often associated with the International Accounting Standards Board.
- In practice, the words are often used interchangeably.
- It is necessary to distinguish between *de jure* harmonization (that of rules, standards, etc.) and *de facto* harmonization (that of corporate financial reporting practices).

Harmonization of accounting

- For any particular topic or set of countries, it is possible to have one of these two forms of harmonization without the other.
- For example, countries or companies may ignore the harmonized rules of standard setters or even lawmakers.
- By contrast, market forces persuade many companies in France or Switzerland to produce English-language financial reports that approximately follow Anglo-American practice.

Harmonization of accounting

- The EU achieves its harmonizing objectives mainly through Directives (which must be incorporated into the laws of member states) and Regulations (which have direct effect).
- In the 1970s and 1980s attention was given to harmonizing national laws through Directives).
- During the 1990s, the EU began to take more notice of international standards, leading to a Regulation of 2002 requiring IFRSs for the consolidated statements of listed companies.

Relevant EU Directives

- The relevant body of law for accounting is company law, and the concern of this section will be with the Directives on company law. These are listed on the slides below.
- The exact effects of any Directive on a particular country will depend upon the laws passed by national legislatures.
- For example, there are dozens of provisions in the Fourth Directive that begin with such expressions as 'member states may require or permit companies to …'

Relevant EU Directives

- The Fourth Directive covers public and private companies.
- Its articles include those referring to valuation rules, formats of published financial statements, and disclosure requirements.
- It does not cover consolidation, which is left to the Seventh Directive.
- The Fourth Directive's first draft was published in 1971, before the United Kingdom, Ireland and Denmark (let alone the later entrants) had joined the EU (or its predecessors).

Relevant EU Directives

- This initial draft was heavily influenced by German company law, particularly the *Aktiengesetz* of 1965.
- Consequently, for example, valuation rules were to be conservative, and formats were to be prescribed in detail.
- Financial statements were to obey the provisions of the Directive.
- The UK, Ireland and Denmark joined the then ‘common market’ in 1973.

Relevant EU Directives

- The influence of Anglo-Saxon thinking was such that a much amended draft of the Fourth Directive was issued in 1974.
- This introduced the concept of the ‘true and fair view’.
- Another change by 1974 was that some flexibility of presentation had been introduced.
- This process continued and, by the promulgation of the finalized Directive, the ‘true and fair view’ was established as a predominant principle in the preparation of financial statements (Article 2, paragraphs 2–5).

Relevant EU Directives

- In addition, the four basic principles (accruals, prudence, consistency and going concern) were made clearer than they had been in the 1974 draft (Article 31).
- More rearrangement and summarization of items in the financial statements was made possible (Article 4).
- There were also calls for more notes in the 1974 draft than the 1971 draft, and more in the final Directive than in the 1974 draft (Articles 43–46).
- Another concern of Anglo-Dutch accountants was with the effect of taxation on Franco-German accounts.

Relevant EU Directives

- The extra disclosures called for by the 1974 draft about the effect of taxation are included in the final Directive (Articles 30 and 35).
- The fact that member states may permit or require a type of inflation accounting is treated in more detail than in the 1974 draft (Article 33).
- As a further accommodation of Anglo-Dutch opinion, a 'Contact Committee' of EU and national civil servants is provided for.

Relevant EU Directives

- This was intended to answer the criticism that the Directive gives rise to laws that are not flexible to changing circumstances and attitudes.
- The Committee looks at practical problems arising from the implementation of the Directive, and makes suggestions for amendments (Article 52).
- For over twenty years, the Fourth Directive was not changed in any substantial way.
- However, in 2001, it was amended to allow financial instruments to be valued at fair value with gains and losses taken to income, as is required by the international standard (IAS 39).

Relevant EU Directives

- In 2003, further amendments removed other incompatibilities with IFRSs.
- The Second Directive concerns a number of matters connected with share capital and the differences between public and private companies.
- For example, the Directive requires all member states to have separate legal structures for public and private companies and to have separate names for the companies.

Relevant EU Directives

- As noted in that chapter, a ‘public’ company in this context is one that is legally allowed to have a market in its securities, although it does not *need* to have one.
- For example, many PLCs, SAs or AGs are not listed. It is important to note that ‘public’ in this sense means neither listed nor anything to do with government.
- The implementation of the Directive led to the creation of the BV in the Netherlands and to the invention of the label ‘PLC’ in the United Kingdom.

Relevant EU Directives

- The Seventh Directive concerns consolidated accounting.
- The Eighth Directive was watered down from its original draft, which might have greatly affected the training patterns and scope of work of accountants.
- However, its main effect now is to decide on who is allowed to audit accounts in certain countries.
- Norway, although not a member of the EU, has also implemented the Directives because it is required to do so as a member of the European Economic Area.

Directives on company law

- **Second**
- **Draft dates** 1970, 1972
- **Date adopted** 1976
- **Topic** Separation of public companies, minimum capital, distributions

Directives on company law

- **Fourth**
- **Draft dates** 1971, 1974
- **Date adopted** 1978
- **Topic** Formats and rules of accounting

Directives on company law

- **Seventh**
- **Draft dates** 1976, 1978
- **Date adopted** 1983
- **Topic** Consolidated accounting

Directives on company law

- **Eighth**
- **Draft dates** 1978
- **Date adopted** 1984
- **Topic** Qualifications and work of auditors

The EU Regulation of 2002

- By the early 1990s, it had become clear, even to the European Commission, that Directives were too cumbersome and slow to achieve further useful harmonization.
- The Fourth Directive, agreed in 1978, did not cover several topics and it had been too complicated to amend it often.
- Furthermore, global harmonization had become more relevant than regional harmonization.

The EU Regulation of 2002

- It had also become clear that, for large European companies, voluntary harmonization might focus on US rules over which the European Commission and other Europeans have no influence.
- Consequently, from the middle of the 1990s, the European Commission began to support the increasingly important efforts of the International Accounting Standards Committee (later, the IASB).
- The EU also had in mind the creation of powerful harmonized European financial markets.

The EU Regulation of 2002

- In 2000, the Commission proposed the compulsory use of IFRSs for the consolidated statements of listed companies for 2005 onwards.
- This was agreed by the European Parliament and the Council of Ministers in 2002, in the form of a Regulation.
- This Regulation also allows member states to extend the use of IFRSs compulsorily or optionally to unlisted companies and unconsolidated statements.
- For any companies falling under the Regulation, the national laws and standards on accounting are overridden.
- For other companies, the national rules (including the national implementations of the Directives) are still in effect.

US GAAP

- **Generally Accepted Accounting Principles**, also called *GAAP* or **US GAAP**, is the accounting standard adopted by the U.S. Securities and Exchange Commission (SEC).
- While the SEC has stated that it intends to move from US GAAP to the International Financial Reporting Standards (IFRS), the latter differ considerably from GAAP and progress has been slow and uncertain.

History of US GAAP

- Auditors took the leading role in developing GAAP for business enterprises.
- Accounting standards have historically been set by the American Institute of Certified Public Accountants (AICPA) subject to Securities and Exchange Commission regulations.
- The AICPA first created the Committee on Accounting Procedure in 1939 and replaced that with the Accounting Principles Board in 1959.

History of US GAAP

- In 1973, the Accounting Principles Board was replaced by the Financial Accounting Standards Board (FASB) under the supervision of the Financial Accounting Foundation with the Financial Accounting Standards Advisory Council serving to advise and provide input on the accounting standards.
- Other organizations involved in determining United States accounting standards include the Governmental Accounting Standards Board (GASB), formed in 1984; and the Federal Accounting Standards Advisory Board (FASAB), formed in 1990.

History of US GAAP

- Circa 2008, the FASB issued the FASB Accounting Standards Codification, which reorganized the thousands of US GAAP pronouncements into roughly 90 accounting topics.
- In 2008, the Securities and Exchange Commission issued a preliminary "roadmap" that may lead the United States to abandon Generally Accepted Accounting Principles in the future, and to join more than 100 countries around the world instead in using the London-based International Financial Reporting Standards.

History of US GAAP

- As of 2010, the convergence project was underway with the FASB meeting routinely with the IASB.
- The SEC expressed their aim to fully adopt International Financial Reporting Standards in the U.S. by 2014.
- With the convergence of the U.S. GAAP and the international IFRS accounting systems, as the highest authority over International Financial Reporting Standards, the International Accounting Standards Board is becoming more important in the United States.

Basic objectives of GAAP

- Financial reporting should provide information that is:
  - Useful to present to potential investors and creditors and other users in making rational investment, credit, and other financial decisions
  - Helpful to present to potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts about economic resources, the claims to those resources, and the changes in them
  - Helpful for making financial decisions
  - Helpful in making long-term decisions
  - Helpful in improving the performance of the business
  - Useful in maintaining records

Basic concepts of GAAP

- To achieve basic objectives and implement fundamental qualities GAAP has three basic assumptions, four basic principles, and five basic constraints.

Basic concepts of GAAP - Assumptions

- **Business Entity:** The business is separate from its owners and other businesses.
  - Revenue and expense should be kept separate from personal expense.
- **Monetary Unit:** A stable currency is the unit of record.
  - The FASB accepts the nominal value of the US Dollar as the monetary unit of record, unadjusted for inflation.
- **Periodicity:** The economic activities of an enterprise can be divided into artificial time periods.

Basic concepts of GAAP - Principles

- **Historical cost principle:** Companies must account for and report the acquisition costs of assets and liabilities rather than their fair market value.
  - This principle provides information that is reliable (removing the opportunity to provide subjective and potentially biased market values), but not very relevant.
  - Thus there is a trend toward the use of fair values. Most debts and securities are now reported at market values.

Basic concepts of GAAP - Principles

- **Revenue recognition principle:** Companies should record revenue when earned but not when received.
  - The flow of cash does not have any bearing on the recognition of revenue.
  - This is the essence of accrual basis accounting.
  - Conversely, however, losses must be recognized when their occurrence becomes probable, whether or not it has actually occurred.
  - This comports with the constraint of **conservatism**, yet brings it into conflict with the constraint of **consistency**, in that reflecting revenues/gains is inconsistent with the way in which losses are reflected.

Basic concepts of GAAP - Principles

- **Matching principle:** Expenses have to be matched with revenues as long as it is reasonable to do so.
  - Expenses are recognized not when the work is performed, or when a product is produced, but when the work or the product actually makes its contribution to revenue.
  - Only if no connection with revenue can be established, cost may be charged as expenses to the current period (e.g. office salaries and other administrative expenses).
  - This principle allows greater evaluation of actual profitability and performance (shows how much was spent to earn revenue). Depreciation and Cost of Goods Sold are good examples of application of this principle.

Basic concepts of GAAP - Principles

- **Full disclosure principle:** The amount and kinds of information disclosed should be decided based on trade-off analysis as a larger amount of information costs more to prepare and use.
  - Information disclosed should be enough to make a judgment while keeping costs reasonable. Information is presented in the main body of financial statements, in the notes or as supplementary information

Basic concepts of GAAP – Constraints

- **Objectivity principle**: the company financial statements provided by the accountants should be based on objective evidence.
- **Materiality principle**: the significance of an item should be considered when it is reported. An item is considered significant when it would affect the decision of a reasonable individual.
- **Consistency principle**: It means that the company uses the same accounting principles and methods from period to period.

Basic concepts of GAAP – Constraints

- **Conservatism principle**: when choosing between two solutions, the one which has the less favorable outcome is the solution which should be chosen
- **Cost Constraint**: The benefits of reporting financial information should justify and be greater than the costs imposed on supplying it.

Precedence of GAAP-setting authorities

- In the United States, GAAP derives, in order of importance, from:
  - issuances from an authoritative body designated by the American Institute of Certified Public Accountants(AICPA) Council (for example, the Financial Accounting Standards Board Statements, AICPA Accounting Principles Board Opinions, and AICPA Accounting Research Bulletins);
  - other AICPA issuances such as AICPA Industry Guides;
  - industry practice;
  - into para-accounting literature in the form of books and articles.