



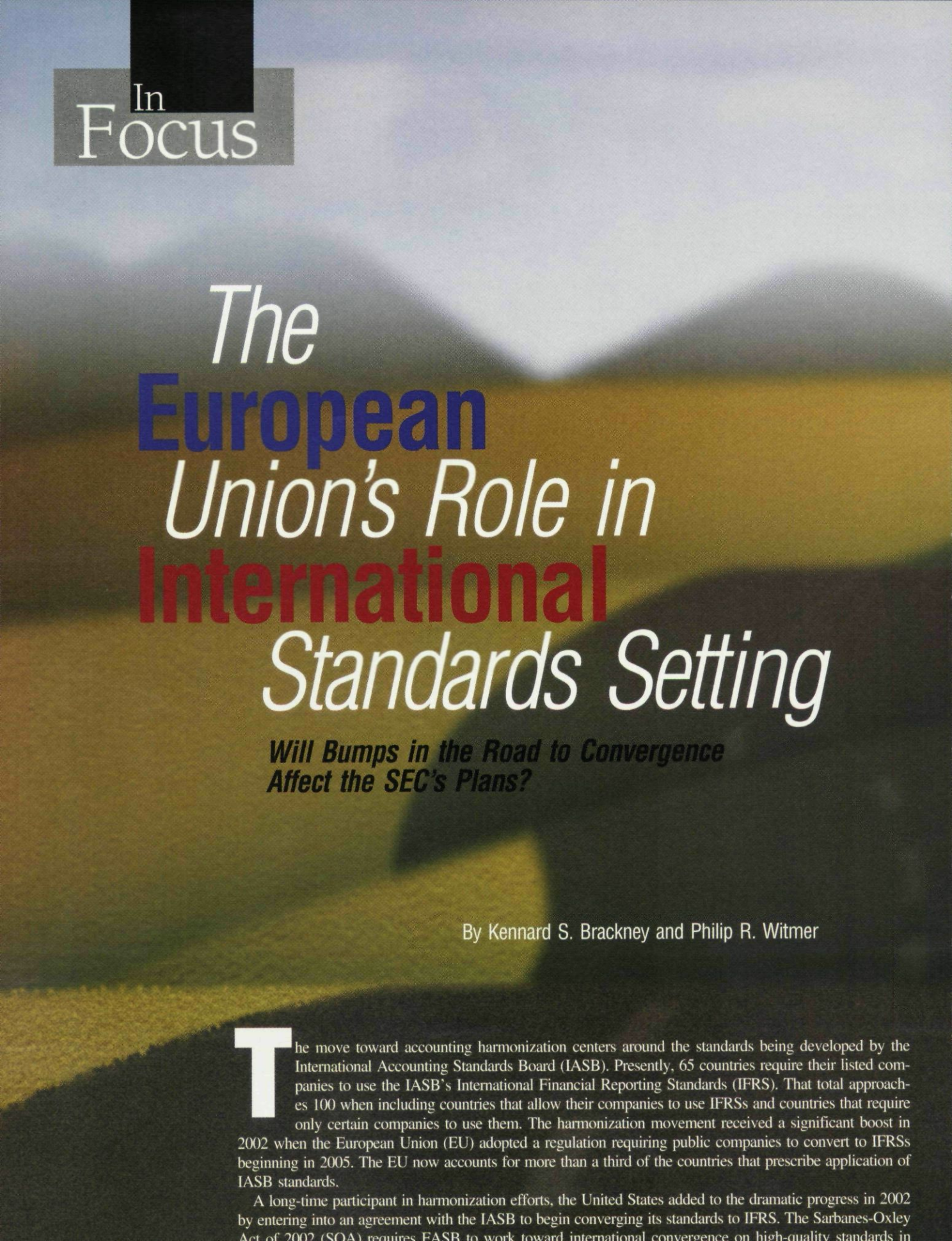
The European Union's Role In International Standards Setting: Will Bumps In The Road To Convergence Affect The SEC's Plans?

By: **Kennard S. Brackney** and **Philip R. Witmer**

Abstract

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Focus

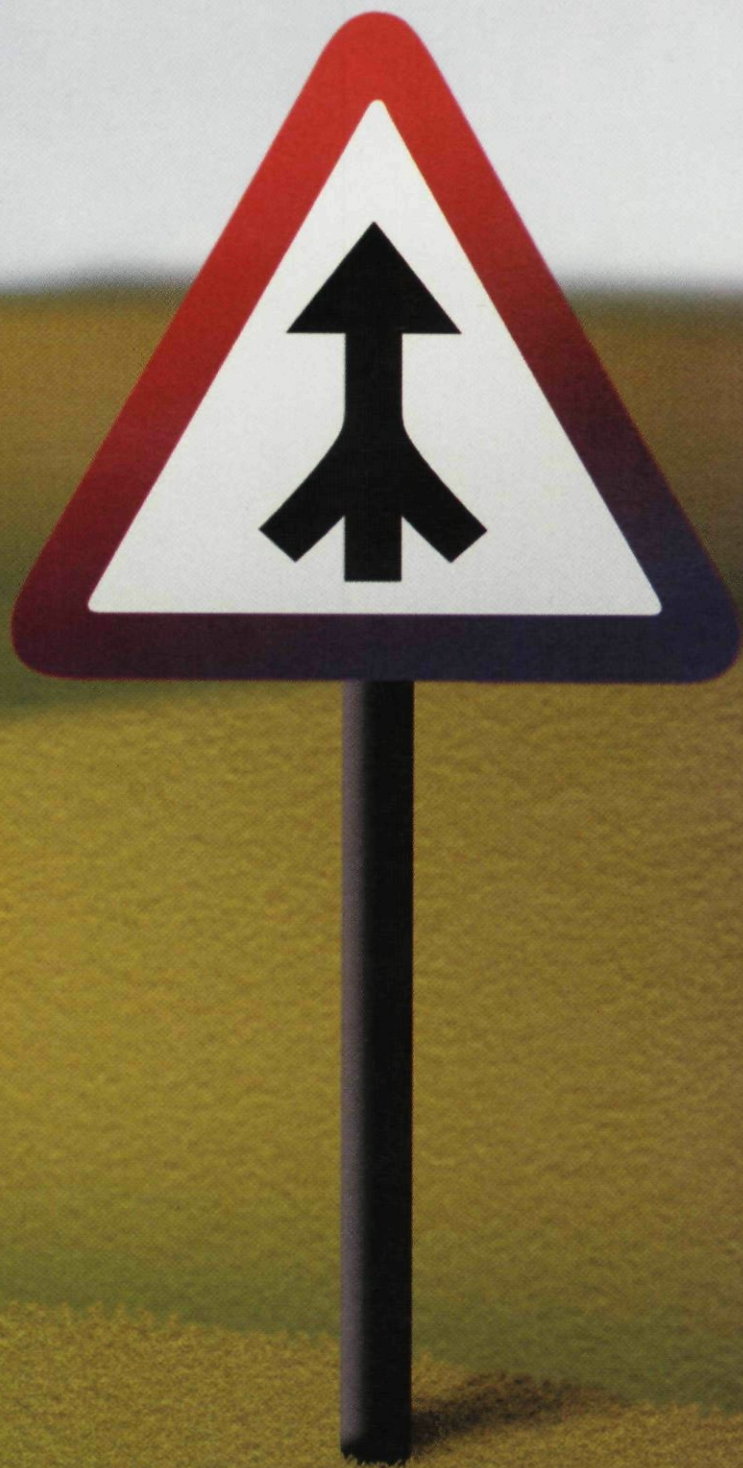
The **European** *Union's Role in* **International** *Standards Setting*

***Will Bumps in the Road to Convergence
Affect the SEC's Plans?***

By Kennard S. Brackney and Philip R. Witmer

The move toward accounting harmonization centers around the standards being developed by the International Accounting Standards Board (IASB). Presently, 65 countries require their listed companies to use the IASB's International Financial Reporting Standards (IFRS). That total approaches 100 when including countries that allow their companies to use IFRSs and countries that require only certain companies to use them. The harmonization movement received a significant boost in 2002 when the European Union (EU) adopted a regulation requiring public companies to convert to IFRSs beginning in 2005. The EU now accounts for more than a third of the countries that prescribe application of IASB standards.

A long-time participant in harmonization efforts, the United States added to the dramatic progress in 2002 by entering into an agreement with the IASB to begin converging its standards to IFRS. The Sarbanes-Oxley Act of 2002 (SOA) requires FASB to work toward international convergence on high-quality standards in



order to maintain its standards-setting role and funding. In a relatively short time, FASB and the IASB have made important progress in narrowing their differences.

While the IASB is concerned with developing standards that can be applied on a global basis, it recognizes that achieving this objective depends on help from the United States and the EU. The IASB's reliance on these two key players is evident from their heavy representation on its oversight and standards-setting bodies. Together, the United States and the EU account for 10 of the IASB's 19 trustees, and 10 of the IASB's 14 board members.

In April 2005, the SEC announced its intention to accept financial statements from EU companies without requiring a reconciliation to U.S. standards if certain conditions can be met. Acceptance depends upon FASB and the IASB continuing to narrow their differences and upon the EU achieving full compliance with IFRS. The SEC anticipates that these conditions can be satisfied by 2009, and possibly as early as 2007. At the same time, the EU is contemplating whether to accept the financial statements of U.S. companies as equivalent to IFRS reporting. With the roadmap in place, it is important for the U.S. accounting and business communities to monitor developments in the EU. This article examines recent developments, from the regulation requiring convergence with IFRSs to the current controversies relating to financial instruments and emission rights. The authors also discuss the EU's single-market vision, its new IFRS endorsement mechanism, and the progress and controversies in adoption of IFRSs.

The EU's Single-Market Vision

EU background. The EU traces its roots to the European Coal and Steel Community, formed in 1951. The six member countries signed the Treaty of Rome in 1957 to form the European Economic Community (EEC), and extended their cooperation to other sectors of their economies. The EEC expanded to nine members in 1973, to 10 members in 1981, and to 12 members in 1986. In 1995, the EEC members signed the Maastricht Treaty to establish the EU, and increased its size to 15 countries. In May 2004, the EU expanded again, to its current membership of 25 countries. *Exhibit 1* shows the 25 member states and four candidates for membership, and identifies the

12 countries that have adopted the euro as their official currency.

The key governing bodies in the EU include the European Parliament, the Council of the European Union, and the European Commission. The European Parliament and the EU Council together are responsible for the legislative aspects of EU government. The council takes on varying configurations according to the nature of the issue being considered. The Economic and Financial Affairs Council (ECOFIN) configuration deals with economic and financial matters, including accounting issues. The European Commission (EC) conducts the executive aspects of EU government. The EC is the body most involved with developing accounting requirements in the EU.

Accounting directives. The founding treaties give the EU authority to develop laws to regulate accounting and auditing for the member states. Its first attempt to establish common financial reporting requirements was the issuance of two Accounting Directives: the Fourth Directive (1978) and the Seventh Directive (1983). Accounting directives are binding on the member states as to the result to be achieved, but they allow states great latitude in achieving those results.

The Fourth Directive, the broader of the two, sets out recognition and disclosure guidelines. It addresses financial statement formats as well as selected recognition and valuation issues. The Seventh Directive addresses consolidated reporting. The directives are rather rigid in terms of financial statement format, but less detailed and more permissive than U.S. GAAP in terms of recognition and valuation. For example, prior to recent changes to the directives associated with the implementation of IFRSs, the accounting options that they permitted for goodwill included capitalizing it, amortizing it, or writing it off directly to retained earnings.

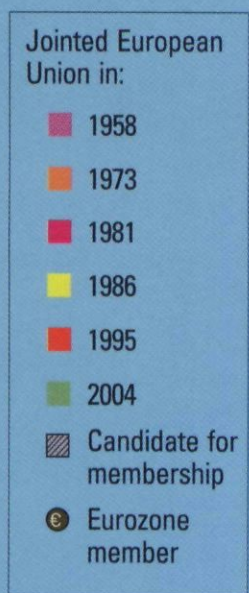
As a result of the directives' permissiveness and the varying financial reporting environments within the EU, the member states' financial reporting standards and practices are very diverse. In countries with a stronger equity culture (e.g., Ireland and the United Kingdom), financial reporting has tended to be more important and more transparent. In contrast, financial reporting has tended to be less important and less transparent in countries where debt financing dominates (e.g., France and Germany). The International Forum on Accountancy Development's

GAAP 2001 survey demonstrates the broad diversity of financial reporting standards among the EU member states under the directives. The survey identified differences between a country's accounting requirements and International Accounting Standards (IAS) for 80 key financial statement items. The survey found that the number of differences with IASs ranged from a low of 20 (Ireland) to a high of 42 (Austria). The mix of types of differences (i.e., recognition, valuation, and disclosure issues) varied significantly as well. It is not surprising that Fritz Bolkestein, then internal market commissioner of the EC, described the state of variation in accounting standards as a European "Tower of Babel."

IAS regulation. The variation in accounting standards mirrored the generally fragmented state of capital markets in the EU. Because EU capital markets lack the size and the degree of integration of those in the U.S., many of the EU's larger companies seek financing in U.S. markets. With the goal of improving the integration and competitiveness of EU capital markets, the EC detailed its vision for a single EU financial services market in a June 2000 position paper, *EU Financial Reporting Strategy: The Way Forward*. The EC identified harmonization of accounting standards for listed companies as central to achieving its vision; more specifically, it identified the adoption of IASs as the best path to successful accounting harmonization.

The EC formally proposed an IAS regulation in February 2001 calling for listed companies in the EU to begin applying IASs in 2005. At the urging of France and Germany, the EU Council added an amendment allowing member states to delay the required adoption of IASs to 2007 for companies with only listed debt and for companies that use a globally accepted GAAP (e.g., U.S. GAAP). The European Parliament approved the amended regulation in March 2002, and the EU Council approved it three months later.

The IAS regulation has affected the vast majority of listed companies in the EU. At the time the regulation was approved, only 275 of the EU's 7,000 public companies used IAS. Of the 7,000 public companies, 6,500 were reporting under their applicable national standards. All of these companies were required to convert to IFRS beginning January 1, 2005. (IFRSs are



issued by the IASB, which was formed in 2001. IASs were issued by the IASB's predecessor, the International Accounting Standards Committee, and many of them remain in effect. The term IFRSs in this article includes the surviving IASs.) With the EU's expansion in 2004, the number of EU public companies applying IFRS in 2005 has grown to 9,000.

The IAS regulation should be viewed as adding to, rather than replacing, the Fourth and Seventh directives. These directives will continue to apply to most private companies, and thus the IAS regulation calls for modernizing them in the direction of IFRSs. Also, certain aspects of the directives that are not addressed in an IFRS will continue to apply to all companies, such

as certain required disclosures concerning a company's workforce and its subsidiaries.

EU Endorsement Mechanism

Two important developments in EU accounting related to financial reporting have occurred since the issuance of the IAS regulation. The first is the establishment of an endorsement mechanism to evaluate IASB standards for adoption in the EU. The second is the series of adoption controversies that have arisen in the evaluation of pronouncements on financial instruments and emission rights. Such controversies are problematic because they could derail the EU's full adoption of IFRSs or delay its implementation of them. These outcomes would impede harmonization and

could affect the U.S.'s decision to accept reporting by EU companies.

Endorsement guidelines. Under the IAS regulation, the EU's adoption of an IASB pronouncement is not automatic. The regulation established an endorsement mechanism for the EU to use in evaluating IASB pronouncements. Pronouncements subject to endorsement review include the IASs and Standing Interpretations Committee Interpretations (SIC) in existence at the time the IAS regulation was adopted, any subsequent IASB amendments to them, and the new IFRSs and International Financial Reporting Interpretations Committee Interpretations (IFRIC) issued by the IASB.

The IAS regulation specifies criteria that an IASB pronouncement must satisfy to

achieve adoption. The pronouncement must: 1) enhance understandability, reliability, and comparability; 2) facilitate "true and fair" reporting by companies; and 3) contribute to the EU public good. The regulation established a two-tier endorsement mechanism to help the EC evaluate the acceptability of IASB pronouncements. While the EC possesses the ultimate decision-making authority in adopting pronouncements, it receives input from two endorsement bodies, one in the private sector and one in the public sector. *Exhibit 2* shows the key players and their roles in this process.

Advisory group. The European Financial Reporting Advisory Group (EFRAG),

formed in June 2001 by European financial reporting interest groups, serves as the private-sector endorsement body. EFRAG advises the EC on the technical merits of IASB pronouncements, and also conveys the EU's perspective in the IASB's standards-setting process. The more successful EFRAG is at influencing the IASB during the development process, the more likely it is to endorse the resulting standard when issued. Thus, the EU considers EFRAG's proactive role to be of primary importance.

EFRAG carries out its technical agenda through the Technical Expert Group (TEG). At present, TEG's 11 voting members are drawn from seven EU countries.

Membership is tilted toward the largest economies, with France, Germany, and the UK having multiple voting representatives. Official, nonvoting observers include the EC, the IASB, and the Committee of European Securities Regulators. EFRAG seeks input from national standards-setting bodies through the Consultative Forum of Standard Setters, which it created. EFRAG may recommend rejecting an IASB pronouncement, but this requires a two-thirds majority of TEG's voting members.

Accounting Regulatory Committee. After receiving and considering EFRAG's endorsement advice, the EC may formulate a draft regulation and submit it to the Accounting Regulatory Committee (ARC), the other endorsement body. ARC's role is to give an official endorsement opinion on the proposal; as a public-sector body, it operates within the confines of EU law, process, and oversight. While the EC chairs ARC, its membership consists of one voting representative from each of the 25 member states. Endorsement decisions are determined by simple majority. In contrast to EFRAG, ARC considers the full range of potential economic and political effects of an IASB pronouncement on member states.

Adoption decisions. If ARC recommends approving the proposed regulation, the EC is able to issue a final regulation adopting the IASB pronouncement. On the other hand, if ARC recommends rejection, the EC has two options: It can return the controversial aspects of the issue to EFRAG for further consideration and advice, or it can send the proposal, along with ARC's recommendation to reject, to the EU Council for it to render a final adoption decision.

Adoption Progress and Controversies

Existing IASs and SICs. As the first step in the EU's conversion to IAS, the IAS regulation stipulated a review of the existing inventory of IASs and SICs to provide a basis for an adoption decision. The regulation set a deadline of December 31, 2002, for the EU to complete its review and adoption of the existing standards. In June 2002, EFRAG recommended adopting them in full. Despite the prompt response from EFRAG, the EU missed its December 31 deadline, citing the challenge of translating the existing standards into the EU's 11 official languages at the time.

The IASB's proposed changes to two standards dealing with financial instruments

EXHIBIT 2
Process of Adopting IASB Pronouncements

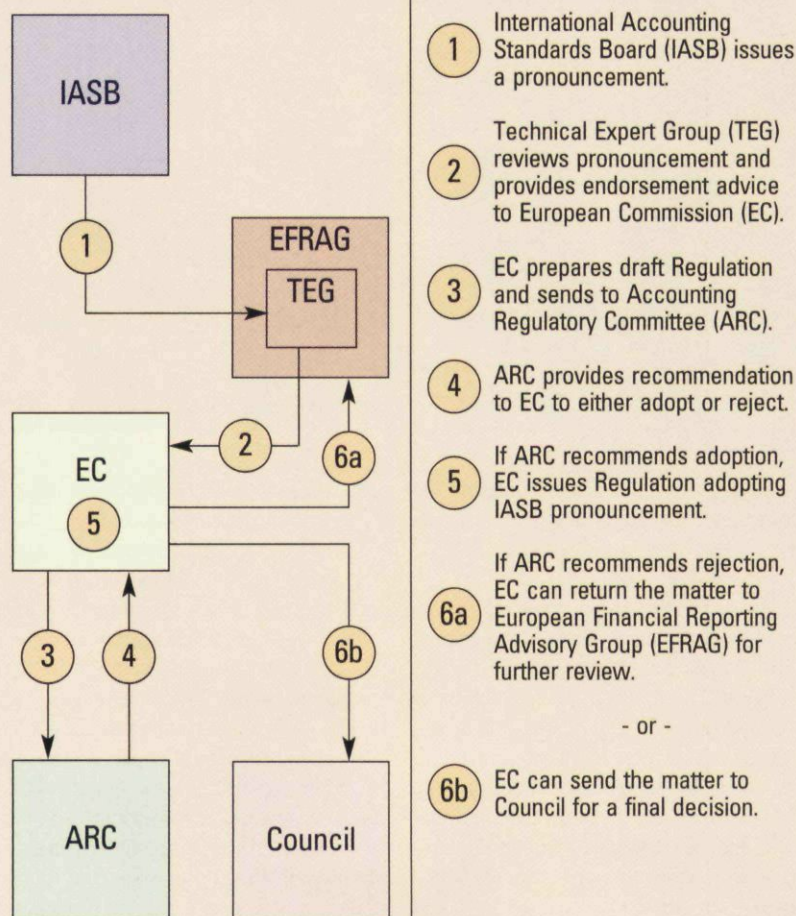


EXHIBIT 3

IAS 39 Cash-Flow Hedge Accounting Example

Bank of Paris, a fictitious French bank, has € 1 million of variable-rate demand deposit liabilities (DDL) at January 1 of Year 1. Based on prior experience, Bank of Paris anticipates these customer accounts will remain outstanding for an average of three years. The bank wishes to hedge its interest-rate exposure on these accounts by entering into an interest-rate swap. The swap has a notional amount of € 1 million and a term of three years, and net settlement in euros is required on January 1 of each year, beginning with Year 2. Under the swap, Bank of Paris receives the London Interbank Offered Rate (LIBOR) plus 1% and pays a fixed rate of 4%. Thus, Bank of Paris will have an asset (a liability) position in the swap when the LIBOR plus 1% is greater than (less than) 4%.

Assume the LIBOR rates, plus 1%, over the term of the swap are as follows:

Year 1 (average and ending)	6%
Year 2 (average and ending)	3%
Year 3 (average and ending)	5%

For reporting purposes, Bank of Paris estimates the fair value of swaps by projecting future settlement amounts using the current year's variable rate and discounting these expected future cash flows for time value using the same variable rate. The relevant present-value interest factors are as follows:

Present value of an annuity due of € 1 for 3 years at 6%	2.83339
Present value of an annuity due of € 1 for 2 years at 3%	1.97087

Year 1			
Dec. 31	Interest expense	€ 60,000	
	Cash		€ 60,000
	(6% interest on € 1 million of DDLs)		
	Interest-rate swap	€ 56,668	
	Net unrealized gain/loss (equity)		€ 56,668
	[Desired balance = € 1,000,000 notional amount x (.06 - .04) x 2.83339 = € 56,668 (asset)]		
	Net unrealized gain/loss (equity)	€ 20,000	
	Unrealized gain (net income)		€ 20,000
	[To offset increase in Year 1 interest expense: € 1 million of DDLs x (.06 - .04) = € 20,000]		
Year 2			
Jan. 1	Cash	€ 20,000	
	Interest-rate swap		€ 20,000
	[To record net settlement for Year 1: € 1 million notional amount x (.06 - .04) = € 20,000 receipt]		
Dec. 31	Interest expense	€ 30,000	
	Cash		€ 30,000
	(3% interest on € 1 million of DDLs)		
	Net unrealized gain/loss (equity)	€ 56,377	
	Interest-rate swap		€ 56,377
	[Desired balance = € 1 million notional amount x (.03 - .04) x 1.97087 = € 19,709 (liability)]		
	Unrealized loss (net income)	€ 10,000	
	Net unrealized gain/loss (equity)		€ 10,000
	[To offset decrease in Year 2 interest expense: € 1 million of DDLs x (.03 - .04) = € 10,000]		
Year 3			
Jan. 1	Interest-rate swap	€ 10,000	
	Cash		€ 10,000
	[To record net settlement for Year 2: € 1 million notional amount x (.03 - .04) = € 10,000 payment]		
Dec. 31	Interest expense	€ 50,000	
	Cash		€ 50,000
	(5% interest on € 1 million of DDLs)		
	Interest-rate swap	€ 19,709	
	Net unrealized gain/loss (equity)		€ 19,709
	[Desired balance = € 1 million notional amount x (.05 - .04) x 1.0 = € 10,000 (asset)]		
	Net unrealized gain/loss (equity)	€ 10,000	
	Unrealized gain (net income)		€ 10,000
	[To offset decrease in Year 3 interest expense: € 1 million of DDLs x (.05 - .04) = € 10,000]		
Year 4			
Jan. 1	Cash	€ 10,000	
	Interest-rate swap		€ 10,000
	[To record net settlement for Year 3: € 1 million notional amount x (.05 - .04) = € 10,000 receipt]		

Summary

	Dec. 31, Year 1	Dec. 31, Year 2	Dec. 31, Year 3
Interest expense	€ 60,000 dr.	€ 30,000 dr.	€ 50,000 dr.
Unrealized gain (net income)	20,000 cr.	10,000 dr.	10,000 cr.
Interest-rate swap	56,668 dr.	19,709 cr.	10,000 dr.
Net unrealized gain/loss (equity)	36,668 cr.	9,709 dr.	—

EXHIBIT 4
EU Adoption of IASB Pronouncements

Pronouncement	European Financial Reporting Advisory Group (EFRAG)	Accounting Regulatory Committee (ARC)	European Commission (EC)
"Existing" IASs and SICs	Endorsed <i>en bloc</i> (6/02)	Endorsed all except IASs 32 and 39 and SICs 5, 16, and 17 (7/03)	Adopted those endorsed by ARC (9/03)
IFRS 1 (6/03)	Endorsed (7/03)	Endorsed (2/04)	Adopted (4/04)
Amendments to IAS 32 (12/03)	Endorsed (7/04)	Endorsed (11/04)	Adopted (12/04)
Improvements to IASs 1, 2, 8, 10, 15, 16, 17, 21, 24, 27, 28, 31, 33, and 40 (12/03)	Endorsed (3/04)	Endorsed (11/04)	Adopted (12/04)
IFRS 2 (2/04)	Endorsed (4/04)	Endorsed (12/04)	Adopted (2/05)
IFRS 3 (3/04)	Endorsed (6/04)	Endorsed (11/04)	Adopted (12/04)
IFRS 4 (3/04)	Endorsed (6/04)	Endorsed (11/04)	Adopted (12/04)
IFRS 5 (3/04)	Endorsed (6/04)	Endorsed (11/04)	Adopted (12/04)
Amendments to IASs 36 and 38 (3/04)	Endorsed (6/04)	Endorsed (11/04)	Adopted (12/04)
Amendments to IAS 39 (12/03 and 3/04)	Gave nonendorsement (7/04) Endorsed carve-out version (9/04)	Took straw poll: 15–4–6 (6/04) Endorsed carve-out version (10/04)	Adopted carve-out version (11/04)
IFRIC 1 (5/04)	Endorsed (7/04)	Endorsed (11/04)	Adopted (12/04)
Amendments to SIC 12 (11/04)	Endorsed (1/05)	Endorsed (5/05)	
IFRIC 2 (11/04)	Endorsed (1/05)	Endorsed (2/05)	Adopted (7/05)
IFRIC 3 (12/04) Withdrew (6/05)	Recommended rejection (5/05)		
IFRIC 4 (12/04)	Endorsed (2/05)	Endorsed (5/05)	
IFRS 6 (12/04)	Endorsed (2/05)	Endorsed (5/05)	
Amendments to IAS 19 (12/04)	Endorsed (2/05)	Endorsed (5/05)	
IFRIC 5 (12/04)	Endorsed (2/05)	Endorsed (5/05)	
Amendments to IAS 39 (12/04)	Endorsed (2/05)		
Amendments to IAS 39 (4/05)	Endorsed (6/05)		
Amendments to IAS 39 (6/05)	Endorsed (6/05)	Endorsed (7/05)	
Amendments to IFRSs 1 & 6 (7/05)	Endorsed (9/05)		
IFRS 7 (8/05)	Endorsed (10/05)		
Amendments to IAS 1 (8/05)	Endorsed (10/05)		
Amendments to IAS 39 & IFRS 4 (8/05)	Gave draft endorsement (9/05)		
IFRIC 6 (9/05)	Endorsed (10/05)		

Sources: Websites of the IASB (www.iasb.org), EFRAG (www.efrag.org), and the EU (www.europa.eu.int).

likely contributed to the missed deadline as well. In June 2002, the IASB issued an exposure draft to revise IAS 32, *Financial Instruments: Disclosure and Presentation*, and IAS 39, *Financial Instruments: Recognition and Measurement*, as part of an improvements program. The exposure draft proposed changes to the guidance on financial instruments, the most significant and controversial of which related to the derivative and hedging provisions of IAS 39. Specifically, it proposed allowing special hedge accounting for portfolio hedges of interest-rate risk. These hedges, also known as macro-hedges, concern a collection of assets, liabilities, or overall net of the two. The IASB's proposal produced a strong reaction, particularly in the EU.

EFRAG sent a comment letter to the IASB in October 2002 expressing its concerns with the proposed changes to hedge accounting requirements. The letter conveyed its view that the accounting for a hedge should follow from the accounting for the hedged item. For hedged items such as receivables and financial liabilities that are accounted for at amortized cost, accounting for the related hedging instrument at fair value creates a mismatching of accounting measurements and, as a result, artificial volatility in a company's equity or net income. The letter also conveyed EFRAG's concerns with the application of fair-value hedge accounting as proposed in the exposure draft. When a hedged item is settled prior to maturity, and the related hedging instrument remains, the hedge is considered ineffective, which disqualifies special hedge accounting. Furthermore, the exposure draft required companies to identify specific items in a portfolio being hedged and to mark them individually to fair value, tasks that would be cumbersome for a large portfolio.

Five member states (Belgium, France, Italy, Portugal, and Spain) expressed strong opposition to IAS 39 and to the proposed changes in the exposure draft. French president Jacques Chirac joined the debate by requesting a meeting of ECOFIN to discuss how to pressure the IASB into eliminating the fair-value reporting requirements for financial instruments altogether. At the July 2003 ECOFIN meeting, Chirac stated that adopting IASs 32 and 39 would be harmful to EU banks and national economies, and he called for the EU to drop the two standards from its endorsement review. ECOFIN

announced that it might recommend delaying adoption of IASs 32 and 39. When ARC met the following day, it unanimously recommended adopting the existing IASs, except for IASs 32 and 39, and three related SICs.

In September 2003, the EC issued a regulation requiring adoption of the 32 IASs and 28 SICs approved by ARC. The EU hoped to work with the IASB to produce new versions of the standards on financial instruments that could be approved by the EU's endorsement mechanism. With input from the EU, the IASB issued an amended version of IAS 32 in December 2003. The revised standard added guidance on netting of assets and liabilities and on classification of redeemable preferred stock, compound financial instruments, and derivatives based on an entity's own shares. EFRAG and ARC endorsed the amended IAS 32, and the EC adopted it in December 2004; EU companies were required to apply it beginning in 2005. In sharp contrast to the relatively smooth revision and adoption process for IAS 32, the EU's consideration of IAS 39 has proved far more contentious, particularly concerning macro-hedging and the fair-value option.

IAS 39 macro-hedging controversy. EU banks objected to the form of the special hedge accounting proposed in the IASB's June 2002 exposure draft for macro-hedges of interest-rate risk. Banks frequently use macro-hedges to neutralize the interest-rate risk on their variable-rate demand deposit liabilities (DDL). The exposure draft proposed cash-flow hedge accounting for these hedges, which banks opposed because they believe it creates artificial volatility in their reported equity.

Exhibit 3 presents an example of cash-flow hedge accounting for a bank's macro-hedge of interest-rate risk. Banks frequently employ interest-rate swaps to hedge the interest-rate exposure associated with their variable-rate DDLs. With cash-flow hedge accounting, a bank revalues the interest-rate swap to fair value at reporting dates, and reports the change in fair value each period directly in equity. In contrast, the hedged item (portfolio of DDLs) is not revalued each period. Rather, the DDLs are reported at their nominal value (sum of customers' account balances).

In the example, the variable interest rate on the DDLs increases during Year 1. When the variable rate increases, the bank reports higher interest expense on the DDLs

in net income. At the same time, it reports the interest-rate swap as an asset and shows a corresponding unrealized gain in equity. In addition, the bank must make a reclassification entry to shift a portion of the unrealized gain from equity to net income. For the perfect hedge in this example, the amount of unrealized gain reclassified from equity to income is the amount required to offset the increase in interest expense (€20,000 for Year 1). In its equity section, the bank shows the residual portion of the unrealized gain that pertains to the swap's remaining term (€36,668 at the end of Year 1). The variable rate on the DDLs decreases during Year 2, leading to a net unrealized loss at year-end of €9,709. Thus, in the example, the unrealized gain at the end of Year 1 becomes a net unrealized loss at the end of Year 2. Many EU banks view these changes in equity as artificial volatility caused by the IASB's "mixed-measurement" model, which requires DDLs to be reported at their nominal amount rather than their fair value.

EU banks cite an additional problem if customers draw down their accounts: The hedged item (portfolio of DDLs) would decrease, yet the hedge would remain in force. The hedge would be ineffective at that point, forcing the bank to give up special hedge accounting and reclassify the remaining unrealized gain on the hedge to net income. Thus, the volatility would be shifted to the income statement.

Following the release of the June 2002 exposure draft, many EU banks and other companies lobbied the IASB aggressively, calling for the board to revise the proposed guidance for macro-hedges to permit fair-value hedge accounting. With fair-value hedge accounting, changes in the fair values of the hedged item and the hedging instrument offset each other in net income. EU banks asserted that fair-value measurement of DDLs is appropriate because, in their experience, the actual term of these accounts is a year or more, and customer withdrawals can vary over this period with changes in interest rates. So, with the settlement of DDLs likely to be deferred at least a year, banks claim the present value of the expected future settlement of these accounts is less than the accounts' nominal amount. Moreover, the banks believe the value of their DDLs varies over time with interest-rate changes, which impact customer withdrawals (a form of interest-rate risk).

In August 2003, IASB responded to the lobbying by issuing a revised exposure draft on portfolio hedging. The revision extended the use of fair-value hedge accounting to more situations, and addressed application concerns raised by EFRAG and others. It proposed allowing companies to group hedged items according to their expected maturities; to identify a currency amount of hedged items; and to use a separate valuation account to adjust hedged items to fair value. However, the revision specifically precluded the use of fair-value hedge accounting for the interest-rate risk associated with DDLs. The IASB cited the immediate settlement rights on these accounts as

tain financial assets are measured at fair value but others are not. Moreover, financial liabilities, which many banks and insurers manage with the goal of maintaining a natural hedge of the interest-rate risk on their financial assets, are reported at their amortized initial amount. This mismatching of asset and liability measurements creates artificial volatility in income. With the fair-value option, companies could report matched financial assets and liabilities at fair value and thus achieve a natural offsetting of unrealized gains and losses in income.

Although many EU banks and insurers favor the fair-value option, banking regulators such as the European Central Bank

against adoption, falling short of the two-thirds majority required for a recommendation to reject. Officially, EFRAG issued no opinion on IAS 39.

With the IFRS implementation date looming, the EC moved quickly to formulate a compromise proposal. It proposed temporarily removing from the EU's adoption review the most controversial aspects of IAS 39, those relating to portfolio hedging and the fair-value option. The EC reasoned that these "carve-outs" would give EU interests more time to develop alternative approaches and present them to the IASB. With the carve-out version of IAS 39, EU banks would not have to apply cash-flow hedge accounting to macro-hedges involving DDLs and would be free to choose fair-value hedge accounting. In addition, EU companies would not be permitted to elect the fair-value option.

The EC asked EFRAG to conduct a limited review of the carve-out proposal to determine if it would be acceptable from a technical perspective. TEG gave a favorable assessment of the proposal as a short-term solution, but expressed concern with applying it on a long-term basis. ARC endorsed the proposal in October 2004, despite opposing votes from the Czech Republic, Denmark, Hungary, and Sweden. The EC adopted the carve-out version in November 2004, with application required in 2005.

Since that time, EU interests have continued to lobby the IASB to rework the carved-out aspects of IAS 39. The European Banking Federation proposed an alternative hedge accounting concept, interest-rate margin hedging, which the IASB is examining. A rapid resolution of the differing viewpoints on macro-hedging seems unlikely at this time.

In contrast to the standoff on the macro-hedging issue, the two sides have resolved their differences on the fair-value option. The ECB sent a proposal to the IASB in 2004 asking for restrictions on use of the fair-value option to prevent companies from writing down their liabilities due to their own deteriorating creditworthiness. The IASB responded favorably to that input, and after further discussions, it issued an amendment in June 2005 limiting use of the option to a few specified situations where fair value is verifiable. These include the following:

- Financial assets and liabilities with embedded derivatives;

IASB Chairman Sir David Tweedie has referred to the EU's mass conversion to IFRSs in 2005 as the biggest change to hit European business since the euro. One could argue that the EU's transition to IFRSs is the largest and most complex accounting conversion in history.

the basis for reporting them at their full nominal amount. The IASB wanted to finalize the guidance on macro-hedging in time for the EU and others to begin applying it in 2005, and in March 2004 issued an amendment to IAS 39 that was in line with the August 2003 revised exposure draft.

IAS 39 fair-value option controversy. A second aspect of IAS 39 has met with stiff resistance in the EU as well. The June 2002 IASB exposure draft proposed a fair-value option for companies to extend the application of fair-value measurement (with value changes reported in net income) to financial assets and liabilities that are not permitted this treatment by IAS 39. A company electing this option must do so at the time of initial recognition of the asset or liability, and the election is permanent. The IASB added this option to address the mixed-measurement problem in IAS 39, whereby cer-

(ECB) strongly oppose it because they believe weaker banks with deteriorating credit conditions could use it to write down their liabilities, thus helping them meet statutory capital requirements. Despite the concerns, in December 2003 the IASB finalized amendments to IAS 39 that retained the fair-value option.

IAS 39 carve-out compromise. The EU returned to IAS 39 again after the IASB amended it in December 2003 and March 2004. At a meeting in June 2004, ARC conducted a straw poll on IAS 39; four member states (Belgium, France, Italy, and Spain) opposed adoption of the standard, and six others (including Germany) abstained. The large number of opposing and abstaining countries raised the possibility that ARC might not recommend adoption of the standard. When EFRAG met a month later, TEG's vote was 5-6

■ Financial assets and liabilities where use of the option significantly reduces an accounting mismatch; and

■ Financial assets and liabilities evaluated on a fair value basis according to a documented risk management strategy.

Loans and receivables are specifically excluded. Instruments with embedded derivatives (e.g., convertibles) are included to ease the requirement under IAS 39 to separate the embedded derivative from its related component and apply fair-value accounting to it. As an unusual show of its support for these amendments, EFRAG deviated from its normal process and issued a draft recommendation to adopt the new guidance prior to its official release. ARC followed with its endorsement in July 2005. Thus, one of the two IAS 39 carve-outs has now been eliminated.

The remaining carve-out is creating confusion and frustration within the EU. For example, the United Kingdom's Accounting Standards Board, which opposed the IAS 39 carve-outs, has contemplated recommending that British companies apply the macro-hedging guidance in IAS 39 as issued by the IASB. Because the carve-out relating to macro-hedging allows, rather than requires, EU companies to opt out of the cash-flow hedge accounting guidance in IAS 39, the potential exists for different companies to apply different hedge accounting treatments. The flexibility provided in this carve-out will impair comparability across EU companies, and with non-EU companies that apply IAS 39 as issued.

New IASB Pronouncements

The IAS regulation requires the EU to also review new IASB pronouncements upon their issuance. To date, the IASB has issued seven IFRSs (1–6), and six IFRICs (1–5), and 12 amendments to existing standards. *Exhibit 4* summarizes the EU's endorsement and adoption decisions on these pronouncements. EFRAG has reviewed them and issued a recommendation to adopt for all but one, IFRIC 3, which relates to reporting of emission rights. ARC has reviewed 17 of the new pronouncements and recommended adoption for all. Thus far, the EC has formally adopted 11 of those endorsed by ARC. ARC and the EC are still reviewing several pronouncements.

IFRIC emissions controversy. IFRIC 3 is creating another adoption controversy in the EU. Following TEG's 0–8–2 vote (two abstentions) on IFRIC 3 in February 2005, EFRAG issued a recommendation in May to reject it. With the EU introducing a system of tradable greenhouse-gas emission allowances in 2005, the issue of accounting for emission rights is of great interest to EU companies. EFRAG's objections relate to potential mismatching that could arise in the reporting of emission assets and liabilities. If a company chooses the cost option provided in IFRIC 3, it will report tradable emission allowances at acquisition cost and report the liability for emission penalties at the settlement amount, which could differ. If a company chooses the fair-value option, mismatching will arise in the reporting of unrealized gains and losses. Unrealized gains and losses related to the liability will be reported in income, while those related to the asset will be reported in equity. Similar to the IAS 39 carve-outs, the EU is stating its intention to reject guidance provided by the IASB. Prompted by EFRAG's rejection, the IASB decided to withdraw IFRIC 3 in June 2005. It plans to study the issue further to address the concerns raised regarding mismatching.

Complications Expected

IASB Chairman Sir David Tweedie has referred to the EU's mass conversion to IFRSs in 2005 as the biggest change to hit European business since the introduction of the euro. One could argue that the EU's transition to IFRSs is the largest and most complex accounting conversion in history. It is significantly impacting 9,000 EU companies, their auditors, national regulators, and, more generally, all aspects of the investing and financing functions relating to these companies.

Its adoption process thus far has demonstrated the EU's willingness to assert its influence in protecting its own interests. It has on three occasions voted to reject IASB guidance. Its first act of defiance was to carve out IASs 32 and 39 from its adoption of existing standards. The second was the carving out of certain provisions of IAS 39 dealing with portfolio hedging and the fair-value option from the subsequent adoption of the standard. The most recent case was EFRAG's recommendation to reject IFRIC

3. At each step, the EU has shown its intention to shape IFRSs in its image.

The rejection of an IASB standard is not the EU's only means of promoting its interests. In addition, EFRAG issues comment letters on draft IASB standards. The EU members of the trustees and the board push the EU's agendas. Additionally, EU interest groups directly lobby the IASB.

The EU's participation in the IASB's standards-setting process could complicate and slow the creation of global standards. At the same time, however, the EU has a counterbalancing interest in seeing the swift creation and adoption of standards that the United States would be willing to accept. The 300 EU companies currently listed in U.S. markets want the SEC to accept their filings without reconciliation to U.S. GAAP. If the SEC eliminates the reconciliation requirement, many more EU companies are likely to seek a listing here. Then-SEC chief accountant Donald Nicolaisen stated that failure on the part of the EU to observe IAS 39 and other standards as issued by the IASB could jeopardize or delay U.S. acceptance of EU reporting. The EU is certainly aware of the potential for this undesirable outcome.

Many interests are watching from the sidelines to see how the EU's adoption controversies play out. In addition to the SEC, these interests include U.S. parent companies with EU subsidiaries that may now be using the EU-approved version of IFRSs, and U.S. subsidiaries of EU companies that must now report using EU-approved IFRSs. They also include many companies in the United States making investing and financing decisions regarding EU companies.

While the prospect of the United States deciding to adopt IFRSs as its GAAP would have been unthinkable a few years ago, it could happen. If it does, the EU's endorsement experience could provide potentially useful lessons in carrying out such a program. □

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