

# **The Adoption of IFRS in the EU and New Zealand**

## **A Preliminary Report**

**By Joseph Bebbington and Esther Song**

**National Center for Research on Europe**

**University of Canterbury**

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## **1. Introduction to Accounting Harmonisation**

The financial reporting practices of companies vary vastly between different countries. This leads to great complications for those preparing, consolidating, auditing and interpreting published financial statements. Furthermore, due to the frequent overlapping between the preparation of internal financial information and the preparation of published information, the complications spread further. To combat this, many organisations throughout the world, such as the United Nations (UN), the World Bank, the Organisation for Economic Co-operation and Development (OECD), the World Trade Organisation (WTO), the European Union (EU), the International Organisation of Securities Commission (IOSCO) and many others, are involved in attempts to harmonise or standardise accounting. These organisations support the effort of the International Accounting Standards Board (IASB) (formerly known as the International Accounting Standards Committee (IASC)) to eliminate barriers to investment flows between nations and to assist the efficient allocation of saving to investment on a global basis. The accounting profession, led by the International Federation of Accountants (IFAC) and other capital market participants, sees the globalisation of business as increasingly supporting the need for one set of accounting standards used throughout the world to produce comparable financial information (Roberts et. al., 2002).

“Harmonisation” is a process of increasing the compatibility of accounting practices by setting bounds on their degree of variation. “Standardisation”, on the other hand, is a process by which all members agree to follow the same or very similar accounting practices. Standardisation appears to imply the imposition of a more rigid and narrow set

of rules, with the end result being a state of uniformity (Tay and Parker, 1990). Within accounting, these two words have almost become technical terms, and one cannot rely upon the normal difference in their meanings. Harmonisation is a word that tends to be associated with the supranational legislation promulgated on the EU, while standardisation is a word often associated with the IASB (Roberts et. al., 2002). However, in practice, these words are often used interchangeably.

It is possible to distinguish between *de jure* harmonisation (that of rules and standards) and *de facto* harmonisation (that of corporate financial reporting practices). For any particular financial reporting area or group of countries, it is possible to have one of these two forms of harmonisation without the other. For example, countries or companies may ignore the harmonised rules of standard setters or even lawmakers. By contrast, market forces persuade many companies in France or Switzerland to produce financial reports in English, which approximately follow Anglo-American practice.

## **2. Moves towards Accounting Harmonisation Internationally**

Outright adoption or convergence with International Financial Reporting Standards (IFRS) (formerly known as the International Accounting Standards (IAS)) is now a global phenomenon that is rapidly gathering pace. The EU, Australia, Russia and several other countries in the Middle East and Africa have decided on a wholesale, mandatory change to IFRS. Furthermore, the United States (US), South Africa, Singapore, Turkey and Malaysia are committed to convergence with the international benchmark.

New information technologies have dramatically changed the financial reporting environment, reducing the barriers of physical distance and making information available globally at the touch of a button (PricewaterhouseCoopers, 2003). Consequently, millions of new investors have been brought into the global capital markets, and more importantly, their interests are not constrained by national boundaries.

Undoubtedly, globalisation is making the case for uniform accounting throughout the world irresistible. Investors are attracted to those markets that they understand, trust and have confidence in. Besides investors and analysts, other stakeholders such as employees, creditors, suppliers, customers, lenders and non-governmental organisations are voicing their need for top quality information on which to base their investment decisions. They want to compare the information published by a target company with its competitors, whether based on the same country or other parts of the world (Pricewaterhousecoopers, 2003).

For those reasons, countries which adopt internationally-recognised and –understood accounting standards for financial reporting will be positioned at a significant advantage to those who do not. Provision of information in accordance with a known set of accounting standards that is high quality, transparent and comparable minimises and lowers the cost of capital for investments. Furthermore, many believe that the adoption of IFRS reduces cost of operations for multinational companies, coordinates internal and external reporting of an entity’s operations, eliminates confusion and allows accounting professionals to operate more efficiently across the world, as well as reduces the cost that

a country could incur in developing their own standards. Hence, it is not surprising that large accounting firms around the world, such as Ernst and Young and Pricewaterhousecoopers, considered that the early adoption of IFRS gives companies, particularly large multinationals, the opportunity to make time their ally and enables them to anticipate challenges with IFRS implementation, manage outcomes and implement the best solutions for such challenges.

Although the adoption of IFRS is often seen as being able to bring significant advantages to companies, there are nevertheless a number of problems or challenges that need to be addressed if the progress of accounting harmonisation achieved by each country so far is to be preserved and if the companies is to be in a position to deal with the important challenges which face it. These problems will be outlined and discussed in sections below.

### **3. Why has the EU Adopted IFRS and how has it done this?**

#### **3.1 Development of EU Company Law Harmonisation Programme**

The early moves towards the internationalisation of accounting systems across Europe followed the foundation of the European Community (EC) (currently known as the EU) as based on the Treaty Establishing the European Community (EEC) (also known as the Treaty of Rome) signed in 1957. The primary motive for the harmonisation of accounting systems across all the Community Member States as stated in Article 54 Paragraph 3g of the Treaty is to “reach an economic equal level playing field within the Community” (Haller, 2002, p. 155); this is in terms of freedom of formation and equivalent levels of

protection for shareholders, employees and creditors across Member States (Roberts, 2002). The overall aim could be seen as one which facilitates intra-Community trading and financial transactions, hence contributing to free trade and free movement of capital within the Communities (Roberts, 2002).

The EU achieves its harmonisation objectives through the Directives, mainly the Fourth and the Seventh EC Directives, which must be incorporated into the laws of Member States. The relevant body of law for accounting is company law. A Directive is an instrument that is directly binding following the adoption by the Council of Ministers (since 1994, together with the Parliament). It obliged Member States to enact into national law the provisions of the Directive within a given timeframe (Roberts, 2002). The Regulation, on the other hand, is an instrument, which after it has been adopted, is directly binding and effective on the Member States. This has been far less used for company law harmonisation within the EU (Roberts, 2002). Nonetheless, the EC emphasised that the accounting harmonisation pursued through the implementation of the Directives was aimed at fostering comparability and equivalence of financial information (Commission of the European Communities, 1995, p. 3) (Van Hulle, 1993, p. 99), rather than absolute uniformity (Van Hulle, 1992).

As have been mentioned previously, the Fourth and the Seventh Directives were the main instruments used to promote accounting internationalisation and harmonisation within the EU. The Fourth Directive, which was aimed at harmonising the national laws on the accounting regulations of both public and private companies (Haller, 2002), was finally



adopted by the Council of Ministers on 25<sup>th</sup> July 1978 (Roberts, 2002). In addition, the Fourth Directive intended to make it easier for investors, lenders and suppliers to obtain, understand and rely on the accounts of companies in other Member States, and to promote fair competition among Member State companies (Roberts et. al., 2002). Its articles include those referring to valuation rules, formats of published financial statements and disclosure requirements. It only covers individual company financial reporting, rather than consolidation financial reporting, which is left to the Seventh Directive. The first draft of the Fourth Directive was published in 1971, before the United Kingdom (UK), Ireland and Denmark (let alone Austria, Greece, Portugal, Spain, Sweden and Finland) joined the EU. The initial draft was strongly influenced by the (West) German company law, particularly the Aktiengesetz of 1965 (Nobes, 1983). As a result, valuation rules, for instance, were to be conservative and formats were to be prescribed in detail. Furthermore, financial statements were to strictly comply with the provisions of the Directive. Besides aspects affecting format and valuation, the Fourth Directive include the requirement that annual accounts present a true and fair view (TFV) of a company's assets, liabilities, financial position and profit or loss, as well as the extensive requirements on information which has to be provided by means of explanatory notes (Haller, 2002) (Roberts et. al., 2002).

The concept of TFV was introduced when the UK, Ireland and Denmark joined the then common market in 1973 (Roberts, 2002). The accounting traditions of these three countries differ significantly from most other countries in continental Europe. The influence of Anglo-Saxon thinking was such that a much amended draft of the Fourth

Directive was issued in 1974. Another significant change which can be found in the amended Fourth Directive was the flexibility permitted in the presentation of annual accounts. The process of changes and updating continued and, by the promulgation of the finalised Directive, the TFV was established as a predominant principle in the preparation of financial statements (Article 2, paragraphs 2-5, Fourth Directive). 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, Fourth Directive). As a result of such changes, more rearrangement and summarisation of items in the financial statements were also permitted (Article 4, Fourth Directive). Furthermore, there were more extensive requirements for explanatory notes in the final Directive compared to both the 1971 and 1974 drafts (Article 43-46, Fourth Directive).

The Seventh Directive, which was adopted on 13<sup>th</sup> June 1983, concerns consolidated accounting in the Member States. It requires a parent company to prepare, in addition to its individual accounts, consolidated accounts and a consolidated annual report in which the financial situation of the group is presented as if it were a single entity. The Seventh Directive contains guidelines for the determination of groups, scope of group accounts and obligation to prepare, audit and publish group financial statements as well as consolidated-related methods (Haller, 2002).

In Europe, legislation requiring such statements to be prepared is first found in the UK in 1947 and in West Germany in 1965 (Haller, 2002) (Roberts, 2002). In fact, prior to the enactment of the Seventh Directive in 1983, there were no legal requirements for such

statements to be produced in other EU Member States. Nonetheless, the need for harmonisation in this area was foreshadowed in the Fourth Directive, where Articles 57-61 clearly mention a future Directive on consolidated accounts (Roberts, 2002). Indeed, many of the requirements contained in the Fourth Directive, notably, formats, accounting principles and valuation rules, as well as the overriding concept of TFV, were incorporated into the Seventh Directive.

The implementation process through the Member States is characterised by an extensive time period between the approval of the Fourth Directive in 1978 and its first and final transformation in national law (Haller, 2002); and the speed of the transformation into national laws varies between Member States (Roberts et. al., 2002). The UK and Denmark were, in 1981, the first two countries; and Austria, with the completion of the last adjustments in 1996 (due to its late entry into the EU in 1995), the last country to have completed the transformation so far (Haller, 2002). As for the Seventh Directive, the first countries to finish the transformation were France and Germany, and Austria was the last (Haller, 2002). These matters will be further discussed in the following sections of this report.

The implementation of the Directives into national laws had provoked significant changes to the legal accounting requirements, which affected each Member State differently. For example, in the UK (where the accounting practices have traditionally been characterised as more flexible and requiring subjective professional judgements of accountants), detailed account formats were prescribed by law for the first time

(Haller, 2002) (Roberts, 2002). Similarly, in Italy and Spain (where the company law contains only general requirements regulating the form and content of accounts), the new financial reporting requirements became more narrow and prescriptive following the implementation of the Fourth Directive (Thorell and Whittington, 1994, p. 218) (Zambon and Saccon, 1993) (Vigano, 1998, pp. 394-396) (Giner, 1993) (Mora and Rees, 1998). As for consolidated accounting, the UK and Ireland, which already had extensive legal regulation for group accounts, while several other countries had very broad and general provisions for consolidated financial statements, has repeatedly resulted in a variety of different consolidation method being used in Member States (Haller, 2002).

In addition to the above changes, the purpose of financial statements in many Member States has also changed. Before discussing further, it is worth mentioning that the classification of the differences of financial reporting practices in Europe can be divided into two main categories: an Anglo-Saxon countries group which include the UK, Ireland, the Netherlands and Denmark, and a Continental countries group which basically comprises most other western European countries. Accounting in the Anglo-Saxon group has traditionally been characterised by a considerable amount of options or a freedom of choice and the exercising of subjective judgement in selecting accounting methods, and a relative disconnection between tax and financial reporting. The Anglo-Saxon accounting has also been marked by the compliance with accounting standards rather than law, and a concern for communicating relevant and timely information to investors for their decision-making. Accounting for the Continental group, on the other hand, has traditionally been very much state-driven and tax dominated (which means a close

relationship between tax and financial reporting). Furthermore, the financial reporting practices follow very strict and rigid prescriptions as contained in commercial codes, company law and general accounting plans, and featured by the absence of authoritative standard-setting bodies. Nonetheless, following the implementation of the Directives, the aim of individual accounting in many Continental European countries, such as Spain, Belgium, Austria and Germany, has shifted from the purpose of determining tax and dividend payments to providing useful information for business decision-making among investors (similar to the Anglo-Saxon orientation). Also, group accounts in particular, which have been largely neglected prior to the implementation of the Seventh Directive in countries such as Austria, Belgium, Greece, Italy and Spain, have gradually become more recognised as a solid basis for business and investment decisions (Giner, 1993) (Mora and Rees; 1998) (Zambon and Saccon, 1993, p. 257).

### **3.2 The Effectiveness of the Fourth and Seventh Directives**

When evaluating the effectiveness of the Fourth and Seventh Directives in fostering accounting harmonisation within the EU Member States, the fact that the issue of accounting harmonisation at the time of the issuance of the Directives was a “highly political task” has to be taken into consideration (Haller, 2002, p. 156). In fact, accounting harmonisation was considered as a “building block of the political aim and process to reach a common European economic market” (Haller, 2002, p. 156) and it was aimed to serve as an instrument to achieve a “common political vision” (Haller, 2002, p. 156). Nonetheless, this common vision was further complicated by the reluctance of each Member State to compromise, and the national strongholds, which neither the national

political parties nor the market had been ready at that point in time to discard for the sake of international comparability and equivalence of financial statements between the Member States. This problem had been compounded by the differing relationships of financial accounting in respect to income and corporate tax determination among the Member States, coupled with the “diverse weight” and interpretation of the principle of prudence (Haller, 1992) (Liener, 1992, p. 272) (Evans and Nobes, 1996).

As mentioned previously, the harmonisation programme within the EU was implemented through the medium of company law (Haller, 2002) (Roberts, 2002). The Fourth Directive was used to revise commercial codes that applied to all business entities, whether incorporated or not, with or without limited liability, in many continental European countries. On the other hand, in Anglo-Saxon countries such as the UK and Ireland, the vastness of accounting regulation was, and is, through the promulgation of accounting standards, rather than the company law, and it is focused solely on limited liability companies (Roberts, 2002). Furthermore, since the Fourth Directive did not aim to achieve a complete standardisation of accounting rules, rather the comparability and equivalence of financial information, it contained a considerable number of options for Member States or for companies, thus permitting different accounting treatments. Indeed, comparability between different options is established through additional information in the explanatory notes that must accompany the balance sheet and profit or loss statements. Nonetheless, exemptions were allowed for small and medium-sized entities (Commission of the European Communities, 1995).

While the options from the provisions represented a compromise between the two different categories of accounting tradition in the Anglo-Saxon and Continental European countries, hence, constituting the solution for bridging the conflict of interests and views among each Member State (Thorell and Whittington, 1994, p. 220), it is believed that the extensive amount of options were factors which “weakened” the potential extent of harmonisation in the EU (Roberts, 2002, p.8). This is an approach which was highlighted in the Directive’s objective of bringing about “minimum equivalent legal requirements” (Preamble to Fourth Directive) (Roberts, 2002). Moreover, influenced by the national accounting traditions of the Member States, these available options had been carried out in different ways throughout, thus, further hampering the proposed and intended degree of comparability and equivalence of financial statements in the EU (Haller, 2002).

Other problems relate to the coverage of accounting issues in the Directive; for instance, its “minimalist stance” indicated that it did not address a variety of major reporting issues such as accounting for construction contracts, pensions and unsettled foreign currency translations (Commission of the European Communities, 1995) (Roberts, 2002, p. 8). This, together with the fact that some principles contained in the Directives were interpreted differently in different Member States, had had negative consequences for the comparability of accounts. One of such problem had been the differing perceptions of the role of concrete rules versus the professional judgement in accounting (Nobes, 1986) (Haller, 2002), along with the difficulties in translating the TFV concept into the various languages of the EU Member States (Alexander, 1993) (Nobes, 1993) with the effect that its Anglo-Saxon sense had been largely reduced in some continental countries, such as

Italy and Germany (Roberts, 2002). The importing of the TFV concept from its Anglo-Saxon counterparts had further increased the confusion about its content and the complications in the application of such principle while preparing the financial statements of companies in the continental countries. Worse still, due to the connection between financial and tax accounting, several Member States, including Austria, Germany and Sweden, refused to implement the override function of the TFV required in Article 2 of the Fourth Directive into their national laws (Commission of the European Communities, 1998) (Van Hulle, 1997, p. 716f).

In addition to such 'internal' problems, the absence of a common position on accounting issues had prevented the EU from playing an effective role in international forum that discuss accounting issues. The fact that EU Member States had difficulty in coordinating their efforts and in identifying a common position was also "disorienting" for other European countries, which increasingly looked to the EU when they had to set up or to restructure their national financial reporting systems (Commission of the European Communities, 1995).

Given these and other limitations inherent in the provisions of the Fourth Directive, this key Accounting Directive might be considered to have contributed only a small input to accounting harmonisation in the EU (Haller, 2002) (Roberts, 2002). Thorell and Whittington (1994), however, argued vigorously that the Directive has brought about significant changes in the EU. Van Hulle and Van der Tas (2001) also demonstrated the powerful influence that the Fourth Directive had had on countries outside the EU.



With regards to the Seventh Directive, its development was manifested by a controversy as to what constitutes a group, a concept which seemingly underpins the production of consolidated accounts (Roberts et. al., 2002). The UK's approach to the definition of a parent-subsiary relationship was, essentially, *de jure*, based upon a majority shareholding control criterion. The German approach, on the other hand, was to define a group (known as Konzern) in economic terms. Thus, the notion 'control' was characterised in *de facto* terms, rather than *de jure* (Roberts, 2002). After analysing the "evolution" of the Directive through its various drafts, Diggle and Nobes (1994) concluded that, although the final version of the Seventh Directive showed a German origin, it was very similar to the UK consolidated practices.

In attempting to solve such controversy, Articles 1-15 of the Directive circumvented the use of term 'group', opting instead to set out the "conditions for the preparation of consolidated accounts" (Roberts, 2002). Likewise, other controversies which arose in the course of drafting were resolved through the inclusion of considerable options within many of the Directive's provisions. In fact, there are many more such options (potentially over 50 of them) in the Seventh Directive than in the Fourth Directive (Roberts, 2002).

Despite the fact that the Fourth and Seventh Directives had allowed the preservation of the different accounting traditions which existed in Member States prior to their adoption, some parties contended the Directives had a real positive impact, in the sense that the quality of financial reporting has considerably improved in Member States (Commission

of the European Communities, 1995). Furthermore, it is believed that the free circulation of comparable financial information constituted an important condition for the proper functioning of the common market and helped foster fair competition (Commission of the European Communities, 1995).

Overall, there are three fundamental features of the Fourth and Seventh Directives, which are significant (Haller, 2002) (Roberts, 2002). The first feature concerns the accounting traditions that underlined the creation of the Accounting Directives. The Fourth Directive, for instance, clearly exhibited a continental European accounting laws origin, but was substantially amended by an Anglo-Saxon input; and the Seventh Directive, notwithstanding its Germanic origins, is much more clearly Anglo-Saxon in “inspiration” and in the detail of the provisions (Roberts, 2002, p. 10). The second point concerns the differential impact of the two Directives upon continental European countries. As mentioned previously, the accounting tradition of these countries have been characterised by a close connection between tax and financial reporting and the provision of information to the tax authorities, rather than the providing of timely and useful information for investors’ decision-making. Thus, the Fourth Directive was often enacted into the national law of Member States, in a manner in which this function was preserved. Nonetheless, as have been outlined in the foregoing discussion, there were no legal requirements to prepare consolidated accounts and consequently, no tax implications arising from accounting consolidation. The enactment of the Seventh Directive therefore, indicated that most Member States in the continental European countries could adopt the method of consolidated accounting that is Anglo-Saxon in nature. Finally, the third

feature relates to the flexibility permitted by the large amount of options for accounting treatment. Likewise, it shared the same deficiency with the Fourth Directive, which did not deal with a number of important accounting matters such as accounting for construction contracts, pensions and so forth (Roberts, 2002).

It is worth emphasising that the adoption and implementation of the Fourth and Seventh Directives, with their later amendments, were only achieved with difficulty and no further progress had been made at the EU level in harmonising the basic rules on accounting and financial reporting (Commission of the European Communities, 1995) (Haller, 2002). Furthermore, there had been disputes between EU Member States about the usefulness of the Directive as a tool for accounting harmonisation. In fact, some Member States proposed at the time that they would opt for a broader international harmonisation and/or harmonisation based on standards rather than accounting law (Commission of the European Communities, 1995).

### **3.3 The EU in Search of a New Strategy**

By the end of the 1980s, the EU company law harmonisation programme was nearly complete and the two Accounting Directives had been implemented in almost all of the national laws of the Member States (Haller, 2002) (Roberts, 2002). These Accounting Directives could be viewed as a significant preliminary step to accounting harmonisation in Europe (Alexander and Archer, 2001). Nonetheless, the “minimalist legal approach” to reducing financial reporting practices could only go so far (Roberts, 2002, p. 10).

By the early 1990s, it had become clear, even to the EC, that the Directives were too cumbersome and slow to achieve further useful harmonisation. The inherent limitations of the Accounting Directives had resulted in many different financial reporting rules and inconsistent interpretations based on distinct traditions within the EU. In fact, Karel Van Hulle, the Head of Accounting at the EC Commission, suggested that:

“If one leaves out the adoption of the Seventh Directive on consolidated accounts and the sectoral directives on banks and insurance companies, one must admit that nothing has happened since 1978.....The lack of dynamism at EC level could prove very dangerous.”

(Van Hulle, 1993, p. 391)

Therefore, unless a reform is undertaken, such inconsistencies – many of them of major importance – will persist. The European financial reporting will remain fragmented, thereby hampering the development of a deep liquid single EU capital market. As mentioned earlier, the Fourth Directive, agreed in 1978, did not cover several topics and it had been complicated to amend it often. Furthermore, global harmonisation had become more relevant than regional harmonisation. Essentially, accounts prepared in accordance with the Directives and the national laws that implement them did not meet the more demanding standards required elsewhere in the world, notably by the Securities and Exchange Commission (SEC) in the US (Commission of the European Communities, 1995). As the world’s strongest capital market, US had refused to exempt EU companies listed in US stock exchanges from having to prepare their financial

statements according to US GAAP (Flower, 1997). It had also become clear that, for large European companies, voluntary harmonisation might focus on US GAAP over which the EC and other Europeans have no influence.

As it turned out, the EC published a Communication, ‘Accounting Harmonisation: A New Strategy vis-à-vis International Harmonisation’, on 1<sup>st</sup> November 1995 (Commission for the European Communities, 1995). This document underlines the problem facing the EU in the following manner:

“The most urgent problem is that concerning European companies with an international vocation. The accounts prepared by these companies in accordance with their national legislation, based on the Accounting Directives, are no longer acceptable for international capital market purposes. These companies are therefore obliged to prepare two sets of accounts, one set which is in conformity with the Accounting Directives and another set which is required by the international capital markets. This situation is not satisfactory. It is costly and the provision of different figures in different environments is confusing to investors and to the public at large. There is a risk that large companies will be increasingly drawn to US GAAP.” (Paragraph 3.3)

As a result of this, from the middle of 1990s, the EC began to support the increasingly important efforts of the IASC (now known as the IASB) in order to develop truly international accounting standards. To be more specific, the Commission agreed to take

up the invitation extended to it by the IASC by committing itself to become a member of the IASC's Consultative Group and to sit on the Board in an observer capacity (Commission of the European Communities, 1995).

The IASC, which is established in 1973 by the accounting profession, is the appropriate international organisation to set and interpret international accounting standards for use throughout the world. Although the accounting standards developed by this private organisation were not legally binding, they were being used by several large and multinational companies around the globe at the time. Indeed, they have influenced the standard setting process in several countries. Unlike US GAAP, which reflects a particular national environment, IAS were specifically designed from an international outlook (Roberts, 2002). Additionally, IAS appear to be more flexible and are principles-based, as opposed to the US GAAP, which are often rules-based. An essential element of how the IASC was moving to meet its ultimate goal of accounting harmonisation between countries was its agreement with the International Organisation of Securities Commissions (IOSCO). In 1995, IOSCO agreed to endorse IAS for use in cross-border listings in all major countries when the IASC successfully completes a core set of high quality accounting standards (Commission of the European Communities, 1995). As a result, there had been a reduction in the amount of options for accounting treatments in IAS. The bonus from such move had been the ease of European companies that apply IAS to gain access to international capital markets, particularly the US capital market.

In June 2000, the EC issued another policy document, entitled 'EU Financial Reporting Strategy: The Way Forward' (EUFRS), which proposed that European listed companies, including banks and insurance companies, would no longer have a free choice to prepare their consolidated financial statements in accordance with their national accounting standards, US GAAP or IFRS (or IAS). At a meeting in July 2000, the proposal of this Communication was endorsed by the Economic and Finance Ministers of the European Union (ECOFIN).

In February 2001, the EC presented draft legislation to the Parliament and the Council of Ministers embodying the policy set out in their Communication. It proposed that all EU companies listed on a regulated market (including banks and other financial institutions) be mandated to prepare their consolidated accounts in accordance with IFRS. It was intended that this requirement be effective by 2005 at the latest. Furthermore, it was intended that within two years the requirement will be extended to all companies preparing a public offer prospectus in accordance with the EU's Listing Particulars Directive. The Commission also suggested that Member States be permitted either to require or to allow unlisted companies to publish financial statements in accordance with the same set of standards as those for listed companies. In other words, individual Member States have the option to extend the application of IFRS to non-consolidated financial statements as well as to accounts of non-publicly traded companies. The requirement to use IFRS concerned the consolidated accounts of listed companies. The EU Member States were allowed to defer the application of IFRS until 2007, primarily for those companies that are listed in the EU and elsewhere and were, at the time, using

the US GAAP. The 2001 draft regulation was approved by the European Council of Ministers in June 2002 and it was immediately passed into the national laws of Member States.

Consequently, approximately 7,000 publicly listed EU companies will be required to prepare financial statements in accordance with IFRS by 2005. This represented a monumental leap from the 350 or so companies that were using IFRS at the time. Inevitably, the application of IFRS by European professionals will be a challenging task. The standards will be applied by professionals in at least 15 different countries despite some deep-seated differences in national traditions.

The Communication was part of the EC's Financial Services Action Plan, which was adopted in 1999. The Action Plan sought to adapt all aspects of the EU's regulatory structure to accommodate the single internal market and the introduction of the euro, with the ultimate goal of establishing an efficient capital market within Europe.

Financial reporting was recognised as a key part of an efficient capital market, and the EC realised that the accounting standards chosen must meet investors' needs and be compatible with global developments. It wanted those accounting standards to be in accordance with an internationally recognised financial reporting framework. Within Europe, two such frameworks were then being used: US GAAP and IAS (Commission of the European Communities, 1995).



As mentioned previously, the EC recognised that it cannot influence the elaboration of the US GAAP. On the other hand, it considered that IFRS could provide a comprehensive and conceptually robust set of standards for financial reporting that is able to serve the needs of the international business community. IFRS has the advantage of being developed with an international perspective, rather than tailored to any one business environment. Furthermore, the EC, via its Observer status at the IASC Board and on steering committees was able to participate in IASC deliberations. The role of day-to-day participation in IASB's due process had been the responsibility of the European Financial Reporting Advisory Group (EFRAG), established under the EU Commission's proposed Regulation of 13 February 2001, and subsequently endorsed by the Council of Ministers in March 2001.

The Commission's proposal was accompanied by some important provisos, including the establishment of an 'endorsement mechanism' within the EC (Commission of the European Communities, 1995). The Commission believed that the EU "cannot delegate responsibility for setting financial reporting requirements for listed EU companies to a non-governmental third party" and that, within the EU's legislative structure it was appropriate to exercise oversight. It had, therefore, proposed a two-tier mechanism to give legislative weight to IAS in Europe (Commission of the European Communities, 1995, paragraph 19, p. 7) (Roberts, 2002).

In addition, the Commission recognised the importance of the EU to contribute its input prior to any new standards being adopted by the IASB (Commission of the European

Communities, 1995). Therefore, it had decided to institute a committee at the EU level that will facilitate that adoption of IFRS in each Member State. There will also be a technical level of review that is supported by the private sector. The Commission intends to establish a constructive, dedicated and continuous dialogue with the IASB, particularly with the IASB's Standing Interpretations Committee (SIC), when implementation guidance is required. The endorsement mechanism will also advise the Commission on whether or not an amendment to the EU Accounting Directives is recommended in the light of international accounting developments.

Further amendments were made to the Fourth and Seventh Accounting Directives in order to bring existing EU rules in line with current best practice and to remove inconsistencies of the existing Directives with IFRS (IAS Plus, 2003). These amendments were approved by the European Parliament in January 2003. Complementing the Accounting Regulation adopted in June 2002, the amended Directives required almost 7,000 European companies listed on the stock exchange to apply IFRS starting 2005, and proposed to address accounting by the estimated 5 million European companies that are not subject to the IFRS Accounting Regulation. The amended Directives were scheduled for final vote by the Council of Ministers in March 2003 (IAS Plus, 2003).

On 26 March 2003, the EC published, and sent to the European Parliament and Council of Ministers, a proposed Directive that would upgrade the current level and transparency of the mandatory financial information that publicly traded companies must provide to the markets throughout the financial year. The requirement for all securities issuers to

publish an audited financial report based on IFRS and a management report, within three months of the end of each financial year and a half-yearly condensed financial report based on IAS-34 as well as the latest information regarding the last annual management report were among the proposed requirements of the Directive. Besides that, share issuers were mandated to publish a less extensive quarterly financial report for the first and third quarters of a financial year, including turnover and profit and loss before or after tax. As for companies that issue only debt securities, they were not subject to any interim reporting at all at the time. However, they were required to issue half-yearly financial reports for the first six months of a financial year. All interim information must be published within 60 days after the end of the period.

In May 2003, the EU's Council of Ministers had also approved the amended EU Accounting Directives and brought them into law. As a result of these amendments, the EU accounting requirements were being brought in line with modern accounting theory and practice. Also, in doing so, all inconsistencies of the old Directives and IFRS have been eliminated. However, given the newly proposed relationship between tax and financial reporting, it is suggested that each Member State move toward IAS at a pace that is suitable for that country. Furthermore, the amended Directives have made it more difficult for any company to keep liabilities off the balance sheet by setting up 'artificial structures' or using special purpose vehicles is restricted. Besides modernising accounting requirements, the changes to the Directives made clear that, in the financial report, the analysis of risks and uncertainties facing a company should not be restricted to financial aspects of its business. Therefore, this meant that the disclosure of key social

and environmental aspects is required where relevant. The amendments also facilitate a more harmonised presentation of statutory audit reports, by outlining the necessary content of such reports. Audit reports were also made more consistent across the EU Member States (IAS Plus, 2003).

#### **4. Why has NZ adopted IFRS and how has it done this?**

##### **4.1 Adoption of IFRS in NZ**

After the announcement in Europe that EU listed companies would have to prepare their consolidated financial reports in accordance with IFRS by 2005, Australia and NZ both announced that they would be following suit. The shock announcement by Australia came as a result of the decision in the EU. Once Australia adopted IFRS NZ was left with little choice but to follow. The decisions in Australia and NZ differ from that of the EU in that IFRS will apply to a wider range of entities and financial statements. The following will discuss why and how NZ has adopted IFRS.

The primary statute governing the establishment of accounting standards in NZ is the *Financial Reporting Act 1993* (FRA). The FRA gives legal backing to accounting standards. The private sector standard setter in NZ is the Financial Reporting Standards Board (FRSB) and is part of the Institute of Chartered Accountants NZ (ICANZ). The FRSB, although it does not have a monopoly over standard setting, is the only body to ever issue a standard in NZ. The Accounting Standards Review Board (ASRB), which is a crown entity, was set up under the FRA to review and approve accounting standards.

Standards issued by the FRSB do not get legal backing until they are approved by the ASRB (Deegan & Samkin, 2001).

The ASRB announced on 19 December 2002 that reporting entities<sup>1</sup> in NZ will be required to apply IFRS for periods commencing on or after 1 January 2007 and reporting entities have the option to adopt IFRS early from 1 January 2005 (Hickey et al., 2003a). The decision of the ASRB differs from that of the EU in a number of ways. Firstly, the requirement to apply IFRS extends to all reporting entities in NZ rather than just listed companies as in the EU. This includes public benefit entities as well as profit-oriented entities (Hickey et al., 2003a). Secondly, the requirement in NZ is for both consolidated and individual financial reports, whereas it is only for consolidated financial reports in the EU. Thirdly, the requirement in NZ is from the beginning of 2007 with the option to adopt IFRS from 2005, whereas the requirement is for 2005 in the EU.

The decision by the ASRB followed an announcement by the Australian Financial Reporting Council (FRC) on 3 July 2002 to require the Australian Accounting Standards Board (AASB) to fully adopt IFRS by 2005 (FRC, 2002)<sup>2</sup>. The requirement in Australia also applies to all reporting entities (Howieson & Langfield-Smith, 2003), and this includes the not-for-profit sector as it does in NZ (Alfredson, 2003). Australia, before the FRC's announcement, had a policy of harmonisation with IFRS. The decision by Australia to move to a 'big bang' approach of adopting IFRS, rather than gradual

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<sup>1</sup> The term "reporting entity" is yet to be operationally defined for the purpose of adopting IFRS.

<sup>2</sup> The FRC is responsible for providing broad oversight of the process for setting accounting standards in Australia, including overseeing the AASB, and monitoring international accounting developments (<http://www.frc.gov.au/content/about.asp>).

harmonisation, was a result of the decision in the EU. The FRC (2002) notes that the 2005 adoption date was determined by the decision of the EU because Australia cannot afford to lag behind Europe in this regard (Alfredson, 2003).

Although Australia's sudden decision to adopt IFRS was a result of the decision in the EU, various other reasons have been put forward to why it was advantageous for Australia to adopt IFRS. Haswell and McKinnon (2003) argue that it is no coincident that the FRC's decision has come so soon after recent accounting catastrophes in the United States (US) such as Enron and WorldCom. These have dented the reputation of US generally accepted accounting principles (GAAP). Haswell and McKinnon (2003) argue that the switch to IFRS may be a political move to distance Government from accounting standard setting. If corporate collapses occur in Australia the blame will be partly diverted away from the Australian Government, toward the IASB. It also fulfils the need for the Government to be seen to be doing something about accounting criticisms, and it differentiates Australian accounting from US GAAP. It has also been suggested that the FRC's decision may have been made to reduce the cost of standard setting, and to give Australia more influence over the IASB (Haswell & McKinnon, 2003).

Once the announcement in Australia was made the FRSB debated what action should be taken and informal discussions were held with the ASRB. The FRSB agreed that NZ would follow suit, but certain concerns such as retaining sector neutrality, resulting compliance costs, and the timing of adoption meant that they would wait and see what

Australia was doing until any final decisions were made. On 21 October 2002 the ASRB proposed the adoption of IFRS in NZ.

The final decision to adopt IFRS on 19 December 2002 by the ASRB was the result of consultations undertaken following the ASRB's initial announcement on 21 October 2002. The consultations were carried out by the ASRB and the FRSB. It also included a wide range of interested parties including the Government, the Securities Commission, the NZ Stock Exchange, the Controller and Auditor General, Treasury, the Ministry of Economic Development, the Inland Revenue, Local Government NZ, the Society of Local Government Managers, the NZ Bankers Association, the Institute of Finance Professionals NZ, small and large accounting firms, and other private sector interests (Hickey et al., 2003a).

The consultations showed strong support for adopting IFRS. A lot of this support was derived from the decisions of the EU and Australia adopting IFRS. There was recognition of the fact that the decision by Australia to adopt left NZ with little option but to follow. Hickey et al. (2003a) argue that given NZ's strong links to the Australian economy and the high level of foreign investment in NZ, the credibility of NZ financial reporting would have been placed at risk had NZ standards been continued with. Some of the support for IFRS was also because IFRS would, arguably, be of higher quality than NZ standards in the future. Also NZ has worked towards convergence with IFRS either directly by harmonising NZ standards with IFRS or indirectly by harmonising with

Australia. Therefore the adoption of IFRS is a matter of timing rather than a change in direction of standard setting in NZ (Hickey et al., 2003a).

There was a lot of support from private sector interests to adopt IFRS from 2005 to keep it in line with the EU and Australia. The ASRB's decision to make the adoption date 2007 was because of concern that 2005 was too early, especially for smaller entities (Hickey et al., 2003a). There has been criticism in Australia that the 2005 adoption date is far too early, and leaves no time for entities to prepare (e.g. Howieson & Langfield-Smith, 2003). The option to adopt IFRS early in NZ is to allow entities, which want to adopt IFRS in line with the EU and Australia, to do so. It is unclear how many entities will choose this option but it is likely to be entities that are cross-listed, have subsidiaries in Australia or Europe or are themselves a subsidiary of a parent in Australia or Europe. Other entities may adopt early to show a commitment to high quality financial reporting (Hickey et al., 2003a).

The reason that NZ will adopt IFRS for all types of accounts, and not just consolidated accounts as in the EU is that it would make no sense having separate rules for the two types of accounts. The reason that the regulation in the EU was not extended to individual accounts is because regulatory and tax requirements in some EU countries could make the use of IFRS inappropriate or even invalid at the individual account level, e.g. Germany. Countries such as the UK, Ireland and the Netherlands are likely to extend the regulation to individual accounts because, like NZ, their financial reporting systems are very similar to IFRS.



IFRS apply only to for-profit entities whereas the ASRB has decided that there should be one set of standards applicable to all reporting entities in NZ. NZ has had sector neutral accounting standards since 1992 (Simpkins, 2003), and the decision to apply IFRS to all sectors is carrying on this tradition. It could also be argued that NZ is going to continue with sector neutral standards simply because Australia is doing so. The same argument could be applied to NZ's decision to require IFRS for individual as well as consolidated financial reports.

The decision in NZ was a direct result of the decision in Australia. Australia mainly adopted IFRS because of the decision in the EU, but other reasons have also been offered. IFRS will apply to a wider range of financial statements and entities than in the EU; however will not be mandatory until 2007. The next section discusses some problems that NZ is likely to encounter as a result of adopting IFRS.

#### **4.2 Problems NZ is Likely to Face**

NZ is likely to encounter a number of problems because of the decision to adopt IFRS. Because of NZ's decision to apply IFRS to a wider range of entities and financial statements it will also encounter problems which the EU has avoided. The following outlines some of the problems NZ is likely to face as a result of the decision to adopt IFRS.

IFRS and current NZ standards are relatively similar compared to IFRS and standards of some EU countries such as France or Germany, but there are still differences which could have a significant impact on NZ companies. There are major differences between some IFRS and the corresponding NZ standard. Some examples of these are accounting for income taxes, accounting for defeasance of debt, and accounting for intangibles. There are also some IFRS for which there is no corresponding NZ standard. Accounting for share-based payment, and accounting for agriculture<sup>3</sup> are examples of these (Hickey et al., 2003b).

Some new differences could also emerge as a result of the IASB's current revision process (Hickey et al., 2003b). This creates the added problem of uncertainty. IFRS will change moving up to 2005 and 2007 and are therefore a moving target. This not only makes it difficult for companies trying to prepare for IFRS, it also makes it difficult for the FRSB when issuing exposure drafts of NZ IFRS. The FRSB has to start issuing exposure drafts now if it is to have them ready on time for the change. However, this is difficult if it is uncertain what the final IFRS will be. Currently the FRSB has been including changes in the exposure drafts which it anticipates the IASB will make.

Another problem which could also emerge is the difference between the application of the true and fair view (TFV) principle in IFRS and NZ GAAP. In IFRS the TFV principle is *overriding*. If the financial statements of an entity do not present a TFV after applying

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<sup>3</sup> NZ does, however, have Technical Practice Aids (TPA) on accounting for agriculture. These are TPA 5 which deals with valuation of livestock, and TPA 7 which deals with accounting for bloodstock. NZ entities may also take authoritative support from the Australian standard AASB 1037/AAS 35 which deals with accounting for self-generating and regenerating assets.

IFRS then the entity may depart from those requirements so that the financial statements do present a TFV. In NZ standards the TFV principle is *additive*. If the financial statements do not present a TFV after applying NZ GAAP then the entity must add extra disclosures, not depart from the standards. Changing to IFRS will mean a change in the TFV principle in the FRA.

The above mentioned problems for NZ may also exist in the EU but NZ will also face additional problems because of the requirement for all reporting entities, including unlisted and public benefit entities, to apply IFRS. One problem is determining what entities will be “reporting entities” and what entities will qualify for full or partial exemptions from IFRS. The FRSB (2003) gives some clues on this, but its proposed structure is yet to be approved. This creates even more uncertainty for entities planning for the adoption of IFRS because they may not know whether IFRS will apply to them or not. The FRSB’s proposed structure is discussed more below.

Another problem that could emerge because of the requirement for all reporting entities to adopt IFRS is that IFRS imposes significant costs on unlisted and public benefit entities and arguably has no real benefits for them (Howieson & Langfield-Smith, 2003), except that having one set of rules for every reporting entity may be seen as beneficial. This is because the purpose of having uniform accounting worldwide is for the free movement of debt and equity capital between countries. Unlisted and public benefit entities have no need for foreign capital, and therefore no need to have financial

statements which are comparable with overseas entities. This would mean they incur significant costs when changing to IFRS, and receive no benefits for doing so.

The process that the FRSB is following for public benefit entities is to start with the IFRS and then determine whether a different approach can be justified for public benefit entities. A consequence of this approach is that public benefit entities may be required to change their accounting treatments even when their existing treatment may be more applicable and comply with International Public Sector Accounting Standards (IPSAS) (Simpkins, 2003). One example is IAS 16 where entities are required to disclose the historic cost of revalued items of property, plant and equipment. This was considered when developing FRS 3 and IPSAS 14 but rejected because it was of minimal value (Simpkins, 2003). The requirement in IAS 16 would be very difficult, if not impossible, for public sector entities to implement because of the unique nature of some public sector assets.

NZ will encounter more problems when adopting IFRS than the EU because IFRS will apply to a wider range of financial statements and entities. The only relief for NZ entities is that they are not required to adopt IFRS until 2007 instead of 2005 as in the EU. The next section outlines the response in the EU to the decision to adopt IFRS.

## **5. What was the Response to the Adoption of IFRS in the EU?**

The response from EU countries to the requirement for listed companies to prepare their consolidated financial reports in accordance with IFRS from 2005 has generally been

positive. This requirement was not unexpected and is seen as a positive step toward a common European market, so it is not surprising that it was received positively. Not only has the accounting profession responded positively (Corcoran, 2002), but EU companies affected by the change also showed a positive response to the change (PricewaterhouseCoopers, 2002). This excludes the financial services industry who has responded unfavourably to some IFRS. Although the response was positive, research has shown that companies in the EU are not preparing as well as they should be for the change.

PricewaterhouseCoopers (2002) commissioned a survey of more than 650 chief financial officers across the 15 European Union member states to determine companies' views on the requirement to adopt IFRS by 2005. Overall the survey found that there was strong support for the use of IFRS. The survey found that most companies believed that the introduction of IFRS would help establish a common European market, and that this would be beneficial to Europe. The survey showed that a lot of the companies believed that IFRS would have direct benefits for their company. Also most companies wanted the regulation to be extended to individual company accounts. This is understandable because if they are preparing consolidated accounts under IFRS, then it would be easiest to also prepare their individual accounts under IFRS. This may not be possible in some EU countries. This is discussed in more detail below.

IAS 32 on disclosure and presentation of financial instruments, and IAS 39 on recognition and measurement of financial instruments have caused negative reactions in

the EU, especially among banks and insurance companies. Financial service companies are opposed to these two standards because of the level of volatility that they will introduce into their accounts. The EU has rejected these two standards and subsequently the IASB has issued ED 6 which deals with macro hedging (Chisnall, 2003).

ED 6 aims to make hedge accounting more accessible and reflects many of the suggestions made by banks. In particular it recognises hedge accounting based on interest rate risk and permits hedge effectiveness to be based on expected maturity (Chisnall, 2003). But the exposure draft also reflects the fact that it was not possible to reach any agreement in two areas: hedge ineffectiveness; and demand deposits. The latter is very important to banks. The IASB argues that the maturity of demand deposits must be based on their contractual on-call maturity and not their expected maturity. As a result banks will not be able to use fair value hedge accounting when it comes to the risk exposure arising in the period between the contractual maturity and the expected maturity. Banks dependant on demand deposits for a core part of their funding will have to adopt cash flow hedging and will suffer the false volatility in their equity that this brings with it (Chisnall, 2003).

Despite the positive attitude about adopting IFRS of EU companies, they still remain relatively under-prepared for the adoption date of 2005. In a further survey commissioned by PricewaterhouseCoopers (2003) it was found that 34% of the respondents would be adopting IFRS in 2005. This is not surprising on its own, but 45% of respondents to the survey indicated that they would be required to adopt IFRS by 2005. This means that

some companies that are required to adopt IFRS by 2005 would not be doing so. The survey also found that 42% had yet to start implementation, with a large group of respondents waiting for the IASB to issue final standards. These results are surprising considering that in PricewaterhouseCoopers (2002) 81% of respondents indicated that they wanted the freedom to adopt IFRS before 2005. PricewaterhouseCoopers (2003) indicates that companies would not be in a situation to adopt IFRS early.

Overall, the idea of moving to internationally recognised standards in the EU has been well received by both the accounting profession and companies. However, there has been disagreement in the EU over certain controversial standards, mainly IAS 32 and 39. Despite the positive attitude about IFRS, companies in the EU are still not preparing as well as they should be for IFRS. The next section looks at what individual countries in the EU are proposing to do in response to regulation 1606/2002.

## **6. What are Individual Countries in the EU are proposing to do?**

What each individual country in the EU has proposed to do as a result of regulation 1606/2002 has differed quite significantly. This can be put down to the diversity of accounting practice and accounting regulation within the EU. Despite the diversity in the EU, accounting regulation and practice in can be split into two main groups. These two groups, as mentioned above, are commonly referred to as Anglo-Saxon and Continental. Making up the Anglo-Saxon group in the EU are the UK, Ireland, the Netherlands and, to some extent, Denmark<sup>4</sup>. The continental group encompasses most other EU countries

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<sup>4</sup> NZ would also be included in an Anglo-Saxon group.

(Roberts, 2002). The following will outline what countries in each of these groups is proposing to do, and why this is the case.

The reason for the differences in accounting practice and regulation is due to the role financial accounting plays in the various countries. In the Anglo-Saxon accounting group the role of financial reporting is to provide information for decision-making. Conversely the traditional role of financial reporting in the Continental accounting group is to regulate companies. As seen above the traditional role of financial reporting in Continental countries is shifting toward a decision-making role similar to that of the Anglo-Saxon orientation.

Nobes (1998) classifies different financial reporting systems rather than classifying countries. This was done because of the different systems that could operate in one country. For example US GAAP is used by SEC-registered companies but not by all US companies. Similarly some Japanese companies are allowed to follow US GAAP for their consolidated accounts for both US and Japanese purposes (Nobes, 1998). Another example is that IFRS are permitted for domestic listed companies in Germany in the preparation of consolidated statements.

In Nobes (1998) IFRS are classified as being in the Anglo-Saxon group of financial reporting systems. IFRS, although not set entirely by Anglo-Saxon countries, are dominated by the Anglo-Saxon approach to accounting. This may be partly due to its involvement in Anglo-Saxon groups such as the G4+1 group of standard setters. It also



makes sense because the purpose of accounting at an international level is to provide information for decision making, rather than providing information for regulating. The purpose of having standardised accounting worldwide is so that financial statements can be compared between companies in different countries. This is to facilitate the free movement of debt and equity capital worldwide. IFRS therefore have a decision making, rather than regulating, role.

All of the Anglo-Saxon countries look likely to extend regulation 1606/2002 by either permitting or requiring the use of IFRS for individual and unlisted entity financial statements. This is an expected result because accounting regulation and practice in these countries is similar to that of IFRS. Prohibiting companies from extending the regulation to individual accounts would put unnecessary costs on companies because then they would have to use two sets of rules when producing their financial statements. Unlisted companies may also want to produce their financial statements in accordance with IFRS. It would make no sense prohibiting companies from choosing this option because in all the Anglo-Saxon countries, accounting standards are being converged with IFRS anyway. Allowing companies to choose this option just means that they adopt IFRS sooner.

Of the 7 000 EU companies which will be required to adopt IFRS, over 3 000 of them are in the UK (Lymer, 2003a). The Department of Trade and Industry in the UK has already announced that it will permit, but not require: publicly traded companies to use IFRS in their individual accounts from 2005; and, other companies and limited liability partnerships to use IFRS in both their individual and consolidated accounts from 2005

(Department of Trade and Industry, 2003). It is not surprising that the UK has extended the regulation considering the similarities between UK GAAP and IFRS. They have, however, only permitted, and have not required, the use of IFRS for individual and unlisted financial statements. One reason for this could be that the 2005 deadline is too early for many smaller companies. The UK Accounting Standards Board currently issues standards that are based on IFRS. This will mean eventual convergence of individual and unlisted financial statements with IFRS anyway.

The Institute of Chartered Accountants in Ireland is currently lobbying the Government to reach a decision on the option to apply IFRS to all companies and the option to apply them to individual accounts. They have recommended to the government that IFRS be required for all companies with a three-year transitional period (Deloitte Touche Tohmatsu, 2003, October). A recent survey has indicated that businesses in Ireland have a negative attitude to the new standards, believing that they would increase costs and reporting requirements (Institute of Chartered Accountants in Ireland, 2003). It is somewhat surprising that businesses in Ireland have a negative attitude toward IFRS considering the similarities between Irish GAAP and IFRS. This suggests that there may not be many benefits for Irish companies who will be required to adopt IFRS. Irish accounting standards are those issued by the UK accounting standards board, so individual and unlisted entity financial reports will also eventually converge with IFRS (McDonnell, 2003).

The Danish Government has invited public comment on proposed legislation that would: require the use of IFRS in individual company financial statements if an entity uses IFRS in its consolidated statements; and permit non-listed companies to choose to follow IFRS in both consolidated and individual company financial statements (Lymer, 2003b). A date has not been proposed in this legislation. Danish listed companies are already permitted to use IFRS provided that they also comply with the provisions of the Danish Financial Statements Act (Lymer, 2003b).

The Dutch Government has also issued a draft amendment to which would permit the extension of regulation 1606/2002 by companies in the Netherlands (Tukker, 2003). Recent changes in Dutch GAAP have been based on IFRS and recent developments in IFRS have been incorporated into accounting standards in the Netherlands (Tukker, 2003). There is a clear trend amongst the Anglo-Saxon countries to base their local standards on IFRS at present.

Although Ireland, Denmark, and the Netherlands are yet to make final decisions on the extension of IFRS, it does look likely that they will be extended. Whether the Anglo-Saxon countries permit or require the extension of IFRS makes no difference because all the countries have policies to converge their national standards with IFRS. It is a matter of the timing of extending the regulation rather than differences between what the Anglo-Saxon countries are proposing to do.

Many of the Continental countries have permitted the use of IFRS for unlisted entities, but only for consolidated reports. This may appear unusual given the significant differences in the financial reporting systems of the two countries but is not that extraordinary. If it is feasible for unlisted companies to use IFRS in their consolidated reports then there is no reason to forbid it. Most of the Continental countries do not intend to extend the regulation to individual financial reports, although there are some exceptions. In many of the Continental countries it is not possible to prepare individual reports using IFRS because of tax links and regulatory factors. Consolidated financial statements are not affected by tax links and regulatory factors because it is the individual companies that are taxed and regulated, not the group as a whole.

In Germany non-listed companies will be permitted to use IFRS to prepare their consolidated financial statements starting in 2005. However, no companies will be permitted to use IFRS for statutory (individual) financial statements; these will continue to follow German GAAP. Companies may present additional individual accounts that comply with IFRS (Deloitte Touche Tohmatsu, 2003, October). The German Accounting Standards Board has revised its work programme to make cooperation with the IASB and other major national standard setters its primary objective (Deloitte Touche Tohmatsu, 2003, October). This may bring German GAAP closer to IFRS over time.

France is yet to make a decision on whether they are going to extend the regulation but they expect that non-publicly traded companies will be free to use IFRS for consolidated accounts if they wish. However, as in Germany, firms will not be allowed to use IFRS for

individual company accounts (Eurostat, 2003). Spain has the same intentions. Non-publicly traded corporations would be given the option to use IFRS for consolidated financial reports, but individual financial reports are to be prepared under Spanish GAAP for tax and trade reasons (Eurostat, 2003).

In 2002 the Greek Government passed legislation that adopted IFRS from 2003. The legislation applies to annual financial statements beginning after 31 December 2002, and is compulsory for all companies listed on the Athens Stock Exchange. The new legislation applies to both individual and consolidated financial statements and may be optionally applied by any other entity that is audited by the Institute of Certified Accountants and Auditors of Greece (Deloitte Touche Tohmatsu, 2002, July). This is an unusual move for a Continental accounting country. However it shows that Greek GAAP may be closer to IFRS than other Continental countries. It also shows that they do not have the same tax links as other countries do because the law also applies to individual accounts.

The most surprising announcement amongst the Continental countries has come from Belgium. The Belgian Commission for Accounting Standards (CBN/CNC) has recently proposed that IFRS should be mandatory for all consolidated annual accounts starting from 2007. This move would affect more than 600 unlisted Belgian entities. The CBN/CNC has also proposed an ambitious plan to converge Belgian GAAP with IFRS as from 2007. The CBN/CNC intends to put all adaptations into effect simultaneously on 1

January 2007 (Deloitte Touche Tohmatsu, 2003, July). These proposals are very surprising considering the differences between Belgian GAAP and IFRS.

Italy for the present time does not intend to make any extensions to the regulation and Finland only intends to extend the regulation to the financial sector (Eurostat, 2003). Other Continental countries in the EU have yet to make proposals or make their intentions public. It would be expected that if the other countries did extend the regulation it would only permit the use of IFRS rather than require. In addition, they would most likely only permit the use of IFRS for consolidated reports because of the function which individual reports play in Continental countries.

It has been seen above that there is clear differences between the Anglo-Saxon and Continental groups of countries and what they propose to do in relation to regulation 1606/2002, with the exceptions of Greece and Belgium. The next section outlines the response in NZ to the requirement to adopt IFRS from 2007, and the option to adopt IFRS in 2005.

## **7. What was the Response to the Adoption of IFRS in NZ?**

The response to the adoption of IFRS in NZ was one of shock. First of all there was a shock in both NZ and Australia when the FRC announced IFRS would apply to Australian companies in 2005. This move went against prior policies of harmonisation in Australia, and made this move completely unexpected. Once Australia adopted IFRS, as seen above, this left NZ with little option but to follow. Despite this, the decision to adopt

IFRS in NZ still came unexpectedly. The following will discuss why this was such an unexpected move in both NZ and Australia.

The reason that the decision by the FRC to require Australia to adopt IFRS by 2005 was unexpected was because the FRC's announcement was a complete change in policy for Australia. The tight deadline for the adoption of IFRS announced by the FRC (2002) (made 3 July 2002) contrasts with the policy expressed in AASB Policy Statement 4 (PS 4) on international convergence and harmonisation (Alfredson, 2003). PS 4 was issued in April 2002, which followed an exposure draft on international convergence and harmonisation issued in July 2001. The exposure draft on international convergence did not propose a date for full convergence, and the final policy statement PS 4 did not establish one. Rather, PS 4 envisaged a more gradual convergence with IFRS. This was to result from the AASB working with the IASB as one of its formerly recognised liaison standard setters (Alfredson, 2003). The complete turnaround in policy caused by the FRC's announcement came less than two months after the issue of PS 4. The FRC's announcement came without warning and shocked the accounting profession in Australia. This included the AASB because PS 4 had been reviewed and approved by the FRC itself.

Not only did the FRC's announcement shock the Australian accounting profession, it also came as a complete surprise to the NZ accounting profession. Subsequent to the issue of PS 4 the FRSB decided to revise the Explanatory Foreword to General Purpose Financial Reporting and issued the exposure draft ED 92. ED 92 included in it a policy statement

on international convergence and harmonisation which was based on PS 4. ED 92 stated that the policy in NZ would be to issue standards that harmonise with IFRS and IPSAS. ED 92 also noted that the FRSB would only depart from this policy in rare and exceptional circumstances.

The issue of PS 4 in Australia and ED 92 in NZ demonstrates neither country intended to fully adopt IFRS anytime in the near future. The FRC's announcement just months after each of these statements was released shocked the accounting profession, and companies in both countries. Australia's decision left NZ with little option but to follow suit, but as seen above NZ has delayed the adoption date by two years. The next section discusses what the FRSB has proposed leading up to 2005 and 2007.

## **8. What is NZ proposing to do?**

NZ has made quite extensive proposals on what the process for adopting IFRS leading up to 2005 and 2007 will be. The following discusses how the FRSB is adopting IFRS and what standards entities adopting in 2005 and 2007 will most likely have to apply. It will also discuss what a reporting entity is under the current financial reporting structure and the FRSB's proposed new financial reporting structure. This proposed structure gives an idea of what types of entities are likely to be required to adopt IFRS.

IFRS are tailored for profit-oriented entities, but NZ intends to apply them to all entities. For this reason the FRSB will add additional requirements on measurement and recognition applicable to just public benefit entities. Certain options contained in the



standards will also be deleted and extra disclosures may be required for all entities (FRSB, 2003). The IASB has confirmed that adding disclosure requirements to or eliminating choices contained in IFRS does not jeopardise compliance with IFRS. It is not possible, however, to change the measurement or recognition requirements in any standard and still comply with IFRS (Teixeira & Warren, 2003). Where a profit-orientated reporting entity prepares its statements in accordance with NZ IFRS it will simultaneously comply with IFRS. A public benefit entity will only simultaneously comply with IFRS if it does not apply any of the additional measurement and recognition requirements (FRSB, 2003).

The FRSB (2003) outlines the process which it will follow for the adoption of IFRS. The FRSB intends to review existing IFRS and prepare an exposure draft (ED) for each IFRS for comment. The EDs will contain the IFRS including the additional requirements for public benefit entities, and excluding some options. The EDs could also contain changes that are expected to be made by the IASB to IFRS before 2005. The EDs will also provide a comparison of the current financial reporting requirements in NZ and the corresponding IFRS, and request comment to the FRSB. Following a review of the comments, the FRSB will submit the ED to the ASRB for approval in the same way as previous standards (FRSB, 2003).

The IASB has established that reporting entities adopting IFRS by 2005 should apply revised IAS, IFRS 1 which deals with the first time adoption of IFRS, and other new IFRS that are applicable from 2005 (Hickey et al., 2003b). The requirements for 2005

adopters in NZ are the same except they will be required to adopt NZ IFRS, which as mentioned above will include less options and extra disclosure requirements than IFRS, and include different recognition and measurement requirements for public benefit entities. Reporting entities adopting IFRS from 2007 will apply NZ IFRS then on issue and in effect. Until 2007 they will continue to apply NZ standards. These standards may however be revised or new standards issued on previously uncovered topics that are based on IFRS (FRSB, 2003).

Currently in NZ reporting entities under the FRA are: issuers; overseas companies; subsidiary companies; companies that have one or more subsidiaries; companies with assets valued at more than \$450 000; or companies with a turnover in excess of \$1,000,000. All other companies are exempted under the FRA and are only required to report under the *Financial Reporting Order*<sup>5</sup>. An issuer is defined in part 1, section 4 of the FRA and is broadly an entity which has allotted securities to the public. NZ currently also has a framework for differential reporting in which qualifying entities are granted full or partial exemption from complying with certain standards (Deegan & Samkin, 2001). Under paragraph 4.25 of the framework an entity qualifies for differential reporting exemptions if:

- It is not publicly accountable; and
- At balance date, all of its owners are members of the entity's governing body; or
- The entity is not large.

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<sup>5</sup> Source: [http://www.med.govt.nz/ri/co\\_reg/fra1993.html](http://www.med.govt.nz/ri/co_reg/fra1993.html)

An entity is considered large under paragraph 4.23 of the framework if it exceeds any two of the following:

1. Total assets of \$2.5 million;
2. Total revenue of \$5 million;
3. 20 employees.

The FRSB (2003) has proposed a new financial reporting structure which is intended to operationalise the reporting entity concept for the purpose of adopting IFRS. The ASRB has reviewed the structure and in turn proposed it to the Ministry of Economic Development for approval. The structure attempts to exclude entities from the requirement to apply IFRS where the costs of doing so outweigh the benefits. The proposed structure covers all entities in the private and public sectors including companies, partnerships, trusts and sole traders. The structure therefore widens the types of entities potentially subject to the legal requirements of financial reporting. The thresholds for being a large entity under this structure are higher than the current differential framework; therefore the requirements of the structure would be likely to give relief to many smaller entities currently subject to such requirements (FRSB, 2003).

Figure 8.1 is a summary of the proposed reporting structure for all entities. The term issuer has the same definition as currently in the FRA. An entity is regarded as having reporting responsibilities where:

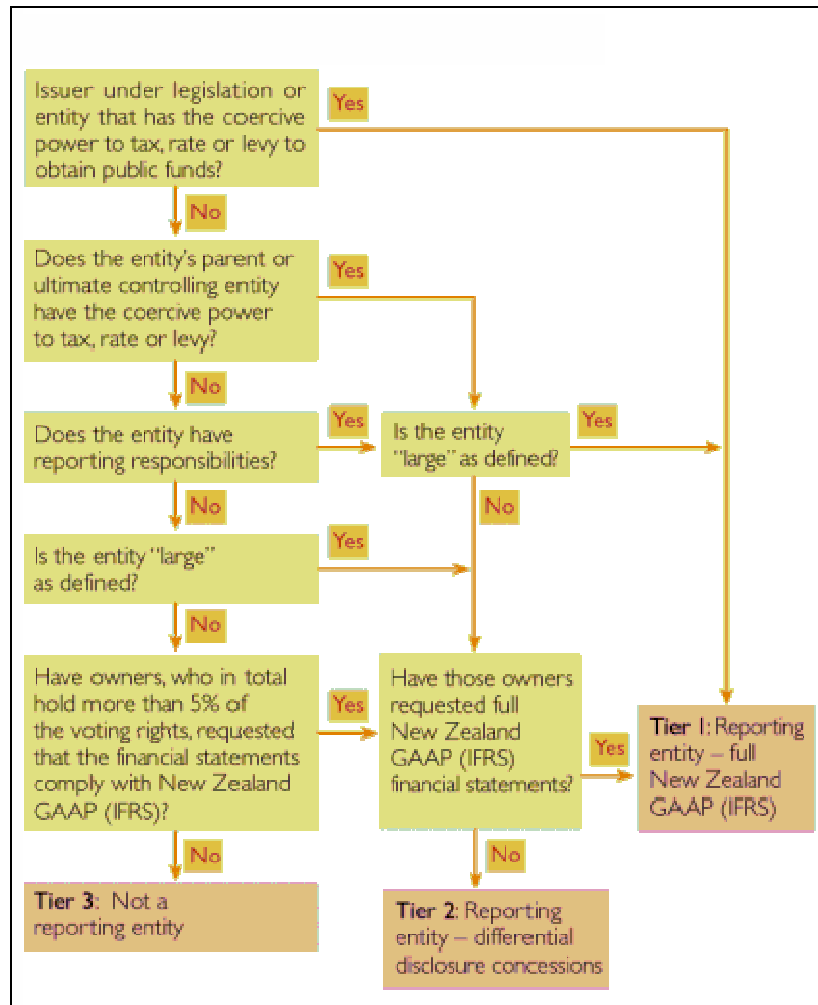
- The constitution of the entity or governing legislation requires the entity to account to the public (e.g., a requirement to file with an appropriate registrar); or
- The office holders are accountable to the general public; or
- The elected officers are like trustees in their stewardship (e.g., clubs, member-owned entities); or
- The entity has a charitable purpose (as approved by Inland Revenue); or
- There is "foreign ownership" as defined by the Financial Reporting Act 1993; or
- There is separation of ownership and management.

The proposed size test classifies an entity as being large if it meets two of the following three criteria:

1. More than \$5 million in assets;
2. More than \$10 million in revenue;
3. More than 20 full-time equivalent employees.

These criteria are the same as are currently applied in Australia, except for the number of employees where Australia uses 50 as the cut-off point (FRSB, 2003).

Figure 8.1: Proposed Financial Reporting Structure for all Entities



(Source: FRSB (2003))

The proposed structure categorises entities into three groups, tier 1 which are full reporting entities, tier 2 which are reporting entities but have differential disclosure concessions, and tier 3 which are not reporting entities. The tier 1 group would consist of: issuers; entities that have power to tax, rate or levy; large entities in the public sector; large entities which have reporting responsibilities; and entities where owners with 5% or more total voting rights request financial statements that comply with full NZ GAAP.

Tier 2 entities would consist of: entities where owners with 5% or more total voting rights request financial statements that comply with differential NZ GAAP; small public sector entities whose owners have not requested compliance with full NZ GAAP; and small entities with reporting responsibilities in which owners with 5% or more total voting rights have not requested compliance with full GAAP. All other entities would fall into tier 3.

In summary, the FRSB intends to issue IFRS as EDs with various changes in them to suit the NZ environment. The FRSB has also proposed a new financial reporting structure which is intended to operationalise the reporting entity concept for the purposes of adopting IFRS. This has increased the types of entities potentially subject to financial reporting requirements, but also increased the thresholds for being a large company. This will give relief to a number of smaller entities currently classified as large. This proposed structure is awaiting approval from the Ministry of Economic Development, but still gives a good idea of which entities are likely to be required to adopt IFRS by 2007 in NZ.

## **9. What are the requirements of IAS 40 – Investment Property?**

IAS 40 – Investment Property prescribes the accounting treatment for investment property. It was approved by the IASC in March 2000 and became effective for financial statements covering periods beginning on or after 1 January 2001. The following provides a summary of the requirements of IAS 40.

## **Definition**

Investment property is defined as “property (land or a building – or part of a building – or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both” (IAS 40.4). It does not include:

- Property held for sale in the ordinary course of business (covered by IAS 2 – Inventories);
- Property being constructed or developed on behalf of third parties (covered by IAS 11 – Construction Contracts);
- Owner-occupied property (covered by IAS 16 – Property Plant and Equipment); or
- Property being constructed or developed for future use as investment property. IAS 16 applies until construction or development is complete. IAS 40 does however apply to existing investment property that is being redeveloped (IAS 40.7).

If the owner uses part of a property for its own use and part to earn rentals or capital appreciation, and the portions could be sold separately then the portions are accounted for separately. If they could not be sold separately the property is investment property only if an insignificant portion is owner occupied (IAS 40.8).

If an entity provides ancillary services to the occupants of a property held by the entity then classification is determined by the significance of the services provided. If the services are a relatively insignificant component of the arrangement as a whole (e.g. where the owners of an office building provide security and maintenance services to the

occupants) then the property would be classified as investment property (IAS 40.9). However, if the services provided are a more significant component (e.g. as in the case of an owner managed hotel) then the property is owner occupied and treated as property, plant and equipment (IAS 40.10).

Property that is held under an operating lease cannot be classified as investment property (IAS 40.13). Property that is leased to a parent or a subsidiary does not qualify as investment property in the group accounts because from the perspective of the group the property is owner occupied. However, from the perspective of the individual entity that owns the property it is investment property (assuming it meets the definition) and therefore should be treated as investment property in the individual financial statements (IAS 40.14).

### **Recognition**

Investment property should only be recognised as an asset when: it is probable that the future economic benefits that are associated with the investment property will flow to the enterprise; and the cost of the investment property can be measured reliably (IAS 40.15).

### **Initial Measurement**

Investment property should be measured initially at its cost. Cost is defined as “the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction” (IAS 40.4). Transaction costs should be included in the initial measurement (IAS 40.17). Cost of purchased



investment property includes its purchase price and any directly attributable expenditure (IAS 40.18). The cost of self-constructed investment property is the cost at the date when construction or development is completed (IAS 40.19). Costs that should not be included are: start-up costs; initial operating losses incurred before the investment property achieves the planned level of occupancy; and abnormal amounts of wasted material, labour or other resources incurred in constructing or developing the property (IAS 40.20). If the payment for the investment property is deferred then its cost is the cash price equivalent. Any difference between this amount and the payments made is recognised as interest expense (IAS 40.21).

### **Subsequent Expenditure**

Subsequent expenditure is recognised as an expense when incurred except when it is probable that future economic benefits, in excess of the originally assessed standard of performance of the existing investment property, will flow to the enterprise. In this case the expenditure is added to the carrying amount of the investment property (IAS 40.22).

### **Measurement Subsequent to Initial Recognition**

IAS 40 permits an entity to choose between a fair value model and a cost model as its accounting policy and requires this policy to be applied consistently to all of its investment property (IAS 40.24). A change in this policy is only permitted if it will result in a more appropriate presentation, and it is highly unlikely that a more appropriate presentation will be achieved by a change from the fair value model to a cost model (IAS 40.25).

### **Fair Value Model**

Fair value is defined as “the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm’s length transaction” (IAS 40.4). Gains or losses arising from a change in the fair value of investment property should be included in the net profit or loss for the period in they arise (IAS 40.28). Fair value of investment property is usually its market value (IAS 40.29) and an entity should determine fair value without any deduction for transaction costs that the entity may incur on sale or other disposal (IAS 40.30)

Fair value should reflect the actual market state and circumstances as of the balance sheet date (IAS 40.31). The best evidence of fair value is normally given by current prices on an active market for similar property in the same location and condition and subject to similar lease and other contracts (IAS 40.39). In the absence of such information the entity considers: current prices on an active market for properties of different nature, condition or location, adjusted to reflect those differences; recent prices on less active markets, with adjustments to reflect any changes in economic conditions since the date of the transactions that occurred at those points; and discounted cash flow projections based on reliable estimates of future cash flows (IAS 40.40).

There is a rebuttable presumption that an enterprise will be able to determine the fair value of an investment property reliably on a continuing basis. However, in exceptional cases, if there is clear evidence when an enterprise first acquires an investment property

that the property's fair value is not expected to be reliably measurable on a continuing basis, then the property is accounted for under the benchmark treatment in IAS 16 – Property, Plant and Equipment (cost less accumulated depreciation less accumulated impairment losses) (IAS 40.47). This is the only case where the accounting policy for investment property is not consistently applied to all investment property. If an entity has previously measured an investment property at fair value, the enterprise should continue to measure the property at fair value until disposal, even if comparable market transactions become less frequent or market prices become less readily available (IAS 40.49).

### **Cost Model**

If an entity chooses the cost model all investment properties should be accounted for under the benchmark treatment in IAS 16 (cost less accumulated depreciation less accumulated impairment losses) subsequent to initial recognition (IAS 40.50).

### **Transfers to or from Investment Property Classification**

Transfers to, or from, investment property should only be made when there is a change in use evidenced by:

- Commencement of owner-occupation (transfer from investment property to owner-occupied property);
- Commencement of development with a view to sale (transfer from investment property to inventory);

- End of owner-occupation (transfer from owner-occupied property to investment property);
- Commencement of an operating lease to another party (transfer from inventory to investment property); or
- End of construction or development (transfer from property in the course of construction or development to investment property) (IAS 40.51).

When an entity decides to dispose of an investment property without development, the entity does not treat the property as inventory but continues to treat it as an investment property until it is disposed (IAS 40.52).

For a transfer from investment property carried at fair value to owner-occupied property or inventories, the property's cost for subsequent accounting under IAS 16 or IAS 2 should be its fair value at the date of change in use (IAS 40.54). When property is transferred from owner-occupied property to investment property carried at fair value, IAS 16 should be applied up until the date of reclassification. Any difference arising between the carrying amount under IAS 16 at that date and the fair value is dealt with as a revaluation under IAS 16 (IAS 40.55). For a transfer from inventories to investment property at fair value, any difference between the fair value at the date of transfer and its previous carrying amount should be recognised in the net profit or loss for the period (IAS 40.57). When an enterprise completes construction or development of an investment property that will be carried at fair value, any difference between the fair value at the date

of the transfer and the previous carrying amount should be recognised in the net profit or loss for the period (IAS 40.59).

When an entity uses the cost model, transfers between categories do not change the carrying amount of the property transferred and they do not change the cost of that property for measurement or disclosure purposes (IAS 40.53).

### **Disposal**

An investment property should be derecognised on disposal or when the investment property is permanently withdrawn from use and no future economic benefits are expected from its disposal (IAS 40.60). Gains or losses arising from the retirement or disposal of investment property should be determined as the difference between the net disposal proceeds and the carrying amount of the asset and should be recognised as income or expense in the income statement (IAS 40.62).

### **Disclosure**

An entity should disclose:

- The criteria that were used to distinguish investment property from owner-occupied property and property held for sale;
- The methods and significant assumption applied in determining the fair value of investment property;

- The extent to which an independent valuer was used in the determination of the fair value of investment property;
- The amounts included in the income statement for :
  - Rental income from investment property;
  - Direct operating expenses for property that generated income during the period; and
  - Direct operating expenses for property that did not generate income during the period.
- Restrictions on the sale of investment properties; and
- Obligations to purchase, construct or develop investment property or for repairs, maintenance or enhancements (IAS 40.66).

In addition to the above an entity that uses the fair value model should disclose:

- Investment property additions and disposals;
- Net gains or losses from fair value adjustments;
- Foreign exchange differences related to investment properties;
- Transfers to and from inventories and owner-occupied property; and
- Other movements (IAS 40.67)
- Some special disclosures in the event that the benchmark treatment is used because of lack of a reliable fair value (IAS 40.68).

In addition to the above an entity that uses the cost model should disclose:

- Depreciation methods used and useful lives;
- Gross carrying amount and accumulated depreciation;
- Reconciliation of carrying amount at the beginning and end of the period showing the various components of change; and
- The fair value of investment property carried at cost and extra disclosures because of lack of reliable fair value (IAS 40.69).

### **Transition**

For a change to fair value an entity should adjust opening retained earnings of the period in which IAS 40 is first applied. However, if fair value was disclosed in the past an entity should apply the fair value model retroactively (IAS 40.70).

## **10. What are the requirements of IAS 41 – Agriculture?**

IAS 41 – Agriculture prescribes the accounting treatment for accounting for agricultural activity. It was approved by the IASC in December 2000 and became effective for financial statements covering periods beginning on or after 1 January 2003. The following provides a summary of the requirements of IAS 40.

### **Definitions**

A biological asset is a living animal or plant. A group of biological assets is an aggregation of similar living animals or plants. Biological transformation comprises the processes of growth, degeneration, production and procreation that cause qualitative or

quantitative changes in a biological asset. Agricultural produce is the harvested product of the enterprise's biological assets. Agricultural activity is the management by an enterprise of the biological transformation of biological assets for sale, into agricultural produce or into additional biological assets (IAS 41.5).

Point-of-sale costs include commissions to brokers and dealers, levies by regulatory agencies and commodity exchanges, and transfer taxes and duties. Point-of-sale costs exclude transport and other costs necessary to get assets to a market (IAS 41.14).

### **Initial Recognition**

An enterprise should recognise a biological asset or agricultural produce when, and only when: the enterprise controls the asset as a result of past events; it is probable that future economic benefits associated with the asset will flow to the enterprise; and the fair value or cost of the asset can be measured reliably (IAS 41.10).

### **Measurement**

A biological asset should be measured on initial recognition and at each balance sheet date at its fair value less estimated point-of-sale costs, except for where the fair value cannot be measured reliably (IAS 41.12). Agricultural produce harvested from an enterprise's biological assets should be measured at its fair value less estimated point-of-sale costs at the point of harvest. Fair value measurement stops at harvest. This measurement is the cost at that date when applying IAS 2 – Inventories, or another



applicable IAS (IAS 41.13). The determination of the fair value of biological assets or agricultural produce may be done by grouping similar assets together (IAS 41.15).

An active market is the most appropriate basis for determining the fair value of biological assets or agricultural produce (IAS 41.17). If an active market does not exist then an enterprise, when determining fair value, should use one or more of the following: the most recent market transaction price; market prices for similar assets with adjustments to reflect differences; and or sector benchmarks (e.g. the value of cattle expressed per kilogram of meat) (IAS 41.18). If market-determined prices or values are unavailable then an enterprise should use the present value of expected net cash flows from the asset discounted at a current market-determined pre-tax rate in determining fair value (IAS 41.20). Also in some circumstances cost can approximate fair value, where little biological transformation has taken place or the impact of biological transformation on price is not expected to be material (IAS 41.24).

The fair value of a biological asset or agricultural produce is based on current quoted market prices and is not adjusted to reflect the actual price in a binding sale contract that provides for delivery at a future date (IAS 41.16). Agricultural land is accounted for under IAS 16 – Property, Plant and Equipment. However, biological assets that are physically attached to land are measured as biological assets separate from the land (IAS 40.25). Unconditional government grants received in respect of biological assets measured at fair value are reported as income when and only when the grant becomes

receivable (IAS 40.34). If the government grant is conditional, it should be recognised when and only when those conditions are met (IAS 40.35).

A gain or loss arising on initial recognition of a biological asset at fair value less estimated point-of-sale costs, and from a change in fair value less estimated point-of-sale costs of a biological asset should be included in net profit or loss for the period in which it arises (IAS 41.26). A gain or loss arising on initial recognition of agricultural produce at fair value less estimated point-of-sale costs should be included in net profit or loss for the period in which it arises (IAS 41.28).

There is a rebuttable presumption in IAS 41 that fair value can be measured reliably. The presumption can be rebutted only on initial recognition for a biological asset for which market-determined prices or values are not available and for which alternative estimates of fair value are determined to be clearly unreliable. In this case the asset is measured at its cost less any accumulated depreciation and any accumulated impairment losses. Once the fair value of such an asset becomes reliably measurable the entity should measure it at its fair value less any point-of-sale costs (IAS 40.30). This presumption cannot be rebutted after initial recognition (IAS 40.31) or for agricultural produce (IAS 40.32).

### **Disclosure**

Disclosure requirements in IAS 41 include:

- The carrying amount of biological assets separately on the face of the balance sheet (IAS 41.39);
- The aggregate gain or loss arising from initial recognition of biological assets and agricultural produce, and change in fair value less point-of-sale costs (IAS 41.40);
- A description of each group of biological assets (IAS 41.41);
- The nature of its activities involving each group of biological assets and non-financial measures or estimates of physical quantities of output during the period and assets on hand at the end of the period (IAS 41.46);
- Methods and assumptions applied in determining fair value for each group of assets (IAS 41.47);
- The fair value less estimated point-of-sale costs of agricultural produce harvested during the period (IAS 41.48);
- The existence and carrying amounts of biological assets whose title is restricted and the carrying amounts of biological assets pledged as security (IAS 41.49);
- The amount of commitments for the development or acquisition of biological assets (IAS 41.49);
- Financial risk management strategies related to agricultural activity (IAS 41.49); and
- Reconciliation of changes in the carrying amount of biological assets, showing separately changes in value, purchases, sales, harvesting, business combinations and foreign exchange differences (IAS 41.50).

Disclosure of a quantified description of each group of biological assets, distinguishing between consumable and bearer assets or between mature and immature assets, is

encouraged but not required (IAS 41.43). Separate disclosure of the physical change and unit price change in the fair value of biological assets is also encouraged but not required (IAS 41.51).

If fair value cannot be reliably measured additional disclosures include:

- A description of the assets;
- An explanation of why fair value cannot be measured reliably;
- If possible, a range within which fair value is highly likely to fall;
- Depreciation method;
- Useful lives or depreciation rates;
- The gross carrying amount and the accumulated depreciation at the beginning and end of the period (IAS 41.54);
- Certain other disclosures for disposed assets measured at cost (AS 41.55); and
- Certain additional disclosures if the fair value of assets previously measured at cost become available (IAS 41.56).

Disclosures relating to government grants include the nature and extent of grants, unfulfilled conditions and significant decreases in the expected level of grants (IAS 41.57).

## **Transition**

A change in accounting policy to adopt IAS 41 may be accounted for in accordance with either of the treatments for changes in accounting policies allowed in IAS 8 – Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies. These are restatement or cumulative effect in earnings in the period or change, with pro forma disclosures as if restated.

## **11. What is the Regulatory Context of UK Financial Reporting and how do the Requirements in the UK differ to IAS 40 and IAS 41?**

### **11.1 Background of Accounting Regulation in the UK**

Accounting and financial reporting practices in the UK has a strong tradition of professionalism. Although the statute law and accounting standards set general bounds on financial reporting requirements, the professional accountant reserves the right to decide on the details of practice (Roberts et. al., 2002). The accounting profession is reasonably well-established and the professional bodies were responsible for issuing guidance to their members regarding financial reporting practices. The important role that accountants play in financial reporting can be seen from the fact that most company accounts are required to be audited by qualified accountants to check if the accounts satisfy the requirement of presenting a ‘true and fair’ view.

The first company law in the UK, Companies Act 1844, permitted the straightforward incorporation of limited liability companies, by overriding the earlier requirement of the Act of Parliament for forming a company (Roberts et. al., 2002). Law setting at the time

was not intended to be intrusive and it was believed that the regulation of a company should be left to the company directors and shareholders to settle. Therefore, the Companies Act 1844 only contained the basic rules for accounting and auditing; and these requirements did not come into effect until 1900.

Although companies are required to prepare an audited balance sheet from 1907 onwards, there were no detailed guidelines as to the format and content of the audited financial statements. The Companies Act 1948, which came into force later, as a result of a series of business scandals, contained more rigid prescriptions and stipulated the minimum level of disclosure in annual accounts. Companies were required to prepare an audited profit and loss account and balance sheet, group/consolidated accounts and enhancement of rights and duties of auditors. Basically, the new Act focused on the disclosure and the protection of shareholders and creditors. No rules existed regarding the matters of valuation, formats of financial statements and the method of recording transactions. These tasks were given to each company directors to decide upon. Having said that, some small changes extending the disclosure requirements were made in 1967, which focused on the reports of the directors and additional notes to company's balance sheet (Roberts et. al., 2002). This meant that most of the principles contained in the 1948 Act still existed. The modified legislation survived until UK became a member of the EU and was required to adopt the Fourth and Seventh Directives. There were further amendments to the legislations in 1980 and 1981; however, a major consolidation of company laws resulted in the more comprehensive Companies Act 1985.

Consolidated accounting was required under the Companies Act 1948 and it was carried out based on the definitions of a subsidiary (Roberts et. al., 2002). This method of consolidated accounting persisted until the incorporation of the Seventh Directive in the Companies Act 1989, where some amendments were made to the definition of a subsidiary company. Since the 1948 Act gave no guidance on the method of consolidated accounting, professional accountants were given the responsibility to determine the method of consolidation, and that would have satisfied the requirements of law to consolidate all the accounts of a parent company and its subsidiary(s).

As can be seen from above, there was no system of written accounting standards in the UK prior to 1970. There were no mandatory requirements or laws governing the presentation of financial statements of companies. Furthermore, the only statutory provisions that did exist contained minimal amount of prescriptions as to the presentation and content of company financial statements. For this reason, professional bodies such as the Institute of Chartered Accountants in England and Wales (ICAEW) established a comprehensive Handbook of Recommendations on accounting and auditing issues to its members. Nonetheless, the guidance provided was only advisory in nature, rather than mandatory.

The many complications, inconsistencies and inappropriate accounting practices, as well as a series of well-publicised business scandals that occurred in the nineteenth century, have led the Council of the ICAEW to issue a ‘Statement of Intent on Accounting Standards’ in the 1970s. The strategy for the development of accounting standards was

set out in the statement. The intent was to provide more authoritative pronouncements to support current company law, rather than relying on the recommendations of professional bodies, which were only advisory in nature. Consequently, the ICAEW set up the Accounting Standards Steering Committee in 1970 as a way of implementing this strategy. The Institute of Chartered Accountants of Scotland and the Institute of Chartered Accountants of Ireland decided to become co-sponsors of this Committee shortly after its establishment. The Chartered Association of Certified Accountants and the Chartered Institute of Management Accountants joined in 1971, while the Chartered Institute of Public Finance and Accountancy joined in 1976.

Starting 1 February 1976, the Committee became the Accounting Standards Committee (ASC) and was reconstituted as a joint committee of the above six accountancy bodies. Each of these professional bodies retained the power of veto over any standard and all proposals for new standards that had to be approved by the Council of each member body (Roberts et. al., 2002). The Consultative Committee of Accountancy Bodies (CCAB) is now comprised of these accounting bodies. The primary objectives of the ASC were to define the accounting concepts, to narrow the differences of financial accounting and reporting treatment, as well as to codify generally accepted best practice in the interest of the public (Wilson et. al., 2001, p. 3). The ASC was also given the tasks “(1) to keep the standards of financial accounting and reporting under review; (2) to propose to the Council of each of the CCAB members the statements of standard accounting practice and interpretations of such statements; (3) to publish consultative documents, discussion papers and exposure drafts and submit to the Councils of each of the CCAB members



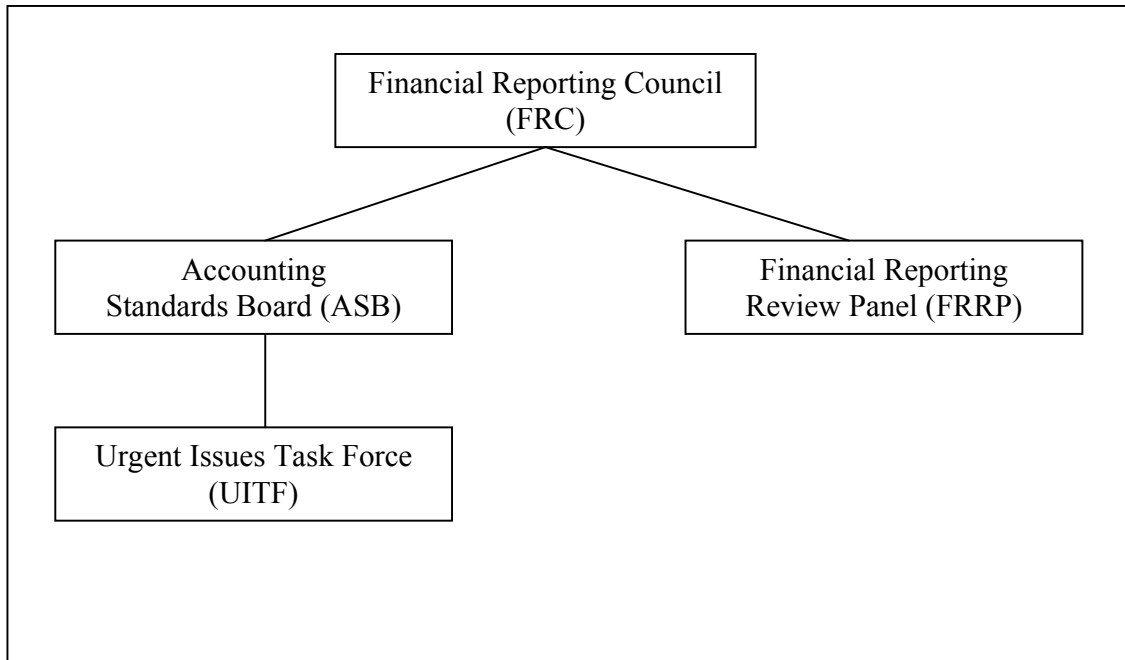
non-mandatory guidance notes with the object of maintaining and advancing accounting standards; (4) to consult, as appropriate, with representatives of finance, commerce, industry and government, and other bodies and persons concerned with financial reporting; and (5) to maintain close links with the IASC/IASB and the accounting profession in Europe and throughout the world” (Wilson et. al., 2001, pp. 3-4).

The accounting standards in the UK have been amended and improved with time in order to meet the economic needs of the day. Furthermore, the standard-setting process had undergone several reviews by various review groups. A major review of the standard-setting process, known as the Dearing Review, was conducted in November 1987 to review and make recommendations on the standard-setting process at the time. This is in response to the mounting criticisms for being unable either to respond promptly to changing needs or deal adequately with important issues such as inflation accounting, off-balance-sheet transactions and goodwill. It was apparent that the standard-setting process and the Committee, which comprised a voluntary part-time committee, were no longer appropriate to meet the challenging and ever changing business environment. The Dearing report recommended that accounting standards should remain, as far as possible, the responsibility of preparers, users and auditors, rather than becoming a matter that is strictly regulated by law. An independent standard-setting body was therefore necessary, in order to provide adequate financial assistance for it to carry out its tasks. There were also recommendations about the organisation of the standard-setting process and the need for a conceptual framework to guide financial reporting practices (Wilson et. al., 2001).

Many of the Dearing recommendations were adopted in 1990, when the government announced the establishment of the Financial Reporting Council (FRC) to address the need for the involvement of a wide constituency of interests in the development of accounting standards. The Council's chairman would be appointed jointly by the Secretary of State for Trade and Industry and the Governor of the Bank of England. The function of the FRC would be to guide the standard-setting body on issues of policy, to ensure that the Council is adequately financed and to act as an influence on good accounting practice (Roberts et. al., 2002).

The Accounting Standards Board (ASB) succeeded the ASC on 1 August 1990. As one arm of the FRC, the ASB consists of a panel of experts having a full-time Chairman, Sir David Tweedie, and a technical director, Allan Cook, along with seven other members. These members are part-timers selected from the accounting profession and business. However, the membership of the Board has now increased to ten. A two-thirds majority of the Board is required for approval of an accounting standard. A second arm of the FRC is the Financial Reporting Review Panel (FRRP), which holds the responsibility to enquire into the annual accounts of companies where there are signs of them potentially breaching the Companies Act. The ASB is assisted by an Urgent Issues Task Force (UITF) in dealing with matters of detail arising out of existing legislation or standards where clarification or a change in practice is required.

The present standard-setting structure in the UK is illustrated in the diagram below:



**Figure 11.11 - UK Standard-Setting Structure (Wilson et. al. p. 8)**

From 1970 to 1990, the Statements of Standard Accounting Practice (SSAPs) were issued by the ASC. The ASB has adopted all the SSAPs issued by the ASC and remaining in force in 1990. New standards issued for the first time by the ASB are known as the Financial Reporting Standards (FRS).

The process of consultation before the issue of an FRS consists of the issue of a Financial Reporting Exposure Draft (FRED) which in turn may be preceded by a Discussion Paper obtaining views and feedback on major points of accounting principles. Letters of comment to the ASB will be stored in a public record, unless when confidentiality is requested by senders. Other forms of consultation and discussion can take place in private. The ASB seeks to operate the maximum possible consultation (Roberts et. al.,

2002). When there have been some urgent issues drawn to the attention of the ASB, the UITF will be responsible for dealing with such issues, which often involved detailed aspects of an existing accounting standard or company law.

Other bodies which represent different industry-specific sectors are given permission to develop Statements of Recommended Practice (SORPs). This idea of developing SORPs intends to ensure that proper guidance exists on issues that are not specifically dealt with by an appropriate accounting standard at the time (Wilson et. al., 2001). Although the ASB do not specifically provide legal backing to SORPs, it will give an assurance that the SORP does not appear to conflict with existing accounting standards (Roberts et. al., 2002). This means that the ASB retains the power to reject or withdraw the recognition of those SORPs that are inconsistent with the existing accounting standards.

Like other Anglo-Saxon countries, the tax law in UK has developed separately from accounting law and there is no requirement that accounting profit must be calculated under fiscal rules to be an acceptable base for taxable profit.

A proper system of accounting standards existed when the Companies Act 1985 was formulated as a result of an amendment introduced in 1989. To date, the Act regulates the constitution and conduct of nearly all business corporations, including both limited and unlimited liability companies incorporated in Britain (Wilson et. al., 2001). The Act requires directors of companies, other than small-medium-entities (SMEs), to disclose whether company accounts have been prepared in accordance with applicable accounting

standards and to offer explanation for any departure from those standards (Roberts et. al., 2002). In an event of departure from the requirements of the Companies Act 1985, the legislation gives right to the Court to order the preparation of a revised set of company accounts, at the expense of company directors who gave approval to the misleading accounts. A new form of limited liability vehicle, known as the limited liability partnership (LLP), was introduced into the UK legislative framework by the Limited Liability Partnerships Act 2000 (Wilson et. al., 2001). LLPs fall within the scope of the Companies Act by virtue of the requirements of the Limited Liability Partnerships Regulations 2001 (Wilson et. al., 2001).

The Companies Act 1985 represents almost 150 years of “continuous development” of British company law and therefore, is very comprehensive (Wilson et. al., 2001, p. 1). Its provisions include matters on company formation, company administration and procedure, the allotment of shares and debentures, the increase, maintenance and reduction of share capital, accounts and audit, and the distribution of profits and assets (Wilson et. al., 2001). The Act requires that the annual accounts of limited liability companies meet the ‘true and fair’ view requirement. Furthermore, the Act requires that company annual accounts (with the exception of some small companies) be audited in accordance with the UK auditing standards.

By far the most significant inward influence on UK accounting has been membership of the EU (Nobes and Parker, 1984; Nobes, 1993). Membership of the EU and the adoption

of the Fourth and Seventh Directives brought more specific requirements in the shape of accounting formats and rigid prescriptions in terms of accounting practices.

The most significant change in approach was taken in 1981, when the Fourth Directive was implemented in UK company law. This brought formats and valuation rules to company law for the first time, thereby, reducing the flexibility in accounting practices among UK companies. Concepts such as prudence, consistency, accruals and going concern were introduced to law, as was the requirement to report only realised profit in the profit and loss account. The 1981 Act was additional to the 1948 and subsequent Acts. However, as mentioned earlier section of this report, all these acts were consolidated into one comprehensive act in 1985, producing the Companies Act 1985. Implementation of the Seventh Directive, on the other hand, was by way of the 1989 Act, amending the principal Act of 1985.

UK accounting standards always indicate, by way of an appendix, whether or not they are consistent with IASB standards (Roberts et. al., 2002). Companies applying UK accounting standards are therefore, to a considerable extent applying IAS/IFRSs indirectly but seldom acknowledge this fact in their annual reports. In fact, UK has been the only country in the EU that has the closest conformation to IAS/IFRS.

## **11.2 Accounting for Investment Properties in UK**

The current legislation governing the accounting for investment properties in the UK is SSAP-19 'Investment Properties'. SSAP-19 was first issued in 1981 and has been strict

on the definition of an investment property. Investment properties are defined as “an interest in land and/or buildings; or where development and construction work has been completed; and where the interest is held for investment potential, where its rental income is negotiated at arm’s length” (Wilson et. al., 2001, p. 963). Investment properties under SSAP-19 exclude owner-occupied properties and properties that are let to and occupied by other group companies.

If an investment property falls under the definition of an investment property, it must be accounted for under the standard. The standard requires freehold investment properties to be carried at the current market valuation without provision for depreciation. Leasehold investment property must also be carried at the current market valuation and may be depreciated over the life of the lease, or not be depreciated until the lease has twenty years or fewer remaining, when it must be depreciated.

SSAP-19 also requires that investment properties be included in the balance sheet at their open market value. With the exception of insurance companies, pension funds and certain investment properties should not be taken to the profit and loss account but should be taken to the statement of total recognised gains and losses. However, if a deficit (or its reversal) on an individual investment property is expected to be permanent, it should be charged (or credited) in the profit and loss account of the period. All other valuation movements in investment properties are to be shown in the statement of total recognised gains and losses (as movements on the investment revaluation reserve) even if this results

in a temporary revaluation deficit. SSAP-19 requires companies to consider their properties individually.

SSAP-19 requires that the carrying value of investment properties and the investment revaluation reserve be displayed prominently in the accounts. This means that if assets other than investment properties are revalued, the revaluation reserve should be split to show the amount relating to investment properties as opposed to other revalued assets. Nonetheless, such practice is seldom seen in reality.

The standard does not require that the valuation of investment properties to be carried out by qualified or independent valuers, but recommends that ‘where investment properties represent a substantial portion of the total assets of a major enterprise, for example, a listed company, the valuation thereof would normally be carried out annually by persons holding a recognised professional qualification and having recent post-qualification experience in the location and category of the properties concerned, and least every five years by an external valuer’.

SSAP-19 is an early example of accounting based on fair values rather than cost. This could be known as ‘user-driven’ accounting in that fair value of an investment is considered to be more relevant to predicting future cash flows than historical cost. However, there exists some controversy between the Companies Act 1985 and the requirements of SSAP-19. The Act requires that fixed assets of any kind be depreciated, while SSAP-19 considers that current value is more relevant and of greater importance.



In practice, this disagreement is reconciled by the accepted use of the true and fair override. This use of the overriding principle is hardly the purpose for which it was put into the legislation, but has become something of a necessary loophole to enable property companies to report fair value information for which users believe achieves more relevant accounting.

One other area where the Act is out of date is its reference to the recognition of changes in value, where permanent falls in value must be charged to the profit and loss account, but temporary falls in value can be ignored. SSAP-19, on the other hand, states that all changes must be identified and recognised, where temporary movements in value, whether up or down, should be reported in the statement of total recognised gains and losses, and stored in the revaluation reserve. Nonetheless, all permanent impairments should be reflected in the profit and loss account.

There are no specific requirements concerning accounting for agriculture in the UK.

On the international scene, fair value has formed the basis of accounting in three recent accounting standards, financial derivatives in IAS-39, investment properties in IAS-40 and agricultural livestock and produce in IAS-41. IAS-40 became effective from 2001. Prior to IAS-40, investment property was accounted for under the general tangible fixed asset standard IAS-16 'Property, Plant and Equipment'. Alternatively, a treatment similar to SSAP-19 was possible by dealing with investment properties under the investment standard, IAS-25. However, the IASB contended that the characteristics of investment

property were sufficiently different from owner-occupied property. This led to the creation of IAS-40.

An investment property is defined under IAS-40 as land held for long-term capital appreciation rather than for short-term sale in the ordinary course of business; or land held for a currently undetermined future use; or a building owned and leased out under one or more operating leases; or investment property being redeveloped for future use as investment property. As opposed to the provisions of SSAP-19, IAS-40 states that property held under an operating lease by a lessee does not constitute an investment property, thus, cannot be recognised on the balance sheet. Consequently, property which was previously classified as investment property under SSAP-19 will generally also be classified as investment property under IAS-40 with the above mentioned major exception.

Investment properties are initially measured at cost under IAS-40. Cost includes any directly attributable expenditure such as legal fees and property transfer taxes; however, it excludes start-up costs unless they are necessary to bring the property to its working condition; initial operating losses incurred before the investment property achieves the planned level of occupancy, as well as abnormal amounts of wasted resources, such as labour and materials, incurred in constructing or developing the property. After the initial recognition, companies are allowed to adopt either the fair value model or the cost model. Companies are required to apply the model chosen for all their investment properties. However, whichever option is chosen, companies are still required to determine the fair

value of investment property as the fair value needs to be disclosed if the cost model is adopted.

Fair value is defined as ‘the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm’s length transaction’. If companies opt for the fair value model, all investment property should be measured at its fair value and a gain or loss arising from a change in the fair value of investment property should be reported in the income statement, and included in net profit or loss for the period in which it arises.

The management of companies are encouraged, but not compelled, to determine the fair value of investment property on the basis of a valuation by an independent valuer who holds and recognised and relevant professional qualification; and who has recent experience in the location and category of the investment property being valued.

The provisions of IAS-40 might as first sight appear relatively straightforward, but it is believed that the implications of applying this standard go deeper. Companies with investment properties will be more heavily impacted than any other companies. The effects of adoption IAS-40 will affect what can be included as an investment property, how the property is valued and how changes in a property’s value are recorded.

Although IAS-40 only came into force from 1 January 2001, it raises several practical issues, some of which have a more general application. It includes nearly twenty

substantial paragraphs dealing with fair value, what it means, how to arrive at it and other similar guidance. Nonetheless, the most remarkable thing about IAS-40 is that its establishment (Wilson et. al., 2001). As a result, there are several major issues that UK property companies must be prepared to address in the change to IAS-40. Some of these major issues will affect the practices of reporting, accounting for leases, valuations and taxation.

In terms of reporting, all gains and losses on valuation must be presented in the income statement, although it is not precisely defined where in the income statement those gains or losses should be shown. Furthermore, IAS requires the gain on initial valuation of an investment property, which was constructed by the owner to be included within income. One potential outcome will be that any performance criteria, for example, for share options or executive remuneration, which are linked to reported earnings will need to be re-evaluated. Company management will also be prepared to consider carefully the impact of IAS-40 on performance reporting to investors to ensure that any changes in earnings can be communicated and explained to shareholders clearly (Trewin, 2002).

As for accounting for leases, properties held under operating leases are excluded from the IAS-40 definition of investment property. This implies that many UK companies will be impacted by this change since a large number of UK property leases are currently treated as operating leases (Trewin, 2002). Companies adopting IAS-40 will have to treat these leases as operating and not present them on balance sheets.

In terms of valuation, current best practice will be for valuers to follow International Valuation Standards (IVS), rather than the RICS Appraisal and Valuation Model, as stated in the 2001 edition of the IVS (Trewin, 2002). However, the IVS are currently being revised and updated by the International Valuation Standards Committee (IVSC).

With gains and losses on valuation going through the income statement, rather than the statement of total recognised gains and losses and the revaluation reserve, and based upon the recent trend of the Inland Revenue to tax on the basis of true and fair accounts, it is reasonable to suppose that they will review the basis of taxation following the change to IAS (Trewin, 2002). At least, companies will have to provide in full for deferred taxation on all revalued assets.

## **12. What is the Regulatory Context of Irish Financial Reporting and how do the Requirements in Ireland differ to IAS 40 and IAS 41?**

Accounting regulation in Ireland is very similar (if not exactly the same) as accounting regulation in the UK. Accounting standards in Ireland are exactly the same as accounting standards issued by the ASB in the UK. This is because the Institute of Chartered Accountants in Ireland participates in the work of the ASB in the UK, and its standards are promulgated in Ireland by the Institute of Chartered Accountants in Ireland. The only differences that could exist would be those in commercial law. No such differences have been seen and therefore it is assumed that the two systems of accounting regulation are very similar if not exactly the same.

### **13. What is the Regulatory Context of Dutch Financial Reporting and how do the Requirements in the Netherlands differ to IAS 40 and IAS 41?**

Financial reporting regulation in the Netherlands is characterised by its lack of legal regulation, and greater reliance on more flexible and more ambiguous kinds of guidance. Among these has been the professional judgement of a long-established auditing profession (Camfferman, 1995). This did, however, change to some extent in 1970 with the introduction of new financial reporting regulation, and extensive changes to the way Dutch financial reporting was regulated. Dutch financial reporting is described as an Anglo-Saxon financial reporting system because of its flexibility, its disconnection with taxation rules (Zeff et al., 1992), and its regulation through the accounting profession rather than laws. The following will give an overview of Dutch financial reporting regulation and look more specifically at accounting for investment properties and accounting for agriculture in the Netherlands.

The origins of the accounting profession in the Netherlands can be traced back to the end of the nineteenth century. At this time the role of the accountant changed from bookkeeping to auditing as limited liability companies grew in importance. The separation of owners and management caused the need for independent auditors who could exercise their professional judgement. The Netherlands Institute of Accountants was established in 1895 with the purpose of establishing statutory rules for the accounting profession. These rules did not, however, materialise. No specific legislative action arose until the Chartered Accountants Act of 1962. This law created the

Netherlands Institute of Registered Accountants (*Nederlands Instituut van Registeraccountants*, NIVRA) (Roberts et al., 2002).

NIVRA issues audit guidelines but does not issue accounting standards or guidelines. It does, however, participate in accounting guidelines through membership of the Council for Annual Reporting, which is discussed in more detail below. The education of registered accountants in the Netherlands is substantially more onerous than that required by the eighth directive, and by most other countries. It lasts from eight to twelve years, and includes both undergraduate and postgraduate study as well as professional training (Roberts et al., 2002).

Unlike most other continental European countries, Dutch financial reporting is relatively disconnected from taxation rules. The accounting profession has sometimes used the same criterion as tax rules as the benchmark for financial reporting. However, the two approaches to determining a company's profit, at least for large companies, has developed independently from each other. An example is current cost, which has been used by some companies in the preparation of their financial statements, has never been allowed for income tax purposes. Small and medium sized entities have used tax rules in drawing up their financial statements, but this has been done primarily to avoid having to produce two sets of statements (Zeff et al., 1992).

No research has ever been conducted in the Netherlands to explain why Dutch financial reporting is more like that of the UK and Ireland. One argument is that the early

establishment of important Anglo-Dutch multinationals such as Royal Dutch Shell and Unilever have tilted Dutch financial reporting more toward the Anglo-Saxon, rather than the Continental, model of financial reporting. A similar argument is that the Netherlands is in the Anglo-Saxon group because these countries have a longer tradition of published accounting, and commercial rules have developed before taxation rules. Another argument is that there is a desire in the Netherlands to have financial reporting rules that contain as little prescription as possible. Therefore financial reporting has remained separate from detailed taxation rules (Zeff et al., 1992).

The first legal requirements on financial reporting in the Netherlands were set out in the Commercial Code of 1929. The code, however, only contained one article relating to financial reporting. Among the provisions of the article was a general clause to do with valuation. There were also some very broad rules concerning the system of headings within the balance sheet. This law and financial reporting regulation remained relatively unchanged until 1970 when there were extensive changes in financial reporting regulation in the Netherlands (Klaassen, 2001). The apparent lack of urgency to develop statutory regulation of accounting before 1970 may be attributed to the strong influence of the business economics (*bedrijfseconomie*) approach to accounting theory (Roberts et al., 2002).

Prior to 1970 there was only one type of limited liability company in the Netherlands, which was the *naamloze vennootschap* (NV). Company law was applicable to all companies regardless of size (Zeff et al., 1992). In 1970 a second legal form was created,



which was the *besloten vennootschap met beperkte aansprakelijkheid* (BV), which is a private limited company whose shares are not easily traded. The key distinction between NV and BV is that BV may not be listed or traded on a stock exchange, while NV must be public companies. Companies must have NV or BV before or after their name. Large companies in both categories have the special description of *structuur-NV* or *structuur-BV*, and special rules exist for these companies (Roberts et al., 2002). Large companies are those with a certain level of assets<sup>6</sup>, and which employ at least 100 employees (Zeff et al., 1992).

In 1970 the Annual Financial Statements Act (*Wet op de jaarrekening van ondernemingen*, WJO) was introduced. This new Act was a part of quite extensive changes to company legislation in the Netherlands. This legislation was preceded by the report of a State committee which proposed coordinated changes in company legislation (Klaassen, 2001). As a technical matter the 1970 Act was incorporated into Book 2 of the Civil Code in 1976. This is where all corporate law in the Netherlands is contained. The Civil Code was also amended in 1983 and 1988 when the Netherlands implemented the Fourth and Seventh Directives respectively (Roberts et al., 2002). The 1970 legislation introduced two new institutions which had an important impact on Dutch financial reporting (Klaassen, 2001).

Firstly, the law introduced an Enterprise Chamber (*Ondernemingskamer*). The Enterprise Chamber is a specialist court, connected with the High Court of Amsterdam, which acts

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<sup>6</sup> At least f22.5m of assets used to be the threshold (Zeff et al., 1992), however on 28 January 2002 the Netherlands adopted the Euro. It is unknown what the threshold currently is.

as the judicial institution adjudicating on complaints from interested parties to do with financial reporting (Klaassen, 2001). The Chamber may state that the financial accounts of a company are incorrect and may give an order to the company containing requirements for the preparation of financial statements, now and in the future. It may also give more general instructions which may cause a particular accounting policy to become unacceptable (Roberts et al., 2002). The Enterprise Chamber, being part of the judiciary and having exclusive jurisdiction over financial reporting, was unprecedented in the rest of the world (Zeff et al., 1992).

Secondly, the Minister of Justice encouraged relevant business organisations to enter into consultations with a view to making recommendations on certain valuation and profit determination practices. A Tripartite Accounting Study Group was formed in the early 1970s and is the predecessor of the present Council for Annual Reporting (*Raad voor de Jaarverslaggeving*, RJ). The Tripartite Accounting Study Group was formed as a consultative body consisting of representatives of the accounting committees of three organisations. These were the accounting committees of: the Council of Dutch Employers' Federations; NivRA; and the Consultative Council of Trade Union Federations (Klaassen, 2001).

As a result of its deliberations, the Tripartite Accounting Study Group issued a number of Considered Opinions on financial reporting. By the late 1970s there was recognition of the fact that the Tripartite Accounting Study Group had failed to win broad enough support among preparers and users. Some groups, especially auditors, felt that the

Considered Opinions contained insufficient guidance and their objectives were too modest. This led to the replacement of the Tripartite Accounting Study Group with the Council for Annual Reporting (Klaassen, 2001).

The Council for Annual Reporting took over from the Tripartite Accounting Study Group in 1982. It is a third stage in the process of accounting regulation in the Netherlands, the first being the Civil Code and the second being the Enterprise Chamber (Roberts et al., 2002). The council took over the recommendations of its predecessor and reissued them after a thorough overhaul of the style and presentation (Klaassen, 2001). It comprises representatives from the interest groups of users, preparers and auditors. The users are represented by the two main trade unions and a representative of the Dutch Financial Analysts' Society. Interestingly the emphasis is on employees as users. The preparers are represented by the Principal Industrial Confederation. The auditors are represented by NIVRA (Roberts et al., 2003).

The role of the Council for Annual Reporting is to review accounting principles which are applied in practice and give its opinion on the acceptability of those principles within the framework of the law. Its opinions are published as Guidelines for Annual Reporting (Roberts et al., 2003). The guidelines that the Council is issuing currently are heavily based on IFRS. This is understandable considering listed companies will be required to prepare their consolidated financial reports in accordance with IFRS by 2005.

The Foundation for Financial Reporting was also established in 1981 by the employers' organisations, the trade unions and NivRA. In order to strengthen its position, the Council for Annual Reporting became a body of the Foundation for Financial Reporting. The Foundation for Financial Reporting is funded by grants from the business community and from NivRA. It publishes Guidelines prepared by the Council without interfering with its contents (Klaassen, 2001).

There is a lot of scope for the Council for Annual Reporting to set standards on financial reporting due to the lack of detailed rules in legislation. The guidelines that the Council for Annual Reporting has issued are a fairly complete overview of financial reporting requirements in the Netherlands<sup>7</sup>. The council is not, however, very active in promoting new forms of financial reporting, nor does it take the lead in forming new accounting standards as problems emerge. This is mainly because its primary role is to review existing accounting practices, and issue its opinion on them, not to create new accounting practices (Klaassen, 2001).

The Guidelines of the Council for Annual Reporting do not have the force of the law. Auditors of financial statements are not required to mention failure to comply with the guidelines in their audit opinions. They should, however, take them into consideration as part of the audit process when considering the acceptability of a company's accounting policies. If they consider that non-compliance with the guidelines still gives a 'true and fair view' of the company's performance and position, then they can still issue an unqualified audit opinion (Klaassen, 2001).

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<sup>7</sup> For a list of guidelines issued as of 2001 see Klaassen, 2001.

It has been argued that the Enterprise Chamber could be considered a standard setter. Certain verdicts of the Enterprise Chamber contain general rules that the court has derived from its interpretation of the law. Such rules have the status of a law if they prove to be the consistent practice of the court. An example of this is the requirement to give reasons for changes in accounting policies. In most cases, however, the discussion points that the plaintiffs bring up are specific to the case, and the verdict of the court does not give rise to rules that would be of significance to other companies (Klaassen, 2001).

In October 2001 the Netherlands Council of Ministers agreed to a bill that would permit Dutch companies to prepare their financial statements in accordance with IFRS or US GAAP instead of Dutch accounting rules. The action was taken for two reasons. Firstly, Dutch companies will be required to adopt IFRS in 2005, and this allows them to adopt them earlier if they choose. Secondly, it will ease the burden on many Dutch companies that currently have to prepare two sets of financial statements because they seek capital in overseas markets (IAS Plus, 2003b). As mentioned earlier, the Netherlands has issued draft legislation which would permit the extension of Regulation 1606/2002 to individual and unlisted entity financial statements.

In November 2001 the Council for Annual Reporting issued draft guidelines designed to promote greater convergence with IFRS. The guidelines covered the topics of financial instruments, extraordinary items, changes in accounting policies, changes in estimates, and proposed dividends. There was also a new draft guideline on accounting for

investment property. It included a new benchmark treatment for the measurement of investments in real estate. This was to measure them at fair value, without depreciation, and is now the preferred method. This is the same as IAS 40 and like IAS 40 the guideline also contains an allowed alternative treatment of cost less depreciation (IAS Plus, 2003b).

In November 2002 the Council for Annual Reporting issued a further flurry of draft guidelines, and these were also all based on IAS or SIC (see IAS Plus, 2003b). In addition, the draft guidelines issued in November 2001 became effective as guidelines on 1 January 2003 except for the draft guideline on financial instruments which had not been made final. The Council instead decided to wait for changes to be made by the IASB before finalising this Guideline. Included in the finalised guidelines was RJ 213 – Investment Property, which is now almost completely based on IAS 40 (IAS Plus, 2003b).

Prior to RJ 213 being issued the treatment of investment properties was significantly different to that of IAS 40. There was no separate guideline on investment properties and they were accounted for as property, plant and equipment. Under the old treatment, an investment property could be measured at cost or at its current value. In the latter case, value changes were not included in the profit and loss account as they are under IAS 40. Instead they were recorded directly in equity as part of a revaluation reserve (Deloitte Touche Tohmatsu, 2002).

Despite RJ 213 being based on IAS 40, it still contains one major difference. Like IAS 40, measurement at fair value is preferred to measurement at cost. Also like IAS 40, revaluation changes are included in the profit and loss account. However, under Dutch GAAP a change in the revaluation reserve is prescribed, directly within equity to or from the other reserves or as a part of the appropriation of the result of the year. In addition, the revaluation reserve cannot fall below zero (Verhoek, 2003). In other words, the amount of profit that is attributable to revaluations of investment properties is shown separately in equity as a reserve, and not included in retained earnings. Losses attributable to revaluation of investment properties are only taken to reserves to the extent that they reverse a previous revaluation increment; otherwise they are left in retained earnings. This practice shows that although the Dutch are willing to include gains from revaluing investment properties in the profit and loss, they still want to show them separately from retained earnings so it can be seen to what extent owners' equity has been increased by revaluing assets.

Currently in the Netherlands there are no specific accounting principles or requirements for agriculture activities (Verhoek, 2003). This may come as somewhat of a surprise because 3.4% of GDP in the Netherlands come from agriculture activities (Roberts et al., 2002). However, the source of most of this GDP is likely to come from sole traders, or unlimited liability partnerships as it does in NZ. In addition, most countries around the world have no specific accounting regulation dealing solely with agriculture activities. Therefore it is not really that surprising that the situation in the Netherlands is the same.

Financial reporting regulation in the Netherlands has been left mostly to the accounting profession. Legislation on financial reporting increased to some extent in 1970, and to a greater extent with the implementation of the Fourth and Seventh Directives in the Netherlands. This, however, does not cover a lot of aspects of financial reporting, and therefore a lot of judgement is required from the accounting profession. The Council for Annual Reporting is the standard setter in the Netherlands, however its guidelines are not legally binding, and therefore the audit profession is not required to issue qualified opinions if they are not complied with. Complaints to do with financial reporting, however, can be taken to the Enterprise Chamber for a legally binding decision.

The Council for Annual Reporting currently issues guidelines that are heavily based on IFRS with only minor changes to reflect the Dutch business environment. RJ 213 on investment properties is one such example. It is almost identical to IAS 40 except for a difference in the presentation of equity mentioned above. Currently the Netherlands has no specific financial reporting requirements for agriculture. This is similar to most other countries.

#### **14. What is the Regulatory Context of Danish Financial Reporting and how do the Requirements in Denmark differ to IAS 40 and IAS 41?**

Danish financial reporting has been greatly influenced by trends in foreign financial reporting. This is due to its moderate size, geographical location and other cultural and economic factors. Prior to the Second World War Denmark had close political and cultural ties with its Southern neighbour, Germany. During the evolution of financial reporting the influence of Germany can be seen in some areas, e.g. the importance of the



prudence principle (Christiansen, 1995). For several years prior to Denmark entering the then European Community in 1973 Danish accounting regulation was influenced by attempts to harmonise with other Nordic countries (i.e. Finland, Norway and Sweden) (Hansen, 2001).

Although influences from continental European countries on financial accounting can be observed, Denmark has traditionally had links with the UK, and has followed the Anglo-Saxon accounting tradition with quite flexible financial reporting regulations. One indication of this is that legislation has always been based on some kind of general clause with few specific supplementary rules (Hansen, 2001). Danish financial reporting has also been influenced to some extent by the US. After the Second World War the influence of US culture began, and the establishment of US subsidiaries and US based audit firms was followed by the introduction of several American accounting principles in Denmark (Christiansen, 1995). The influence from the US has not, however, been as strong as the influence from the UK (Hansen, 2001).

Along with its Anglo-Saxon traditions, Danish accounting is relatively separate from taxation rules. Complete segregation of taxation rules and financial reporting, however, did not occur until the implementation of the fourth directive and the adoption of the Financial Statements Act (both of which are discussed in more detail below). A loose connection exists because taxable income is calculated by making changes to reported profit to arrive at taxable profit. Some cost-benefit considerations mean the financial reporting practices may be affected by taxation rules. For example, the upper limit of

small size assets, which are expensed straight away, is usually equal to the upper limit defined in tax legislation (Hansen, 2001). The effect of this, however, is unlikely to be material, and no different than other Anglo-Saxon countries.

The Bookkeeping Act in Denmark sets out general rules concerning the keeping of books, and rules concerning the preparation of annual accounts for businesses. Irrespective of legal form, the Act applies to almost all Danish Businesses. The most important rules in the Act can be summarized in the statement that accounting must comply with 'good accounting practice'. It is not specified in the law what is meant by this phrase. However, "it is widely assumed that it can be compared with 'good practice among competent and responsible professionals' with constant consideration of practical developments as well as the nature and extent of the individual business" (Hansen, 2001, p. 647).

Denmark implemented the Fourth Directive in 1981 (Christiansen, 1995) and as a result the Financial Statements Act was adopted. It replaced the Public and Private Limited Companies Acts. The Financial Statements Act applies to public and private limited companies and limited partnerships which have a public limited company as the general partner. In general the Act does not apply to banks, insurance companies or stock-broking companies. Except for the provisions which concern audits, the Act also does not apply to companies subject to the Acts relating to certain credit institutions and credit secured by mortgages on real property (Hansen, 2001).

In many respects the first Financial Statements Act was a fairly precise repetition of the Fourth Directive, and this applies not only to structure, but also to the directive's options which can also be found in the act. The Financial Statements Act also introduced the concept of a 'true and fair view'. This gave rise to extensive debate in accounting circles to whether the concepts 'good accounting practice' and 'true and fair view' were the same. It was argued that the new concept introduced an increased focus on users of accounts, whereas the old concept was seen as a guide to preparers (Hansen, 2001). The Financial Statements Act was also amended to include the requirements of the Seventh Directive which was adopted by Denmark in 1990 (Christiansen, 1995).

In January 2001 the Danish Parliament proposed a new Financial Statements Act aimed at tying the act to IFRS as much as possible. The new Financial Statements Act came into effect on 1 January 2002. Generally, the Act is based on the IASB Framework and IFRS as far as possible. This means that further interpretation can be sought from IFRS and SIC and when the Act is silent or a paragraph in the Act is worded too generally. This also means that further interpretation can be sought from Danish Accounting Standards (DKAS) because DKAS are generally based on the equivalent IFRS with some minor differences (IAS Plus, 2003a).

However, because the Act was also required to comply with the EC Directives certain differences to IFRS still exist. One of these differences is that the measurement of investment properties at fair value is allowed only if the main business of the enterprise is investing in investment property. As seen above, this is not the case in IAS 40 (IAS Plus,

2003a). Other examples of differences are: revaluations of intangible assets are not allowed; presentation of negative goodwill as a liability is required; restructuring provisions must be recognised when the Board of Directors has made the decision before the balance sheet date; and classification of financial instruments is according to legal form rather than substance (IAS Plus, 2003a).

In August 2003, the Danish Commerce and companies Agency published more proposed changes to the Financial Statements Act. The proposed changes include a number of relaxations for small and medium entities. The relaxations consist partly of a proposed increase in the size limits of the individual reporting classes, and partly of moving a number of disclosure requirements from reporting class B (small entities) to reporting class C (medium and large, but not listed, entities). With regards to measurement, the proposal makes the current statutory requirement for measuring investment assets (such as investment property) at fair value optional. The proposal also allows some exemptions from providing segment information and contains a number of clarifications, and some restrictions and requirements, derived from the changes of the EU Directives. Finally, the proposed changes implement the national part of the EU regulation 1606/2002 by requiring that listed companies apply IFRS in their consolidated financial statements (IAS Plus, 2003a).

Another source of financial reporting regulation after Danish legislation is Ministerial Orders, issued by the Ministry of Business and Industry in Denmark. The Financial Statements Order is the only one of these, and it relates to the preparation, filing and

publication of annual accounts with the Danish Commerce and Companies Accounts. There are also Ministerial guidelines but these are only interpretations of laws and orders. These include the Ministerial Guideline concerning Bookkeeping, and the Ministerial Guideline concerning Group Accounts (Hansen, 2001).

The Danish accounting profession has a long history in publishing accounting standards and opinions. The Institute of State-Authorised Public Accountants (*Foreningen af Statsautoriserede Revisorer*, FSR) in Denmark was established on 12 January 1912<sup>8</sup>. The FSR has been publishing expert opinions since 1925 with a view to establishing good accounting and auditing practice (Hansen, 2001). Since 1978 the FSR has also published IFRS in Danish and English. These have been accompanied by an introduction in Danish, and by the FSR's recommendations and comments. Despite this, the impact of IFRS on Danish financial reporting has been unremarkable (Hansen, 2001)

The first truly national accounting standards in Denmark appeared in 1988 when the FSR's Accounting Committee (*Regnskabsteknisk Udvalg*) published a preface to accounting standards and the first accounting standard entitled 'The Financial Statement: Objectives and Content'. The FSR still publishes both IFRS and commentaries. Both of these must now be considered as a supplement to national standards (Hansen, 2001). The Accounting Committee, prior to 1992, was entitled to submit drafts of standards to interested parties. It made good use of this option. Final accounting standards came into force when they were adopted by the FSR at its annual meeting. The FSR had the final

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<sup>8</sup> Source: FSR's webpage <http://www.fsr.dk/site/fsrstart.nsf/web/fsrframesetnonmember>

say on the content of an accounting standard. Danish Accounting Standards (DKAS) one to eight, shown in table 14.1, were set under this process (Hansen, 2001).

In 1992 the Danish Accounting Standards Board (*Regnskabspanelet*, RP), an advisory body, was established. The FSR holds the presidency of the Board, which consists of representatives of the Accounting Committee and other organisations. These include: the Confederation of Danish Industry; the Danish Bankers' Association; the Danish Shipowners' Association; the Danish Securities Dealers' Association; the Danish Labour Market Supplementary Pension Fund; The Employees' Capital Pension Fund; the Danish Insurance Association; the Council for Labour Market Pension Schemes; the Association of Company Pension Funds; the Danish Association of Public Registered Accounts; and a representative from the Copenhagen Business School is officially appointed as academic adviser to the board (Hansen, 2001).

The Danish Accounting Standards Board recommends subjects for future accounting standards and updating of current standards. The Accounting Standards Board also processes drafts of standards and proposals for final standards (Hansen, 2001). Therefore standards are prepared by the institute in consultation with the Accounting Standards Board; however, the process is primarily carried out by the institute. The final adoption of the standards is the responsibility of the FSR Accounting Committee. Standards issued after DKAS eight were adopted under this process (Hansen, 2001).

**Table 14.1 – Danish Accounting Standards<sup>9</sup>** (Hansen 2001; IAS Plus 2003a)

DKAS	Standard Name	Date Issued	Based On
	Preface to Accounting Standards	1993	?
1	The Financial Statement: Objectives and Content	1988	?
2	Information concerning the Accounting Principles Applied in the Financial Statement	1988	?
3	Changes in Accounting Policies and Accounting Estimates	1989	?
4	Contingencies and Events occurring after the Balance Sheet Date	1990	?
5	Extraordinary Items	1990	?
6	Construction Contracts	1991	?
7	Research and Development	1991	IAS 9
8	Inventories	1993	?
9	Foreign Currency Translation	1995	?
10	Tangible Fixed Assets	1996	?
11	Cash Flow Statements	1996	?
12	Directors' Report	1999	?
13	?	?	?
14	Income Taxes	2001	IAS 12
15	Financial Instruments: Disclosure and Presentation	2001	IAS 32
16	Investment Property	2002	IAS 40
17	Provisions, Contingent Liabilities and Contingent Assets	2002	IAS 37
18	Business Combinations	2002	IAS 22
19	Treasury Shares	2002	SIC 16
20	Disclosure of Share-Based Payments with Own Shares	2003	IAS 19 P. 144-152
21	Leases	2003	IAS 17
22	Revenue Recognition	2003	IAS 18
ED 15	Related Party Disclosure		?
ED 20	Construction Contracts		IAS 11
ED 21	Inventories		IAS 2
ED 22	The Effects of Changes in Foreign Exchange Rates		IAS 21
ED 23	Property, Plant and Equipment		IAS 16
ED 24	Presentation of Financial Statements		IAS 1
ED 25	Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies		IAS 8
ED 26	Events After the Balance Sheet Date		IAS 10
ED 31	Accounting Standard for Smaller Entities		?

<sup>9</sup> The table contains some gaps but has been left in to show what standards have been set in Denmark. It is suspected that ED 15 has been issued as DKAS 13. It is also suspected that ED 20 through to 26 may have replaced earlier standards as they are brought in line with IFRS (e.g. ED 20 may have replace DKAS 6).

DKAS are private sector regulation which is backed by the Copenhagen Stock Exchange as far as quoted companies are concerned (Hansen, 2001) and are mandatory for listed companies (Larsen, 2003). They do not override the Financial Statements Act. An example of this is when the FSR released a statement regarding inconsistencies between the Danish Financial Statements Act and DKAS 7 – Research and Development. The FSR clarified that entities must comply with the Act and that DKAS do not overrule the Act (IAS Plus, 2003a). In most cases, however, DKAS do not contradict the Act.

Listed companies are also subject to additional reporting requirements. They are subject to the rules governing issuers of securities listed by the Copenhagen Stock Exchange. These are mandatory for all quoted companies. Other sources of Danish GAAP include: opinions issued by the accounting profession; standard commentaries; IFRS; and professional journals. These sources have no legal backing, however standard commentaries are indirectly backed by the Ministry of Industry and Business, and IFRS are generally recommended by the audit profession (Hansen, 2001) and are permitted in Denmark so long as all the requirements of the Financial Statements Act are fulfilled (IAS Plus, 2003a).

Accounting for investment properties is dealt with under paragraph 38(1) of the Danish Financial Statements Act<sup>10</sup>. Paragraph 38(1) states: “Enterprises which, as their principal activity, invest in investment properties, commodities or similar assets shall continuously

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<sup>10</sup> The English translation of the Financial Statements Act listed in the references is not completely up to date, but it is for the requirements on accounting for investment properties and agriculture (Larsen, 2003).



adjust assets and related financial liabilities within such activities to the fair value after the initial recognition”. The difference between this and IAS 40 is that fair value is required, and there is no option to value investment properties at cost. Not allowing the option to value investment properties at cost does not jeopardise compliance with IAS 40. As with revaluations in the Netherlands, paragraph 38(4) requires net upward revaluations to be disclosed separately in equity as a revaluation reserve.

In addition, this requirement only applies to Enterprises whose ‘principle activity’ is investing in investment properties. Paragraph 36 of the Act requires assets to be measured at cost less depreciation unless otherwise provided for in the Act. In other words entities with investment properties which do not constitute their ‘principle activity’ would measure those assets at cost less depreciation. This also does not jeopardise compliance with IAS 40 for entities that have investment properties, but it is not their ‘principle activity’ because IAS 40 also allows the option to value assets at cost. These entities would, however, be required to disclose fair value under IAS 40.

Paragraph 38(1) is soon expected to be changed to bring it more inline with IAS 40. The main change will allow the option to measure investment properties at cost less depreciation and impairment losses instead of fair value (Larsen, 2003). It is unknown whether it will also be changed to apply to all enterprises or whether it will only apply to enterprises in which their main activity is investing in investment properties. As mentioned above, this difference exists because of inconsistencies between IFRS and EC

Directives. This could be expected to change as the Directives are modified to accommodate the adoption of IFRS.

As seen above, Denmark also has an accounting standard for investment properties – DKAS 16. As seen above, this is only mandatory for listed companies. DKAS 16 is in line with IAS 40 in all material respects. The only difference is that DKAS 16 requires revaluations at fair value if the main activity of an enterprise is investing in investment properties (Larsen, 2003). This is the same as the requirement in the Financial Statements Act, and would be likely to change with it. However, as seen above, this requirement does not jeopardise compliance with IAS 40, because options may be deleted from IFRS and compliance is still ensured. The main difference between DKAS 16 and paragraph 38(1) of the Financial Statements Act is that DKAS 16 contains more detailed guidance and more disclosure requirements.

Accounting for biological assets is dealt with under paragraph 38(2) of the Danish Financial Statements Act. It states that “Enterprises whose principal activity is to biologically transform living animals or plants for sale, conversion, consumption or breeding of further animals and plants, may continuously adjust the said assets to the fair value subsequent to initial recognition”. As with investment property, this paragraph only applies to enterprises whose ‘principles activity’ is biological assets. Other enterprises must apply a cost model.

Paragraph 38(2) contains one significant difference to IAS 41. This is that it allows but does not require the measurement of biological assets at fair value. As seen above, IAS 41 requires the use of fair value except for in the rare case that this cannot be measured reliably (Larsen, 2003). This could also be expected to be revised to bring it more in line with IAS 41. Other differences could also arise because there is no DKAS on agriculture in Denmark. The requirement in paragraph 38(2) is extremely brief compared to the requirements of IAS 41. The main difference will be a lot more guidance for and detailed disclosure of agricultural activities under IAS 41 compared to paragraph 38(2) of the Danish Financial Statements Act.

Danish financial reporting has been affected from many different sources, but current financial reporting regulations are primarily Anglo-Saxon, and have been mainly affected by the Fourth and Seventh Directives, and IFRS. The most important piece of legislation concerning financial reporting is the Financial Statements Act. Additional guidance can be taken from IFRS, SIC and DKAS. In addition, listed companies are also required to follow DKAS. DKAS are closely based on IFRS, but some differences still exist because of inconsistencies between the IFRS and the Financial Statements act. As seen above accounting for investment properties and agriculture Denmark is similar to that of IAS 40 and 41. However, some differences still exist, and because no DKAS on agriculture exists, the requirements of IAS 41 are a lot more extensive.

### **15. How do the Requirements in NZ differ to IAS 40 and IAS 41?**

NZ, as with the other countries mentioned above, has an accounting standard that deals with accounting for investment properties. This was issued in 1989, before the Financial

Reporting Standards Board (FRSB) took over standard setting in NZ, and is known as Statement of Standard Accounting Practice (SSAP) 17. Also like the other countries discussed above, NZ has no specific accounting regulation dealing with accounting for agriculture. NZ does, however, have Technical Practice Aids (TPA) dealing with the valuation of livestock (TPA 5) and bloodstock (TPA 7), and NZ firms could also use IFRS or standards from another country as authoritative support.

NZ is considered to be an Anglo-Saxon accounting country, and financial reporting is mainly regulated through standards set in the private sector. As seen above the primary statute governing the establishment of accounting standards in NZ is the *Financial Reporting Act 1993* (FRA). The Accounting Standards Review Board (ASRB), which is a crown entity, was set up under the FRA to review and approve accounting standards. The private sector standard setter in NZ is the FRSB and is part of the Institute of Chartered Accountants NZ (ICANZ). Standards issued by the FRSB are given legal backing by the FRA when they are approved by the ASRB (Deegan & Samkin, 2001).

SSAP 17 deals with both accounting for investment properties and accounting for properties intended for sale. As seen in IAS 40, properties intended for sale are accounted for under IAS 2. Therefore the parts dealing with properties intended for sale will be left out of this discussion. Property for the purposes of SSAP 17 is land or buildings in which the reporting entity does not occupy or intend to occupy more than 20 percent of the area of the land or buildings (para. 3.1). Investment property is defined as “property which is held, or development property intended to be held, primarily for capital growth or rental

or similar income” (para. 3.2). Development property is also classed as investment property if the intention of the entity is to hold it as investment property when completed (para. 3.4). A development margin is the difference between the expected net current value on completion and expected cost (para. 3.5). Net current value is the open market value less the costs of disposal that can be reasonably anticipated (para 3.6).

Under SSAP 17 investment properties other than development properties are recorded at their net current value. Development properties should be recorded in the balance sheet at cost plus the accumulated increments to date determined on a percentage of completion basis provided that: the property is unconditionally pre-let to at least 80 percent of the anticipated annual rental revenue; and all costs incurred and expected to be incurred can be reliably estimated. Investment properties, including development properties: should be valued annually by an independent valuer; and should not be subject to periodic charges for depreciation (para. 5.4). Development margins arising from properties which are not pre-let to at least 80 percent, or where costs cannot be reliably estimated should be carried at the lower of cost and net realisable value (para 5.5).

Net change in the value of investment properties and development margins arising from properties which are pre-let to at least 80 percent and costs can be reliably estimated should be disclosed either: in the income statement following profit after extraordinary items and clearly identified as unrealised; or transferred directly to an investment property revaluation reserve. If the total of an investment property revaluation reserve is

insufficient to cover a deficit then the amount of the deficit is charged to the income statement as part of operating results (para. 5.6).

Disclosure requirements include: the method(s) used in accounting for investment properties and development properties; the amounts included in the income statement in respect of changes in value of investment properties and development margins; investment properties separate from other land and buildings; the investment property revaluation reserve separate from other reserves; movements in the investment property revaluation reserve during the year; and information about each valuer employed (para. 5.9).

SSAP 17 does have some similarities to IAS 40; however some significant differences exist between the two. One of these differences is the measurement base in the two standards. IAS 40 uses fair value whereas SSAP 17 uses net current value. Fair value and current value could be taken to be similar if not identical. However, SSAP 17 uses the current value net of any costs of disposal that can be anticipate. IAS 40 on the other hand does not deduct costs of disposal. The approach in IAS 40 makes more sense, because the property is not intended for sale because if it were it would not be meet the definition of investment property. Therefore it makes more sense not to deduct expected disposal costs because it is not expected to be disposed with.

Another of these differences is that the scope of SSAP 17 is wider than that of IAS 40. SSAP 17 includes properties intended for sale, which is left out of this discussion, but

also includes development properties intended to be investment properties within the definition of investment properties. This is very different to IAS 40, because IAS 40 specifically excludes development properties being developed into investment properties from the definition. Under IAS 40 development properties are accounted for under IAS 16 – Property, Plant, and Equipment until development has finished. It is not until this time that the property can be valued at its fair value, and any gain is recognised in the profit and loss. Under SSAP 17 development margins are recognised while development is taking place.

Another difference is that SSAP 17 contains an option that does not exist in IAS 40 and vice versa. SSAP 17 allows entities to either include the change in net current value in the profit and loss or to take it directly to a revaluation reserve within equity provided it does not make the reserve negative. IAS 40 allows no such option. IAS 40 allows the option to measure investment properties at fair value or at cost. SSAP 17 contains no such option.

One further difference between IAS 40 and SSAP 17 is the level of owner occupation of an investment property before the property is considered owner occupied. SSAP 17 prescribes that if the owner occupies more than 20% of an investment property then it is accounted for as property, plant and equipment. IAS 40 on the other hand does not prescribe a specific percentage of owner occupation; rather it states that it is an investment property if an *insignificant portion* is owner occupied. An insignificant portion is not defined and it is left up to the judgement of preparers and auditors to determine what this amount is. In certain circumstances it could be 20%. However, it

relies upon the substance of the owner occupation rather than an arbitrary level of occupation such as 20%. IAS 40 and SSAP 17 are therefore quite different in this respect.

In addition to the above technical differences, IAS 40 and SSAP 17 also have significantly different disclosure requirements. SSAP 17 does not prescribe a high level of disclosure compared to IAS 40. It would be likely that a change to IAS 40 by NZ entities would increase compliance costs because of the extensive disclosure requirements involved when applying IAS 40.

As seen above NZ has no specific requirements on accounting for agriculture, but it does, however, have sources of authoritative support for GAAP. One of these is TPA. TPA 5 deals with the valuation of livestock in the financial statements of farming enterprises. It recommends that net current value be used as the method for valuation and that these should be recognised in the profit and loss separate from operating income. It also recommends that entities should disclose; the accounting policies adopted for the valuation of livestock and the treatment of the holding gains (losses); the total amount of livestock holding gains (losses) for the period; and a summary of livestock by appropriate classes. In addition, TPA 7 deals with accounting for bloodstock enterprises. It recommends different valuation models for different types of bloodstock, none of which are fair value. It is not discussed in detail here because of the specialised nature of the TPA.



TPA 5 is consistent with IAS 41 as the both recommend that livestock should be valued at fair/current value less point-of-sale/disposal costs. They also both recommend that changes in fair value are included in the profit and loss. However, TPA 5 is a lot less detailed and its scope is not as wide as IAS 41. TPA 5 is, however, merely guidance. Entities in NZ could equally use IAS 41 as guidance, or a standard from another country. Some NZ firms are likely to use the Australian standard AASB 1037/AAS 35, which deals with accounting for self-generating and regenerating assets, as authoritative support. The change to IAS 41 will vary in size for different entities because of the different sources of authoritative support in NZ.

It has been seen above that, although there are some similarities between accounting for investment properties under SSAP 17 and IAS 40, there are quite significant differences in technical aspects of the two standards and the level of disclosure required by each standard. There are no specific financial reporting regulations on accounting for agriculture in NZ. There are, however, sources of authoritative support. There are many potential sources, and this also creates the potential for many different ways of accounting for agricultural activities in NZ.

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