THE HARMONIZATION OF ACCOUNTING AND FINANCIAL REPORTING IN THE EU COUNTRIES

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1. INTRODUCTION

All the users of accounting information are interested in the credibility of this information. The users are: managers, capital owners, the state, potential investors, workers, business partners, banks, exchanges, trade unions, and so on.

All first sight, all accounting reports are similar, disregarding the country. A deeper and detailed research points to the essential differences between the countries in accounting regulation. There are still significant differences in the EU countries, in spite of the call for accounting harmonization. To give full consideration to the richness and diversity of accounting practices in Europe would require a special study, and this is not the aim of this work. With the UK and the USA as models of market/commercially driven accounting and France and Germany as examples of government/uniform driven accounting, it is possible to develop an insight into the difficulties not only of harmonization but also of different interpretations of financial reports.

There are some differences in accounting practices of the EU countries. There is a whole range of reasons why countries adopt a particular form of accounting. For the EU countries, these factors have influenced the nature of accounting and financial reporting: legal systems, methods of financing, the way of taxation, the importance of accounting profession, the role of theory and accidents of history. International accounting standards and the EU Directives are of great importance in the field of harmonization.

2. NATIONAL ACCOUNTING DIFFERENCES IN PRACTICES OF THE EU COUNTRIES

Great differences in accounting only rarely originate by accident. There is a whole range of reasons why countries adopt a particular form of accounting. Some are historical such as the similarities between UK accounting and that of many countries in the Commonwealth where the link is the historical connection with Great Britain. Other reasons may relate to the stage of economic development or the influence of religion as in the Islamic world.

"For Western Europe, however, there appear to be six major factors which have influenced the nature of accounting and financial reporting. These are: legal systems, methods of finance, the role of taxation, the importance of accounting profession, the role of theories and, on rare occasions, accidents of history."[1]

The legal system

The USA, England, Ireland and Wales have legal systems based on common law, unlike much of continental Europe.
The United Kingdom has a number of distinguished features in its accounting that make the country

[1] John Watts: "Accounting in the Business Environment", 2nd Edition, London, 1996, p. 236.

distinctive within the European Union. These features are:[2]

1. A strong and independent accounting profession.
2. A tradition of broad legal requirements with detailed accounting methods formulated by private sector.
3. Strong links with US accounting practices and close connection between US and UK offices of the international accounting firms.

The first UK companies Acts, in 1844, required an audited balance sheet. In 1856, however, it ceased to be a legal requirement, apparently because the Government took the view that accounting should be the subject of private agreement rather than legislation.

In compliance with EC directives, UK legislation has prescribed formats and certain rules of accounting measurements. These provisions are now contained in the Companies Acts of 1985, and for group accounts in the Acts of 1989. The tone of UK legislation continues to be flexible, tending to adopt the full range of options allowed by the EC, and relying on the accounting profession to develop detailed guidance. In October 1992 the Accounting Standards Board issued FRS 3, 'Financial Reporting Performance' which required certain classifications of items in the profit and loss account. FRS 3 includes suggested formats which comply with the standards.

Much of continental Europe has a totally different system of law based on the Roman *jus civile* which requires a detailed codification of provisions both to accounting and financial reporting. Such a system based on detailed codes will be much more difficult to change.

Germany has a strong accounting tradition which, to those accustomed to the Anglo-American tradition, must appear paradoxical. On the one hand, accounting is dominated by legal prescription and tightly linked to the tax system. On the other hand, Germany has a strong and highly trained academic and practitioner accounting community.

In Germany, the form and content of the legislation varies depending on the form of incorporation. This is another difference from the UK where the same Companies Acts apply to all types of limited company. In Germany, public companies are subject to the law governing public companies known as the *Aktiengesetz*. With the passing of the *Bilanzrichtliniengesetz* (Accounting Directives law) in 1985, companies are now subject to the EC Fourth and Seventh Directives. Until the passing into German law of the EU Directives, only joint-stock companies, i.e. public companies and certain other types of large business organization had to be audited.

Since January 1, 1990, German companies have been required to provide consolidated accounts.

Some authors /Abel/ see two important characteristics in the development of German accounting practices:

1. The "ready acceptance of state intervention in economic affairs".
2. A strong 'tradition of anti-individualism'.

This strong tradition of central authority in German accounting regulation helps to explain why, despite a highly trained and active accounting profession, the German government continues to dominate accounting regulation.

[2] John Blake and Oriol Amat: "European Accounting", Pitman Publishing, 1993, p. 63.

The main feature of French accounting is that the accounting provisions come from commercial and fiscal legislation. France also has a well-developed system of accounting regulation.

The main objective of the accounting system in French companies, in accordance with the EC Fourth Directive, is that annual accounts should be prudent, regular, sincere and give a true and fair view.

The annual accounts are made up of the balance sheet, the profit and loss account and the notes to the accounts. The accounts can be presented in three ways:[3]

1. **Abbreviated option** - the cited three accounts are presented in summarized form. This option is available to individual businessmen and small companies.
2. **Basic option** - besides the mentioned accounts, there will be a formulation of company documents which are composed of the table showing effects on profits and losses, and other significant elements of the company over the last five years, as well as an inventory of the securities portfolio of investments.
3. **Developed option** - it is voluntary and it includes the accounts in the basic option and the statement of self-financing capacity for the financial year and the chart of financial changes.

Methods of finance

Methods of finance are not the only feature which differentiate the countries of Europe. From the early days of the Industrial Revolution, UK companies have depended to a large extent on outside shareholders to finance business activity. This has manifested itself in a large and active stock exchange. Therefore public companies have played a major role in the economic life of the UK, as they also have in the Netherlands which, despite having a much smaller stock exchange, has many multinational companies (as Royal Dutch - Shell, Philips, and so on).

Different patterns of ownership emerged in other European countries. In France and Italy, a significant amount of capital has traditionally been provided by the state or by banks. The small, family-controlled business was, for a long time, a significant feature of the French economy. In Germany, the banks were important owners of companies as well as providers of loan capital.

The role of taxation

By the time company taxation became important in the UK and the Netherlands, accounting reports and auditing were already well established. Consequently the practice grew up for the tax authorities to start with the financial results produced for reporting purposes and to adjust them to derive the profit figure for tax purposes as laid down by law.

German tax law, in most cases, requires that the same accounting methods be used for tax law and for accounting. Therefore there are relatively few deferred tax "timing differences" arising in German accounts, and those relate mainly to consolidation adjustments. A peculiarity of German accounting practice is that all taxes are covered together in the profit and loss account, irrespective

[3] John Blake and Oriol Amat: "European Accounting", Pitman Publishing, 1993, p. 118.

of whether they are paid in advance or allocated to provisions. This makes it difficult to assess the exact tax position for the year.

In France, deferred tax doesn't normally appear in the accounts. However, with regard to the consolidated accounts, the professional accounting bodies recommend the corresponding provision allowing either partial of total deferral.

Tax base determination must be harmonized to apply the EU tax rate and to compose the results for the application in all the EU member states.

The importance of the accounting profession

Countries with a large number of private shareholders, a large number of public companies and which strive to achieve a true and fair view are likely to need a large number of accountants and auditors. This makes for a very powerful accounting profession which, in turn, enables the profession to influence the form and content of accounting practices.

Six UK independent accounting bodies have formed a joint consultative body, the Consultative Committee of Accounting Bodies (CCAB). These are:

1. **ICAS** (The Institute of Chartered Accountants of Scotland),
2. **ICAEW** (The Institute of Chartered Accountants in England and Wales),
3. **ICAI** (The Institute of Chartered Accountants in Ireland),
4. **CCA** (The Chartered Association of Certified Accountants),
5. **CIMA** (The Chartered Institute of Management Accountants),
6. **CIPFA** (The Chartered Institute of Public Finance and Accountancy).

The accounting profession on much of the continent is not only much smaller than in the Anglo countries but it also developed much later. Consequently it was less able to influence the shape of financial reporting at the earlier stages of the evolution of accounting. This may partly explain another feature of differentiating accounting in France and Germany from the UK and the USA.

The role of theory

The clearest example of theory influencing the practice of accounting has been in the Netherlands. There is a standard setting body Raad Voor De Jaarverslagg (The Council for Annual Reporting) but it has far less power than the Accounting Standards Board in the UK, or the Financial Accounting Standard Board in the USA and companies are not obliged to follow its guidelines. This reflects the important academic influence within Dutch accounting where the concern is to show business economic reality or fairness.

Accidents of history

Accident of history is the final major factor influencing the form of accounting in different countries. The best examples of this have been the adoption of UK laws by members of the British Commonwealth and the German occupation of France in the Second World War which caused France to develop an accounting plan as a way of imposing uniformity on French accounting.

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The great existing differences in accounting practices of different countries are the most important difficulty in accounting harmonization. It is evident that there are some significant differences, even within the Anglo-Saxon system of course, the diversity of accounting practices is significantly greater between the two accounting practices as reported in this work.

General dichotomy between the presentation of a fair insight to shareholders and a conservative presentation to creditors and tax officials is a big problem which can't be surmounted without great changes in behaviour and legislation. If predominant objectives of financial reporting differentiate in some countries it is quite logical that reporting should differentiate. Regarding that some companies, interested in harmonization, get information from different countries where they have their branches, then there is a problem whether it is necessary to make two same financial reports for home and foreign users and needs).

The absence of strong professional accounting bodies in some countries is the second problem in accounting harmonization. In these countries, then, an international institution as IASC, acting through the national institutions of these countries, will not be very efficient.

The next problem is nationalism. It is expressed in not reaching compromises which mean the changes and adjustments of existing accounting practices. It appears, on the one side, because some countries do not want to lose their sovereignty and, on the other side, some countries are unwilling to accept accounting practice from other countries.

3. International Accounting Standards and the EC Fourth Directive

An important contribution in the field of harmonization was given by the International Accounting Standards Committee (IASC), which was particularly active in the harmonization of financial reporting. It was established in 1973 by professional accounting bodies of nine countries (Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the UK with Ireland[4], and the USA).

More than 100 professional accounting bodies in over 80 countries are members of IASC up to now. Their aim is to promote IASCs in their own countries and their regulation in accordance with international accounting standards. IASC published in 1989 the framework for preparing and presenting financial reports.

Financial reports provide information useful to potential investors, creditors and other users for decision-making on investments, credits, and so on. Information should be comprehensible to all

[4] The UK and Ireland have common professional accounting bodies

those interested in business and business activities.

The aims of IASC can be identified in the following:[5]

a) To assist the work of accounting regulations, i.e. accounting policy choice at the 'macro' level.
b) To assist those connected with the production of accounts, i.e. accounting policy at the 'micro' level.
c) To provide information on the IASC's approach, i.e. an educational role.

IASC is closely linked to IFAC (International Federation of Accountants) established in 1977. IFAC doesn't issue accounting standards in competition with IASC, and it has a number of committees dealing with other aspects of harmonization of the work of the accounting profession internationally, such as IAPC (International Auditing Practices Committee).

The United Nations first became involved in proposals for international accounting regulation in 1972 when the Secretary-General set up a group to examine the group of multinational companies. This group identified a need for international accounting harmonization leading to the formation of GEISAR (Group of Experts on International Standards of Accounting and Reporting) in 1976.

The Organization for Economic Cooperation and Development (OECD) produced a set of guidelines to promote greater comparability in company financial report. The OECD draws its membership from the industrialized countries which are the homes of most of the world's multinational companies, so it is not surprising that it proposals are less radical than those of the UN.

For European countries, the European Community is a mayor force for accounting harmonization. The European Community promotes the creation of a free internal market within its membership. In order to promote free movement of capital a common framework of company law is being promoted through a series of directives. Particularly important for European accounting are three of these: the Fourth Directive on company accounts: the Seventh Directive on consolidation, and the Eight Directive on auditing.

Once a directive is adopted it is then for each of the member states to incorporate the directive into national legislation by the prescribed date. The evolution of the Fourth Directive gives an interesting illustration of the problems of harmonizing the very different accounting traditions. The first draft was produced in 1971 and reflected the accounting traditions of France and Germany based on rigid prescription. The UK joined the Community in 1973.

Under pressure from the UK government, the second draft was amended to incorporate the "true and fair view" concept, which was controversial both in connection with translation into the national languages and also as far as the content is concerned.

The EC Fourth Directive identifies, in Article 31, six principles that should apply in accounts:[6]

1. The company must be presumed to be carrying on its business as a going concern.
2. The methods of valuation must be applied consistently from one financial year to another.

[5] John Blake and Oriol Amat: "European Accounting", Pitman Publishing, 1993, p. 39.
[6] Arne Kinserdal: "Financial Accounting", An International Perspective, Pitman Publishing, 1995, p. 136.

3. Valuation must be made on an economic basis, and in particular:
   - only profits made at the balance sheet date my be included,
   - account must be taken of all foreseeable liabilities and potential losses arising in the course of the financial year or of a previous one, even if such liabilities or losses become apparent only between the date of the balance sheet and the date on which it is drawn up,
   - account must be taken of all depreciation, whether the result of the financial year is a loss or o profit.

1 Account must be taken of income and charges relating to the financial year, irrespective of the date of receipt or payment of such income or charges.
2 The components of asset and liability items must be valued separately.
3 The opening balance sheet for each financial year must correspond to the closing balance sheet for the preceding financial year.

In addition to the EC, Europe also has a regional grouping of professional accountants, the Fédération des Experts Comptables Européens (FEE). This federation was formed by a merger in 1987 of the Union d' Experts Comptables, founded in 1951, and the Groupe d' Études, founded in 1961. One of the roles of FEE is to represent the European accounting profession in the European Commission. The European Commission has itself set up an advisory body, composed of representatives from the national standard – setting bodies, European organizations of the main users and preparers of account and the accounting professions.

The differences in financial reporting within the EU have been so great that it has been almost impossible to compare accounts from different European countries without making significant adjustments. There are still differences, but the EC Directives have undoubtedly reduced these.

There is, however, a much more far-reaching effect of the provision contained in the Directives, the use of these regulations outside the EU. Countries having signed the EEA (European Economic Area) agreement will also have to apply the Directives. Many of the former Eastern Bloc countries have applied or will apply the Directives, too. So, we shall see the EU Directives practised in almost every country in Europe in the relatively near future.

4. THE NEED FOR INTERNATIONAL HARMONIZATION OF ACCOUNTING PRACTICES

We are witnesses of an increasing dependance of a country's economy in the world market. The competition in the market, among other things, leads to the technological progress of the economy and the improvement of product quality with acceptable prices. But, very often, the companies' economic activities in market are limited by the regulation of their Countries, as well as the countries with these markets. Two extremes often appear, the companies are either stimulated by political, legal and ideological norms or the state of they are even prevented to do their activity.

The many different approaches to accounting and its regulation found in member states of the European Union was the problem faced by the Commission of the European Parliament when it began to look at means of harmonizing financial reports in order to break down barriers and develop the single market. At the one side were countries like the UK and Ireland where much of accounting had evolved through time to satisfy market needs, where an important role was left to judgement of the true and fair principle, and which was primarily driven by private sector standards and regulations within a general legal framework.

At the other side were accounting systems such as those in Germany and France which were essentially state driven and which required uniform, i.e. identical treatment of similar transactions by all entities and which required accounts to show that these rules had been truthfully obeyed, rather than showing a fair view of the entity's commercial activities.

The initiators for accounting harmonization were mostly transnational corporations. The main reasons for harmonization were linked with the problems of foreign capital investments. One of important conditions for free capital flow in the world is in the comparability of financial reports. This condition is not appropriately fulfilled by IASC.

The different way of presenting financial reports causes the absence of comparability of business results. That's why the IASC countries decided to put efforts in order to harmonize their national accounting standards with the standards of IASC.

The harmonization of accounting practices has an important role in international economic relations.

In 1974 the UN Commission for Transnational corporations (UNCTC) was established with the task to give proposals for solving the problems of transnational corporations. Within the framework of regional communities, some initiatives for international investments were taken. The standardization of accounting practice was also included. The cited hasn't the character of an obligatory application but it is on the level of recommendations. In contrast to this, the EU standards have the validity of legal obligations for the EU countries.

The basic principle of EU is not the unification of regulations at any price, but the harmonization of those national accounting provisions important for functioning the common market and competition in the EU countries.

After adopting the "White Book" and the EU programme for 1992. i.e. in the last stage of the EU development, some changes happened. By forming the Common Market (the Customs Union) between the EU countries, the so-called Rome Contract on EU, some conditions were fulfilled for standardizing legal systems of EU countries.

The practice of adopting directives (Recommendations) to harmonize some problem solving has shown very effective. Although there are still some differences in financial reporting, they are, undoubtedly, reduced by introducing the EU Directives.

IASC is very active in the harmonization of financial reporting. It was established with the objectives to:

a define and publish accounting standards in order to present financial accounts and promote general adoption and observance;
b work on improvement and harmonization of accounting standards and procedures, as well as the treatments relating to the presentation of financial accounts.

5. CONCLUSION

Financial reporting requires an adequate information support to meet different interest groups. The differences in financial reporting within the EU countries are so great that is almost impossible to compare accounts from different European countries without making significant adjustments. There are still differences, but the EC Directives have undoubtedly reduced them. The Directives will be practiced in almost every country in Europe in the relatively near future.

The different approaches to accounting and its regulation in the EU member states was the problem faced by the Commission of the European Parliament, when it began to look at means of harmonizing financial reports in order to break down barriers and develop the single market.

At the one side were countries like the UK and Ireland where much of accounting had evolved through time to satisfy market needs, where an important role was left to judgement of the true and fair principle, and which was primarily driven by private sector standards and regulations within a general legal framework. At the other side were accounting systems such as those in Germany and France, which were essentially state driven, and which required uniform, i.e. identical treatment of similar transaction by all entities and which required accounts to show that these rules had been truthfully obeyed, rather than showing a fair view of the entity’s commercial activities. All other EU countries have based their accounting regulations and financial reporting under the influence of the mentioned countries. Transnational corporations were mostly the initiators for accounting harmonization. One of important conditions for free capital flow in the world is in the comparability of financial reports. The different way of presenting financial reports causes the absence of comparability of business results and in that way wrong decisions are very easily made.

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