PRESENTATION

European criteria for the endorsement of IFRS standards and their compatibility with the conceptual framework

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1 IFRS standards and European principles: a compulsory compatibility defined by Law and depending upon a judicial control

The key question raised herein aims at determining whether IFRS standards and the principles derived from the European Accounting Directive constitute two « separate worlds », independent one from the other, each one having a distinct area of application, or whether, conversely, a compatibility relationship exists.

IFRS standards, aimed at being applied in numerous jurisdictions, and consequently under different legal systems, naturally resort to principles. As opposed to US GAAP which are said to be « rules-based », IFRS are thus said to be « principles-based ». This is clearly spelled out in the IFRS Foundation Constitution art 2.A which indicates that IFRS standards shall be based on "clearly articulated principles"[1]. By contrast, as the IFRS system originates from a "common law" system, the principles in the Conceptual Framework are not of a binding but rather of an "aspirational" nature, representing goals towards which to strive[2].

Continental law (i.e. Romano-Germanic law) underpins the European legal system and fundamentally differs from the approach developed in the IFRS set of accounting standards: in the legal hierarchy, general principles constitute the top level guiding the development of Laws and Regulations. Interpretations are themselves subordinated to the overall set of standards and, when standards are silent, it always remains possible to refer to those general principles.

Some parties have opposed a « bottom-up » legitimacy, based on setting standards from practice (« common law ») to a « top-down » legitimacy based on the primacy of sovereign guidelines over the economy (continental law). This opposition is actually significantly mitigated by the existence, in the continental legal systems, of a permanent dialogue between practice and standards of sovereign design.

Hence, the IFRS system relies on standards aiming at and being inspired by the concepts developed in the general framework. As for the European framework, it consists of two legislative sources: on the one hand, the Accounting Directive, applicable after being transposed in national laws; on the other hand, the European regulations, which are automatically applicable to entities listed on regulated markets within the EU. Regarding the latter, a distinction needs to be drawn between the 2002 endorsement regulation defining the principles, the so-called "IAS Regulation", and implementation regulations endorsing individual accounting standards.

As regards the endorsement process of IFRS standards, European Authorities are required to refer to the criteria mentioned in the IAS Regulation which establishes a direct link to the Directive. Thus a standard can only be adopted if it:

[1] IFRS Foundation Constitution § 2.a
[2] Conceptual Framework § 1.11

- is not contrary to the true and fair view principle set out in the accounting Directive, this principle being considered in the light of the Directive without implying a strict conformity with each and every provision of the Directive,
- is conducive to the European public good and,
- meets the basic criteria of understandability, relevance, reliability and comparability of the financial information required for financial statements to be useful for making economic decisions and assessing the stewardship of management[3].

The Directive's provisions have thus to be taken into consideration in the endorsement process. The type of conformity, which is to be sought, need not be strictly constrained or mechanical. Yet, the spirit and the principles guiding those provisions have to be fulfilled.

Once endorsed, an IFRS standard applies to all entities within the scope, and has supremacy over national laws resulting from the transposition of the Accounting Directive. However, such supremacy remains under the judiciary control, when issues are brought before Courts, which judge if the accounting standards comply with the IAS Regulation and the Accounting Directive's existing principles.

The pathway of compatibility thus builds on the following cornerstones:

- The Conceptual Framework is a source of inspiration for the IFRS standards, which may however depart from its principles ;
- IFRS standards can be endorsed in the European Union if and only if, *inter alia*, they comply with the Accounting Directive's provisions by way of the true and fair view principle ;
- Conformity is not assessed narrowly, but in the light of the Accounting Directive's underlying principles.

From these cornerstones, the compatibility with the European principles of the conceptual framework , and most importantly, that of each and every IFRS standard, will be determined.

First, we will analyse how the complete set of IAS standards was endorsed in 2005, and how the IAS Regulation was subsequently implemented in perpetuating the European endorsement mechanism. We will then examine whether the current review of the IASB's conceptual framework brings changes to the terms by which compatibility is assessed. This will be considered on the basis of the Directive's main provisions.

[3] IAS Regulation1606/2002 Art. 3 Al. 2 and Recital Nr. 9

2 European criteria for endorsement of IFRS standards

2.1 Historical background

In 1995, the European Commission defined a strategy for international accounting harmonisation, promoting the use of a *single language for financial information* in order to facilitate the raising of funds on international financial markets[4] and to foster the European Union securities markets growth, which was dramatically changing due to the development of new technologies, to globalisation and to the transition to the euro in 2001[5]. The Commission then concluded that endorsing international standards for listed entities would be more efficient that adapting the Accounting Directives[6].

The 4th and 7th Accounting Directives stated that « the quality of financial reporting has considerably improved in member states », but that they « allow several options »[7]. Investors and market regulators wanted more stringent financial information disclosure rules[8]. Hence, it was considered « necessary to supplement the legal framework applicable to publicly traded companies"[9]. A first possibility was to supplement and amend the existing accounting Directives. Such solution was set aside due to the length of the Accounting Directives negotiation process and of their transposition into national laws[10]. The other possibility consisted in adopting an existing set of accounting standards, the standards published by the IASB or the US standards (US-GAAP). North American standards, which were ruled-based lengthy documents accompanied by very detailed interpretations, required a considerable investment in training. Finally, considering that the European Union had no means of influencing its standard setting process, by nature prepared to suit the needs of the US economy[11], the European Council of Lisbon decided in 2000 to adopt the standards published by the IASC.

However, as the European Union could not "delegate responsibility for setting financial reporting requirements for listed EU companies to a non-governmental third party", the EU had "to exercise the necessary regulatory oversight and correct any material deficiencies or concerns in relation to IAS »[12]. Hence, it was necessary first to check that IAS standards were «in conformity with the EU's Accounting Directives"[13] with which listed entities had to comply. Such review was performed in 1995 by the Contact Committee[14] composed of representatives of member states and the Commission. The Committee's conclusions were supportive, provided that the existing accounting Directives be amended (regarding badwill, exemption

[4] COM (1995) 508 § 1.3
[5] COM (2000) 359 § 3
[6] COM (1995) 508 § 5
[7] COM (1995) 508 §§ 3.1 et 3.4
[8] COM (2000) 359 § 9
[9] IAS Regulation 1606/2002 Recital n°3
[10] Simon/Stolowy, § 2.1.2
[11] COM (2000) 359 § 15
[12] COM (2000) 359 § 19
[13] COM (2000) 359 § 21
[14] COM (1995) 508 § 5.1

from consolidation for some entities), and that some options be not made available to listed entities (relating to the prohibition of the capitalisation of research and development costs, some translation differences accounting entries, the amortisation of goodwill or to its recognition as part of equity, the incorporation of indirect costs in the valuation of inventories…)[15].

A permanent endorsement mechanism was then defined in 2002 by the « IAS Regulation » [16] which organises the endorsement of new standards and interpretations in the European set of accounting standards. It is supported by a comitology process, and assisted by a technical organisation (EFRAG) in charge of advising the European Commission all along the endorsement process of international standards[17].

2.2 What are the endorsement criteria?

According to the IAS Regulation, a standard can only be adopted if it:

- is not contrary to the *true and fair view principle* set out in the accounting Directive[18],
- is conducive to the *European public good* and,
- meets the criteria of *understandability, relevance, reliability and comparability* required of the financial information needed for *making economic decisions* and *assessing the stewardship of management*[19]".

When assessing the 10 years of implementation of the IAS regulation, the Commission concluded that « overall feedback suggested that the existing criteria work appropriately …»[20] and that the IFRS implementation has « increased the transparency of financial statements through improved accounting quality and disclosure and greater value-relevance of reporting, leading to more accurate market expectations including analysts' forecasts. It also led to greater comparability between financial statements within and across industries and countries although some differences persist[21]. »

2.2.1 First endorsement criterion: Conformity with accounting Directive as regards *"True and Fair view"*

Conformity of the international standards is assessed with regards to the IAS Regulation *and* to the accounting Directive (as both apply), *but* disregarding national law (which reflects, after transposition, the Directive's legal provisions applied in a different scope). The IAS Regulation's first criterion, by referring to the *true and fair view* " basic principle"[22], « first objective»[23] set in

[15] Contact Committee on the Accounting Directive § 15-28
[16] IAS Regulation 1606/2002
[17] COM (1995) § 5.3
[18] Directive 2013/34 Art 4.3
[19] IAS Regulation1606/2002 Art. 3 Al. 2 and Recital Nr. 9
[20] COM (2015) 301 §3.2.3
[21] COM (2015) 301 p.4
[22] Cas C-306/99 mentioned in the 17/09/2015 ARC meeting
[23] Cas C-234/94 mentioned in the 17/09/2015 ARC meeting

the accounting Directive, establishes an immediate and comprehensive link with it: once reached, conformity with the IAS Regulation and the Directive is simultaneously achieved.

Two different perceptions of the true and fair view principle exist in Europe. One is a pragmatic approach (inspired from British "case law"), according to which departures from the Directive's prescriptions on the basis of professional judgment are allowed provided such departures enable a truer and fairer view than the one obtained under strict compliance with the prescribed accounting principles (the "true and fair view override"). The other is a « law-based » approach (as for instance in Germany), according to which, conversely, conformity implies strict "compliance with all rules and therefore allowing no room for any override[24]". In sum, the principle prohibits endorsing standards that are contrary to the provisions of the Directive (legal approach), but acknowledges the standard setter's «humility» in that the accounting rules and standards it has issued are designed for the majority of cases but can never take into account all the cases which may arise in practice (pragmatic approach)[25]."

The duality of this principle is also stated in the 2013 Directive according to which annual financial statements « should give a true and fair view of an undertaking's assets and liabilities, financial position and profit or loss", but "it is possible that, in exceptional cases, a financial statement does not give such a true and fair view where provisions of this Directive are applied. In such cases, the undertaking should depart from such provisions in order to give a true and fair view[26]».

Beyond how it is perceived, it is worth noting that compliance with the true and fair view according to the IAS Regulation implies the consideration of this principle "in the light of the said Council Directive without implying a strict conformity with each and every provision of the Directive[27]". Hence, the true and fair view principle mentioned in this regulation refers, and this point is crucial, to the Directive's provisions: to some extent, it encompasses it. This reference does not imply strict conformity, which can be interpreted as providing some room (however not much) for interpretation as opposed to narrow implementation and as allowing departure, in exceptional cases.

2.2.2 Second endorsement criterion: European Public Good

The second endorsement criterion invokes the *European Public Good*, enabling accounting standards set by and independent private body to tie back to the objectives of Public Good raised by the European Union.

The concept of Public interest differs from that of Public good in that the first stems from public economics while the latter stems from political sciences[28]. The European Public Good can be defined as the implementation of the public interest through the European Union's

[24] Bischof/Daske p. 15
[25] Van Hulle (1997) cité par Bischof/Daske p.16
[26] Accounting Directive 2013/34 Recital n°9 et Art. 4 Al.3 et 4
[27] IAS regulation 1606/2002 Recital n°9
[28] Bischof/Daske p.30

juridical framework. The IAS regulation does not define the European Public Good « but it may be understood to encompass broad financial stability and economic considerations. In particular, it is necessary to assess whether accounting standards could be detrimental to the economy or to particular stakeholders, such as long-term investors"[29]. Some criteria aim at assessing the expected benefits, such as those mentioned in the IAS Regulation: improvement of financial information at a reasonable cost, and of the efficiency of growth-generating financial markets; whereas others aim at assessing the exposure to risks, such as those added in the Maystadt report: "do not endanger financial stability nor hinder the economic development of the European Union[30]".

According to the 17 July 2000 Council, the exercise (*ex-post*) was to demonstrate that the IFRS set of accounting standards would be conducive to the European Public Good. In the IAS Regulation, this objective was instituted as a prerequisite (*ex-ante*) to be applied to each individual standard. The benefits derived from 10 years of IFRS application are not substantiated by much quantitative, notably because it is difficult to distinguish the effects from accounting standards from the effects from other factors. "Nevertheless, companies largely supported IFRS which implies that they find the costs commensurate with the benefits[31]". As a consequence, it is even more difficult to assess the *ex-ante* effects of a standard taken individually[32] and there is a "growing call for regulations to be considered holistically in terms of their cumulative effects[33]".

2.2.3 Third endorsement criterion: the 4 technical characteristics

The third endorsement criteria aims at ensuring financial statements are useful to users for making economic decisions and assessing management's stewardship of the entity's resources. Standards shall provide « a suitable basis for financial reporting by listed EU companies[34] ». According to the European Commission, providing "Relevant, timely, reliable and comparable information about the performance and financial position of an enterprise continues to be of central importance in safeguarding the interests of investors, creditors and other stakeholders to ensure a level playing field between competitors[35] ». Finally, the requirement to have "clear accounting standards " supports the characteristic of understandability. [36]
The Regulation itself specifies the requirements of financial information in terms of: « understandability, relevance, reliability and comparability ».

It is worth noting that assessing in an objective manner that these criteria are met is challenging[37], since some criteria may conflict with each other and involve judgmental trade-

[29] COM (2015) 301 p.6
[30] Maystadt recommandation n°2 p.10
[31] COM (2015) 301 p.3 et 6
[32] Bischof/Daske p.29-30
[33] COM (2015) 301 p.7
[34] COM (2000) 359 § 21
[35] COM (2000) 359 § 8
[36] COM (2000) 359 § 26
[37] Bischof/Daske p.27

offs[38]. For instance, should unreliable but highly relevant information be disclosed? Should options be made available in order to enhance the relevance of accounting treatments at the risk of impairing comparability?

3 Endorsement criteria and the IASB's new conceptual framework

The IASB's conceptual framework is not part of the European Union's endorsed standards. Nevertheless, as it is used as a reference to set future standards, it is worth considering whether the review it is undergoing currently enables compatibility or whether, conversely, potential areas of conflict will arise.

3.1 The conceptual framework was not endorsed by the European Union

The European Commission states that the conceptual framework does not constitute itself an international accounting standard or an interpretation and, as a consequence, shall not be endorsed in the European community law.[39]

The *Contact Committee* examined the IASC's conceptual framework and "came to the conclusion that no conflict exists with the Accounting Directives, for two fundamental reasons: (i) The statements contained in the Framework do not override any rule contained in a specific standard. (ii) The application of the Framework is not compulsory for companies complying with IAS[40]".

Even if the conceptual framework was not endorsed, some standards (IAS 1 and IAS 8) have been endorsed, which recommend, in the absence of an IFRS that specifically applies, to use the concepts in the conceptual framework. So IAS 1[41] refers to IAS 8 setting "out a hierarchy of authoritative guidance that management considers in the absence of an IFRS that specifically applies to an item". IAS 8.10-11 actually states that "in the absence of an IFRS that specifically applies to a transaction, other event or condition, management shall use its judgement in developing and applying an accounting policy". In making that judgement, "management shall refer to, and consider the applicability of, the following sources in descending order:

(a) the requirements in IFRSs dealing with similar and related issues; and
(b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the Framework.

Accordingly, endorsed standards IAS 1 and IAS 8 do refer, in the absence of an IFRS, to a Framework that was not endorsed. However, it appears that sources are to be considered in descending order, and that the Framework is ranked lower than the standards and interpretations endorsed in compliance with the provisions of the Directive. Therefore,

[38] Bischof/Daske p.26
[39] Observations from the Commission (2003) p.6
[40] Contact Committee in the Accounting Directives § 31
[41] IAS 1.17.a

according to the endorsement regulation, the application of endorsed IAS 1 and IAS 8 cannot be contrary to the Directive.

The Contact Committee had envisaged the current situation: "Should the above-mentioned fundamental characteristics of the framework be modified, then conflicts might arise and the Contact Committee would have to reconsider its opinion. »[42.] The review of the IASB's conceptual framework therefore brings back this issue onto the agenda. Hence, it is necessary to compare the proposed conceptual framework with the provisions of the Directive, which the IAS regulation refers to, by way of the true and fair view principle.

3.2 Differing designs and approaches between the conceptual framework and the Directive

The comparison between the provisions of the Directive and the conceptual framework is not immediate as these documents differ both in their design and in their approach of concepts.

As regards the *design*, as aforementioned, the conceptual framework is a document providing non-prescriptive guidance on the underlying concepts for standard setting, the prescriptive provisions coming from the standards themselves. By nature, the conceptual framework is aspirational. The accounting standards' compulsory provisions aim at implementing the conceptual framework's guidance with a rather broad scope for interpretation, close to the concept of options. If necessary, it is possible to depart from the framework's guidance. Thus, the IASB's conceptual framework states that "The concepts are the goal towards which the IASB and preparers of financial reports strive[43] ».

As for the Directive, it aims at harmonising positions while providing a strict and binding framework to member states, in order for them to, following its transposition into national law, set applicable accounting standards.

In the Directive, three levels of binding provisions can be differentiated:

- The basic level of prescription: the principle defined by the Directive is clear. Even though expressed at high level, and as such potentially subject to interpretation, it is unique and unambiguous.
- The preferred level of prescription. This level is more difficult to capture as it often requires taking into consideration the co-legislators' intent. In this always complex context of harmonisation at the European Union level, the way documents are worded often reflects the need to reach compromise to take into account national specificities. However, beyond such compromise, generally evidenced through options available to member states, a general direction is given which explicitly or implicitly indicates a preference. This level is fundamental as it forms an « aspirational » area towards which

[42] Contact Committee on the Accounting Directives § 31
[43] Conceptual Framework, 2015 ED §1.11

a majority of member states are asked or encouraged to tend, even though its boundaries are evolving.

- The optional level of prescription. This level is arguably more open and the most criticised as it is considered to be the weak point of the harmonisation exercise. Although such criticism is partly justified, this level remains insightful because of the very options made available and therefore of the limitations to the range of possibilities it induces.

Observers generally have two, and not three, levels of prescription in mind: they tend to merge the second with the third level. The three-level categorisation of provisions will therefore be made with caution and always explicitly so that it results in a dynamic categorisation rather than a legally enforceable categorisation.

As regards the *approach*, the conceptual framework fundamentally brings everything back to the concept of usefulness, whereas, in the Directive the central concept is the true and fair view principle.

In the Directive, the true and fair view principle is pivotal. The actual principle is not much explained, but the Directive clearly specifies that :

- "True and fair view results first from the application of the provisions of the Directive ;
- Where the application of the Directive would not be sufficient to give a true and fair view, additional information shall be given in the notes to the financial statements ;
- Where, in exceptional cases, the application of a provision is incompatible with the true and fair view obligation, the provision shall be disapplied[44]".

As previously mentioned, the true and fair view concept according to the Directive is above all of a « legal » nature, albeit conceding to the « True and Fair View override », but in a strictly controlled way.

With the true and fair view principle stated, and taking into account the primary link made between the true and fair view and the provisions to apply, the Directive mostly focuses on general principles (art 6, 7 and 8), on the financial statements themselves (chapter 3), by listing some specific provisions (article 12), on the content of the notes to the financial statements (chapter 4), on consolidated financial statements (chapter 6)…

By contrast, the conceptual framework builds everything on the usefulness of financial information. Chapter 2 focuses on the characteristics of such usefulness. The IASB considers that usefulness fundamentally results from the characteristics of relevance and faithful representation. To be relevant the information shall be confirmatory and / or predictive, acknowledging the need for this information to be considered material by users and, when

[44] Recital 9 and Article 4 §§ 3 et 4

based on estimates, that it is subject to some level of uncertainty. Faithful representation of economic phenomena results from:

- The pre-eminence of the substance of an economic phenomenon over its legal form ; and
- Three key features whereby information has be complete, neutral and free from error[45].

The two fundamental characteristics of relevance and faithful representation are enhanced by four qualitative characteristics: comparability, verifiability, timeliness and understandability[46].

The IAS 1 standard adds that « in the extremely rare circumstances in which management concludes that compliance with a requirement in an IFRS would be so misleading that it would conflict with the objective of financial statements set out in the Framework, the entity shall depart from that requirement[47]». IAS 1, endorsed by the European Union, thereby authorises, beyond what is mentioned in the Conceptual Framework, the departure from IFRS requirements to preserve usefulness. Thus, the usefulness concept is supplemented by a "True and Fair View override" approach that indirectly also expands the concept of faithful representation.

With these principles set out, the conceptual framework aims at defining the reporting entity's financial statements (chapter 3), the elements of financial statements (chapter 4), recognition and derecognition criteria (chapter 5), measurement (chapter 6), presentation and disclosure (chapter 7) and, finally the concepts of capital and capital maintenance (chapter 8).

Since the two documents differ both in their design and approach, a holistic compatibility assessment cannot be performed. It must therefore be done item by item. The next chapter examines the level of compatibility for selected key components, following the provisions of the Directive as categorised according to the "dynamic" three levels of prescriptions (basic prescription /BP, preferred prescription /PP or optional prescription /OP).

4 Compatibility component by component

This section presents, for some key-elements of the main provisions of the Directive, their degree of compatibility with the proposed draft of the IASB's Conceptual Framework.

Thus, the True and Fair View, faithful representation and the users of financial information will be first reviewed.

The principles mentioned in Article 6 of the Directive, on which the True and Fair View is based, will be itemised: comparability, going concern, consistency of accounting methods,

[45] 2.15
[46] 2.22
[47] IAS 1.19

intangibility of the opening balance sheet, neutrality, prudence, accrual basis accounting, non-offsetting, substance over form, measurement methods, materiality and completeness.

Additional ancillary characteristics from the Conceptual Framework such as accuracy, clarity and timeliness, will be then reviewed in comparison with the Directive.

Finally, a comparison will be drawn as regards the statements required to be included in the set of financial statements under both frameworks as well as their underlying concepts of net income and financial performance.

4.1 True and fair view and faithful representation

As described in the aforementioned § 3.2, there is no real compatibility between the Directive's *true and fair view* concept and the conceptual framework's notion of faithful representation. In fact the two concepts retain different points of view: for the Directive, the true and fair view is key and results first from compliance with the provisions; for the conceptual framework, faithful representation is one of the two fundamental characteristics of financial information.

Even though they are closely related, due to great semantic proximity, the two concepts do not overlap. It will probably be necessary to consider that the compatibility review can only partly refer to the true and fair view and that it may probably be more appropriate to check whether the standard to be endorsed is not contrary to the Directive's prescriptions, which, altogether, aim at complying with the true and fair view requirement. As for the faithful representation concept, it does not in itself contradict the Directive.

4.2 Users of financial information

According to the third endorsement criterion in the IAS Regulation[48], financial information has to be useful « for making economic decisions and assessing the stewardship of management ». It can be noted that the Regulation does not specify whether the decision making process relates to management, governance or third parties (internal/external view). In this regard, recital Nr. 4 of the Directive states that « annual financial statements pursue various objectives and do not merely provide information for investors in capital markets but also give an account of past transactions and enhance corporate governance[49] ». The Directive thereby ignores neither financial investors (capital markets) nor third parties (specifically due to the limited liability of the company's owners), but introduces, beyond the assessment of management's performance, a key reference to governance. As such, even though this reference could be further expanded, and referring to the aims pursued by the co-legislators, the reasoning is closer to an external/internal view of the users of financial statements rather than to a strict external view (investment decisions and assessment of managers' performance). This reasoning is in line with a basic prescription (BP).

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[48] Règlement 1606/2002 Art. 3 Al. 2
[49] M4

As to the conceptual framework, it states that the objective of general purpose financial information is to provide « financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity[50] ». If the conceptual framework does not exclude the fact that entity's management is also interested in this information, it considers that « however, management need not rely on general purpose financial reports because it is able to obtain the financial information it needs internally[51] ». The conceptual framework is less concerned by the management decisions' making process since the information it provides "about how efficiently and effectively the entity's management has discharged its responsibilities to use the entity's resources helps users assess management's stewardship of those resources[52] ». The conceptual framework subscribes therefore to a strict external view (investors / creditors and assessment of stewardship) without linking this information to the governance and to management's decisions.

The Directive thus provides a broader external / internal view of who the users of financial information's are, whereas the conceptual frameworks only takes an external view based on the usefulness of financial information to investors, as regards the decisions they make and their assessment of management's stewardship.

4.3 Comparability (BP)

The Directive uses the word *comparability* in relation to presenting comparative financial information in the balance sheet[53]. Comparability of financial statements between entities is implicitly embedded in the Directive's accounting principles, as reminded in its recitals[50], but not explicitly mentioned in the Directive's provisions themselves.

The conceptual framework also requires that « financial statements include comparative information about preceding periods[54] ». However, comparability is not limited to comparative information but is more widely defined as « the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items[55] ». Comparability is therefore understood as relating to « similar information about other entities and similar information about the same entity for another period or another date[56] ».

Accordingly, there is basically no incompatibility even if the wording differs.

[50] 1.2
[51] 1.9
[52] 1.22
[53] A9.5
[54] 7.7
[55] 2.24
[56] 2.23

4.4 Going concern principle (BP)

The first of the general principles described in the Directive is that « the undertaking shall be presumed to be carrying on its business as a going concern[57] ». According to recital Nr. 24 « disclosure in respect of accounting policies is one of the key elements of the notes to the financial statements » and « should include a statement on the conformity of those accounting policies with the going concern concept ». The Directive does not define what this assumption relates to in terms of time horizon, nor does it state what the consequences would be if this strict level prescriptive principle (BP) is not complied with.

The conceptual framework « is based on the assumption that the reporting entity is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the need to liquidate or cease trading[58] ». However, the conceptual framework also states that « the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed in the financial statements ». Hence, the conceptual framework does not exclude departure from this assumption, in which case, international standards could still apply, but in specific instances to be mentioned in the notes to the financial statements.

In the Directive, the going concern principle is a key concept. In the notes to the financial statements, a statement of compliance with it should be included. In the absence of such compliance, financial information is *de facto* out of the Directive's scope and becomes in some way *sui generis*. Conversely, the conceptual framework, which also relies on this principle, does not exclude the possibility to depart from it, as long as indications and methods used are clearly stated in the notes to the financial statements, acknowledging the fact that there is no guidance on the methods to apply in such circumstances.

On this specific point, it appears that the rather sparse developments in both documents are not incompatible.

4.5 Consistency of accounting policies (BP) and intangibility of the opening balance sheet (PP)

The Directive states that « accounting policies and measurement bases shall be applied consistently from one financial year to the next[59] ». It also adds that, for consolidated financial statements, « assets and liabilities included in consolidated financial statements shall be measured on a uniform basis »[60], which aims at reaching consistency of the accounting policies used within a group. The opening balance sheet intangibility principle[61] supplements and

[57] A6.1.a
[58] 3.10
[59] Art. 6. 1 b
[60] A24.10
[61] A6.1.e

strengthens the continuity and consistency of accounting policies: it refers to a well-established legal tradition where equity may not be modified without impacting the profit and loss account. In addition to such substantial consistency, the Directive requires that formal consistency be ensured as « the layout of the balance sheet and of the profit and loss account shall not be changed from one financial year to the next. Departures from that principle shall, however, be permitted in exceptional cases in order to give a true and fair view[62] ». The Directive sets out a relatively strict frame on the principles to be applied to financial statement and on their layout, from which it can only be departed in exceptional cases (PP).

In the conceptual framework, « consistency refers to the use of the same methods for the same items, either from period to period within a reporting entity or in a single period across entities. Comparability is the goal; consistency helps to achieve that goal[63] ». The comparability objective, which is an ancillary qualitative characteristic, may compete with other characteristics. « For example, a temporary reduction in comparability as a result of prospectively applying a new financial reporting standard may be worthwhile to improve relevance or faithful representation in the longer term[64] ». The conceptual framework may be identified as minimally prescriptive as regards the consistency of accounting policies, this assumption only being one component of comparability which shall not prevail over using a more relevant accounting method.

Hence, where the Directive requires strict continuity and consistency in the polciies used as well as a standardised layout, the conceptual framework more explicitly ranks the relevance of a new policy higher than comparability.

This comment illustrates a situation where compatibility is not complete and where further reflection is clearly necessary. Hence, for each new endorsement it must be determined what the more adequate solution is; whether it is to support retrospective application, to meet comparability objectives, or rather to support prospective application to comply with the intangibility of the opening balance sheet principle (and also perhaps in regard of the cost/benefit ratio).

4.6 Neutrality

The Directive does not refer to neutrality.

A neutral depiction is defined in the conceptual framework as being « without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users. Neutral information does not

[62] A9.1
[63] 2.25
[64] 2.37

mean information with no purpose or no influence on behaviour. On the contrary, relevant financial information is, by definition, capable of making a difference in users' decisions[65] ».

In the absence of a reference to neutrality in the Directive, the existence of this principle in the conceptual framework may become an obstacle to compatibility if neutrality modifies the compatibility with another principle of the Directive. Therefore, one should examine the consequences of this principle on the prudence principle which, according to the conceptual framework, supports neutrality. Hence if "the exercise of prudence means that assets and income are not overstated and liabilities and expenses are not understated", neutrality also requires of the prudence principle to not allow « for the understatement of assets and income or the overstatement of liabilities and expenses, because such misstatements can lead to the overstatement of income or the understatement of expenses in future periods.[66] »

The neutrality definition in the conceptual framework evidences that the application of the superior principle of neutrality is contrary to the asymmetry concept, and that the prudence principle is therefore based on that of neutrality. This creates *a priori* an area of incompatibility further detailed in § 4.7 on the prudence principle.

4.7 Prudence principle (PP)

The Directive clearly spells out the characteristics of the prudence principle: « recognition and measurement shall be on a prudent basis, and in particular:

(i) only profits made at the balance sheet date may be recognised,
(ii) all liabilities arising in the course of the financial year concerned or in the course of a previous financial year shall be recognised, even if such liabilities become apparent only between the balance sheet date and the date on which the balance sheet is drawn up, and
(iii) all negative value adjustments shall be recognised, whether the result of the financial year is a profit or a loss[67] ».

The Directive also clarifies the definition of a liability indicating that « provisions shall cover liabilities the nature of which is clearly defined and which at the balance sheet date are either likely to be incurred or certain to be incurred, but uncertain as to their amount or as to the date on which they will arise[68] ». Beyond that basic prescription, the Directive introduces a possibility for member states to also: « permit or require the recognition of all foreseeable liabilities and potential losses arising in the course of the financial year concerned or in the course of a previous financial year[69] ».

[65] 2.17
[66] 2.18
[67] A6.1.c
[68] A12.12
[69] A6.5

Thus, the Directive establishes an asymmetry principle, which is in line with the European accounting tradition.

As mentioned in the paragraph related to neutrality, the conceptual framework associates the prudence principle with the neutrality principle and does not refer to the asymmetry concept even if the latter is implemented in a pragmatic manner in some standards.

These two approaches establish a situation of non-compatibility, which should be further detailed and the consequences of which should be more precisely assessed. It is worth referring to Paul André's and Andrei Filip's Policy Paper.

4.8 Accrual accounting principle (BP) and asset and liability definitions (OP)

The Directive indicates that the amounts are accounted for on an accrual basis[70]. This method is, in general, understood as encompassing both the *cost and revenue matching principle* and *the accrual basis accounting* (as opposed to cash-based accounting), according to which an income or an expense (and the related assets and liabilities) are accounted for in the period where they arise and not when they are paid. As regards liabilities, the Directive distinguishes accrual reserves from loss or debt reserves as « at the balance sheet date, a provision shall represent the best estimate of the expenses likely to be incurred or, in the case of a liability, of the amount required to meet that liability[71] ». Accordingly, in the Directive, it is the existence of an expense that generates the recognition of a liability.

The conceptual framework does not mention the accrual principle, but explicitly refers to the *accrual basis* accounting principle and to *the cost and revenue matching*. According to the conceptual framework « accrual accounting depicts the effects of transactions and other events and circumstances on a reporting entity's economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period[72] ». The conceptual framework states that the accrual accounting refers to economic resources, rights and obligations, concepts also used in this document to define assets and liabilities. As for the *cost and revenue matching principle,* it is mentioned as follows: « the recognition of assets or liabilities arising from transactions or other events sometimes results in the simultaneous recognition of both income and related expenses[73] ». In other words, « the concepts in the Conceptual Framework lead to such matching when it arises from the recognition of changes in assets and liabilities. However, these concepts do not allow the recognition in the statement of financial position of items that do not meet the definition of assets or liabilities ». Hence, according to the conceptual framework, it is the change in an asset or a liability that generates the recognition of an expense or of income.

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[70] A6.1.d
[71] A12.12
[72] 1.17
[73] 5.8

Both the Directive and the conceptual framework, albeit from different perspectives, refer to the accrual basis accounting method or the cost and revenue matching principle. The Directive states that applying these principles and methods lead to recognising liabilities based on expenses, whereas and conversely, the conceptual framework states that income and expenses result from changes in assets and liabilities.

On this point, the difference in perspective generates a situation where compatibility cannot be assumed and where it is probably necessary to examine on a case by case basis the practical effects resulting from each of these perspectives.

4.9 Non-offsetting principle (PP)

The Directive mentions that « any set-off between asset and liability items, or between income and expenditure items, shall be prohibited[74] ». However, it anticipates the need to depart from this principle in specific instances to be described in the notes to the financial statements[75]. The offsetting prohibition in the Directive, which applies to both balance sheet items and to profit and loss items, is not strict as it authorises some departures (PP).

The conceptual framework indicates that « offsetting occurs when an entity recognises and measures both an asset and a liability as separate units of account, but presents them in the statement of financial position as a single net amount. Offsetting classifies dissimilar items together and therefore is generally not appropriate[76] ». However, some IFRS standards authorise such offsettings (exchanges, deferred tax…). Nonetheless, the conceptual framework only mentions offsetting in relation to assets and liabilities, and not in relation to the profit and loss. The non-offsetting principle is more a general principle than it is a prohibition.

In the Directive as well as in the conceptual framework, the non-offsetting principle is a principle from which it may be departed. Unlike the Directive, the conceptual framework does not offer the possibility to compensate expenses and income. Such offsetting is nevertheless available in already endorsed standards, as IAS 18[77].

This remark seems to evidence a compatibility situation, even if nuances may exist.

4.10 Substance over form principle (BP for consolidated financial statements, OP for annual financial statements)

The Directive only refers to the substance of a transaction or a contract[78]. It does not explicitly mention the concept in terms of pre-eminence. It avails an exemption possibility to member states.[79].

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[74] A6.1.g
[75] Art.6.2
[76] 7.13
[77] IAS 1.34
[78] A6.1.h
[79] A6.3

The conceptual framework is slightly more descriptive as it specifies that faithful representation « provides information about the substance of an economic phenomenon instead of merely providing information about its legal form[80] », because, if differences arise between the two, information on the legal form would not give a faithful representation.

If the Directive is silent on the opposition between the economic and legal substance, it is probable that one should not deduce that a significant incompatibility area exists. On this point, it is worth referring to Yvonne Muller's Policy Paper.

4.11 Measurement methods: historical cost and fair value

The Directive clearly sets out that the primary principle is historical cost (BP).[81] Conversely, it dedicates one specific article to an alternative measurement method based on fair value[82] (PO), which is arguably linked to the changes brought by the international standards.

A careful review of this article evidences a relatively restrictive approach in terms of the scope of application and of measurement methods, even though options allow member states to, to some extent, converge or align their national accounting provisions with international standards. However, for assets and liabilities measured in that way, the fair value impact is generally recognised in the profit and loss account, even though some exemptions authorise recording these entries in a specific reserve account (hedging, net investment in foreign entities and, on option, assets held for sale). Hence, the Directive implicitly limits the development of the hybrid performance measure known as OCI (Other Comprehensive Income).

On this point, it is worth referring to Didier Marteau's Policy Paper. It is obviously a « grey area » of the Directive due to the multiple options available to member states which prevent actual harmonisation, even if numerous observers note a strong reluctance to the scope extension of the use of fair value because of its related judgmental estimates (level 2 and level 3).

In the conceptual framework, the recognition of a mixed model combining historical cost and fair value, leaves the responsibility of the choice between the two measurement models up to the standards. At this stage, the delimitation in the application of the various methods is not really conceptual, but rather is approached case by case.

Thus, neither the Directive, nor the conceptual framework offers a satisfying principle. One can sense different cultures at play, each allowing some leeway and negotiation in standard setting, which is not really an optimal process. Clarification is therefore necessary to eliminate a "grey area" of compatibility that is detrimental to the acceptance of standards by those who have to implement them.

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[80] 2.14 et 4.53
[81] A6.1.i
[82] A8

4.12 Materiality principle and completeness (PP)

The Directive defines the materiality principle as the ability not to comply with « the requirements set out in this Directive regarding recognition, measurement, presentation, disclosure and consolidation when the effect of complying with them is immaterial[83] ». It sets out that information is material« where its omission or misstatement could reasonably be expected to influence decisions that users make on the basis of the financial statements of the undertaking[84] ». Recital Nr. 17 specifies that « the principle of materiality should not affect any national obligation to keep complete records showing business transactions and financial position[85] ». The application of this principle should not therefore contravene a more prescriptive national law as regards the completeness of accounting entries.

The conceptual framework defines material information in a similar manner[86]. As for completeness, it is not defined in regard of materiality, but rather as *a complete depiction* of « all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations » and also by « a description of what the numerical depiction represents (for example, original cost, adjusted historical cost or fair value) [87] ».

The materiality principle articulated in a similar manner in both texts. Completeness of information is mentioned in the Directive in regard of the materiality principle and in order to comply with legal provisions. As for the conceptual framework, it mentions the *complete depiction* as a quality in itself which has consequences on disclosures and on measurement. However, the fact that these provisions are more detailed in the conceptual framework does not seem to modify its compatibility with the Directive.

4.13 Accuracy (PP)

In the Directive, accuracy of information is required together with the principle of materiality according to which information is material « where its omission or misstatement could reasonably be expected to influence decisions that users make[88] ». Accuracy of information is therefore only required when the information becomes material.

The conceptual framework defines accuracy as free from error, meaning that « there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process[89] ». According to the conceptual framework accuracy is measured based on a quality process.

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[83] A6.1.j
[84] A2.16
[85] motif 17
[86] 2.11
[87] 2.16
[88] A2.16
[89] 2.19

Thus, accuracy, required by both the Directive and the conceptual framework, is appraised according to two different approaches that authorise some judgmental margin: (i) materiality in the Directive or (ii) the evaluation of a process in the conceptual framework. However, these two approaches do not challenge broad compatibility.

4.14 Clarity (BP)

The Directive requires that « the annual financial statements shall be drawn up clearly[90] ».

According to the conceptual framework « Classifying, characterising and presenting information clearly and concisely makes it understandable[91] ».

4.15 Timeliness

The Directive only mentions timing requirements for drawing up financial statements in exceptional instances to justify some consolidation exemptions[92]. Actually, it implicitly relies on national legal provisions for the timely issuance of financial information

Timeliness defined in the conceptual framework as having « information available to decision-makers in time to be capable of influencing their decisions[93] », is one of the 4 ancillary qualitative characteristics that enhance the usefulness of financial information.

Timeliness is not a quality explicitly required by the Directive. It mentions time constraint only in extremely rare cases where an information cannot be obtained without undue delay. At its end, the conceptual framework makes timeliness an ancillary characteristic that cannot be detrimental to compatibility.

4.16 Financial statements and their elements (PP)

In the Directive, « the annual financial statements shall constitute a composite whole and shall for all undertakings comprise, as a minimum, the balance sheet, the profit and loss account and the notes to the financial statements[94] ». The definition of the elements of financial statements (assets, liabilities, equity, profit, expenses and result) is poorly developed. Conversely, the Directive details the presentation of financial statements (structure and content) in several layouts. Member states may allow or require entities « to present a statement of their performance instead of the presentation of profit and loss items in accordance with prescribed layouts, provided that the information given is at least equivalent to that otherwise required by prescribed layouts[95] ».

According to the conceptual framework « Financial statements present, in the statement of financial position and the statement(s) of financial performance, information about recognised

[90] A4.2
[91] 2.33-2.35
[92] A23.9.a
[93] 2.32
[94] A4.1
[95] A13.2

assets, liabilities, equity, income and expenses. They also disclose additional information about those recognised elements and other information that is relevant to users[96] ». the denomination of the financial statements in the conceptual framework therefore sets out the objective of each of the 3 compulsory statements.

In the Directive, the *profit and loss account*, the structure of which is precisely depicted, leads to a net result. The definition of the *statement of financial performance* in the conceptual framework does not equally match with the *profit and loss account* in the Directive, since it provides, in addition to the *statement of profit or loss* (which includes a *net result* as a total), *other comprehensive income* (OCI)[97]. The ambiguity created by the other comprehensive income (OCI) belonging to the statement(s) of financial performance, constitutes a key difference with the Directive's provisions further detailed in § 4.11 and in the policy papers of Didier Marteau on fair value and of Thomas Jeanjean and Isabelle Martinez on performance.

Three chapters[98] of the conceptual framework define and present financial statements and their elements « Recognising assets, liabilities, equity, income and expenses depicts economic resources and claims, and changes in those resources and claims, in a structured summary that is intended to be comparable and understandable. An important feature of that summary is that the amounts recognised in a statement are included in the totals and, if applicable, subtotals, that give structure to the statement[99] ». The conceptual framework demonstrates in § 5.4 to 5.8 that « linkage arises between the statements[100] ». « Recognition links the elements, the statement of financial position and the statement(s) of financial performance[101] ».

Hence, it appears that the Directive aims at, first of all, proposing a standardised structure of financial statements and to their components while the conceptual framework highlights the links between them, whereas such links between the financial statements also implicitly exist in the Directive. Subject to the treatment of OCI, these different approaches do not seem to be detrimental to tcompatibility, but will have to be scrutinised.

Finally, according to the Directive the cash flow statement is not compulsory. Nor is it for the conceptual framework which requires providing « information about cash flows »[102] but no « cash flow statement ».

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[96] 7.8
[97] 7.19
[98] Chapitres 4, 7 et 8
[99] 5.3
[100] 5.6
[101] 5.4
[102] 7.2.b.iii

5 Public interest

The Directive does not mention the European public good, to which its provisions are compliant because of its elaboration and adoption process. The IAS Regulation explicitly refers to these notions (second criterion to comply with), but does not provide any precise definition. Thus, the Regulation creates a requirement that the different players of the endorsement process have to act *« with awareness ».* Recitals of both Regulation and Directive provide information on that through the objectives set out: development of financial markets, security of financial markets and of transactions, financial stability, economic growth, long term investment, inclusive growth... This is not really a cohesive *corpus* but merely directions, important as they may be. If the requirement is clear, the corpus remains to be more precisely defined.

The conceptual framework does not directly refer to the public interest either. However, the IASB declares that it serves the public interest by « the transparency, the accountability and the effectiveness» that its standards bring to financial markets[103]. However, in its Constitution, the IFRS Foundation does not recognise it has any social responsibility beyond the issuance of high quality accounting standards[104] « by fostering trust, growth and long-term financial stability in the global economy» [105]. Consideration of the public interest raises the question of its assessment.

The IASB, following the SEC, has therefore integrated in its due process the carrying out of cost / benefit analyses to assess the opportunity to create or revise a standard[106]. Cost / benefit analyses are one of the ways of assessing whether the public interest objective has been reached. However, the European Commission considers that « to date, the IASB has provided limited analysis of the effects of its standards, focussing on the quality of the information provided to users of financial statements »[107]. Admittedly, the public interest notion on a global scale as stated by the IASB is difficult to capture.

According to the second endorsement criterion, which states that a standard shall « be conducive to European public good », responsibility lies with the European Union to perform its own cost/benefit analysis, independently from the IASB[108]. EFRAG has been notably entrusted with this task, but this body does not have yet at its disposal a clear Framework, nor the resources to conduct this task on its own.

Consequently, it can be considered that *a priori* there is neither compatibility nor incompatibility, but an important task remains to be accomplished in order to comply with the requirement set out and thus to take into account the interests of all stakeholders.

[103] Fondation IFRS « Mission Statement »
[104] Bischof/Daske p.31
[105] Fondation IFRS « Mission Statement »
[106] Bischof/Daske p.32
[107] COM (2015) 301 p.9
[108] Bischof/Daske p.33

6 Conclusion

Compliance of a new standard or a new IFRS Interpretation with the conceptual framework does not and will not suffice to assume it complies with the Directive. Criteria set out by the IAS Regulation, referring to the Directive have a real autonomy, even though their level of prescription varies in the context of European harmonisation. This study has evidenced different approaches on some principles, for which it is difficult, at this stage, to conclude to real compatibility. The most sensitive points are: users of financial information, intangibility of the opening balance sheet, neutrality, prudence, the trade-off between historical cost and fair value, the presentation of financial statements and the concept of profit and loss and of performance… Clarifications on all these points will be more than welcome.

In addition the most crucial limitation remains, relative to the European public good concept, which cannot be fully embodied by an international private organisation despite its willingness expressed in a Constitution[109] or a mission statement[110]. Actually, it is up to the European Union to define the public good concept, that it has itself required needed to be fulfilled.

Consequently, the endorsement process is not limited to applying mechanically those criteria. Implementing an endorsement process remains a conscious and meticulous process, whatever the accuracy of the endorsement criteria and the inherent qualities of the standards. This process could nevertheless benefit from being clarified, as suggested in the report on the evaluation of the IAS Regulation 10 years after adoption that invites “the Commission, together with EFRAG, to provide guidance in order to improve the understandability of the endorsement criteria”. The understandability of the endorsement criteria may be clarified by a reading “aloud” of the underlying ambitions and principles of the Directive, which could outline the features of a European conceptual framework.

This clarification is more than needed as the strategy’s objectives defined by the Commission 20 years ago have now been considered as completed and the current expectations nowadays go beyond the sole organisation of financial markets. The Commission encourages henceforth “facilitating the consideration of some areas such as effects on financial stability[111]”. This aspiration to a broader use of the financial information is also expressed by the European Parliament, for which considering the global character of financial flows and financial business, regulating Finance without modifying the scale of public actions is illusive[112].

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[109] Constitution § 2 : « The objectives of the IFRS Foundation are: « (a) to develop, in the public interest, a single set of high quality, understandable, enforceable and globally accepted financial reporting standards based upon clearly articulated principles. »

[110] Mission statement : « Our work serves the public interest by fostering trust, growth and long-term financial stability in the global economy »

[111] COM (2015) 301 p.10, 12 et 13

[112] Sylvie GOULARD p.11

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