

# Accounting Standards

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## Editorial

In the wake of the global financial crisis accounting and auditing standards have been the focus of much negative media comment. Accounting standards have been cited in the financial crisis, accused of misleading investors and hiding financial problems.

With this context in mind the Oireachtas Library & Research Service commissioned Dr John McCallig and Professor Ciarán Ó hÓgartaigh, both of UCD, to discuss accounting standards and the implications of forthcoming changes in standards.

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# GLOSSARY

**Amortised cost:** in the case of financial instruments, amortised cost allocates the cost of an asset to the income statement over accounting periods using the effective interest rate on the asset.

**ASB:** Accounting Standards Board. This body sets accounting standards for the UK and, through an understanding between Chartered Accountants Ireland, the ASB and the Department of Enterprise, Trade and Innovation, for the Republic of Ireland. The accounting standards it issues are called Financial Reporting Standards (FRS) and are a component part of UK/Irish GAAP.

**Consolidated financial statements:** Financial statements in which the statements of financial position, comprehensive income and cash flows of a reporting entity and the entities it controls are combined (after eliminating all inter-firm transactions) and shown as belonging to a single reporting entity.

**EU-Adopted IFRS:** International Financial Reporting Standards of the International Accounting Standards Board (IASB) which have been endorsed by the Accounting Regulatory Committee of the European Commission.

**EU Regulation 1606/2002** requires that companies governed by the law of a Member State, whose securities are admitted to trading on a regulated market in the EU (publicly traded companies) are required to prepare their consolidated accounts on the basis of EU adopted IFRS.

**Fair Value:** The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction (IASB definition).

**FASB:** Financial Accounting Standards Board. This body is charged by the US Securities and Exchange Commission with setting accounting standards for US entities listed on US stock exchanges.

**FRC:** The Financial Reporting Council. The UK's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment. The FRC's aims are to promote high standards of corporate governance through the UK Corporate Governance Code, set standards for corporate reporting and actuarial practice and monitor and enforce accounting and auditing standards, and oversee the regulatory activities of the professional accountancy bodies and operate independent disciplinary arrangements for public interest cases involving accountants and actuaries.

**FRS:** Financial Reporting Standards, the accounting standards issued by the ASB.

**FRSSE:** Financial Reporting Standard for Smaller Entities. This complete stand-alone standard was developed by the ASB in 2002

in order to simplify compliance with accounting standards for smaller entities. This includes small companies under the Companies Acts as well as other entities which would qualify as small if they had been incorporated under companies' legislation, with the exception of building societies.

**IAS:** International Accounting Standards. Upon its inception, the IASB adopted the body of International Accounting Standards (IASs) adopted by its predecessor, the Board of the International Accounting Standards Committee. The term 'International Financial Reporting Standards' includes IASs.

**IASB:** International Accounting Standards Board: This body sets International Financial reporting Standards (IFRS). A slightly amended version of these standards was required by the EU (Regulation 1606/2002) and in Irish Law (S.I. 116 2005) for listed (on a stock exchange) companies. These standards can be used by smaller Irish companies but in general they still use UK/Irish GAAP.

**IFRS:** International Financial Reporting Standards, IASB publishes its standards in a series of pronouncements called International Financial Reporting Standards (IFRSs). Upon its inception, the IASB adopted the body of International Accounting Standards (IASs) adopted by its predecessor, the Board of the International Accounting Standards Committee. The term 'International Financial Reporting Standards' includes IFRSs, IASs and Interpretations originated by the International Financial Reporting Interpretations Committee (IFRIC) and its predecessor, the former Standards Interpretations Committee (SIC).

**IFRS for SME:** International Financial Reporting Standards for small and medium-sized entities. This standard was developed by the IASB and published in 2009 as a stand-alone standard for small, medium-sized and non-publicly accountable entities.

**Non-publicly accountable entities:** Entities which are not publicly accountable but which publish general purpose financial statements for external users.

**SORP:** Statements of Recommended Practice are recommendations on accounting practices for specialised industries or sectors. They supplement accounting standards and other legal and regulatory requirements in the light of the special factors prevailing or transactions undertaken in a particular industry or sector. SORPs are issued not by the Accounting Standards Board but by industry or sector-level bodies recognised for the purpose by the ASB.

**UK/Irish GAAP:** UK and Irish Generally Accepted Accounting Practice. These accounting standards are developed by the ASB and are currently used by the vast majority of unlisted Irish and UK companies.

*“Accounting is the means by which information about an enterprise is communicated and, thus, is sometimes called the language of business.”*  
(Williams, et al., 2009, p. 151).

### **Introduction**

Accounting standards are important. If accounting is the language of business, accounting standards are its grammar. Properly developed and implemented they can encourage business expansion and help regulate the economic system. High-quality accounting standards can facilitate the flow of information from businesses to a range of different users. These include investors, banks, creditors, the revenue commissioners, regulators, employees and the general public. The availability of accounts prepared in accordance with recognised accounting standards encourages trade by promoting confidence in businesses.

However, financial statements are inherently limited in nature. They provide a snapshot of financial position, performance and cash flows of a company as at the reporting date. They are a function of the estimates and judgements of directors and of the choices made under accounting standards.

Accounting standards are themselves not without controversy. Both the financial crises and recent developments in international accounting standards have drawn attention to the content of accounting standards, the process by which they are developed and the role accounting standards have played in the economic system. For example, both the G20 leaders and the Report of the Financial Crisis Advisory Group have called for the development of a single set of high quality global accounting standards to facilitate transparency and stability in the global economic system (IASB, 2009a; 2010a). Within this, a particular area of concern is how financial assets are valued on

balance sheets. Differences have emerged in the way the US FASB and the IASB have tackled this issue and it seems increasingly challenging for the IASB to satisfy both the EU and the goal of harmonisation with the United States (US) FASB standards.

This spotlight looks at the implications of recent and proposed developments in accounting standards for Ireland.

### **Accounting standards**

Section 149(1, 2) of the Companies Act 1963 requires that company directors present to their shareholders financial statements which give a ‘true and fair view’ of the company’s financial position and profit or loss. What constitutes a ‘true and fair view’ is not defined by legislation in Ireland or internationally. Rather ‘a true and fair view’ is a concept which originates in the nineteenth century and has subsequently been refined by case law (see text box 1). This case law has established that if company directors comply with accounting standards in preparing the financial statements, this is very strong evidence that the financial statements give ‘a true and fair view’. A legal opinion to the Accounting Standards Board from Mary Arden QC suggests that ‘the immediate effect of the issue of an accounting standard is to create a likelihood that the court will hold that compliance with that standard is necessary to meet the true and fair requirement’ (Arden, 1993, para. 10). In other words, accounting standards define best practice in accounting.

The EU 4<sup>th</sup> Directive on company law enshrined the concept of the true and fair view into EU company law. The US equivalent to ‘a true and fair view’ is ‘present fairly . . . in conformity with US generally accepted accounting principles’.

The directors of a company are responsible for ensuring that the financial statements give ‘a true and fair view’. The company directors are

then required by law to present audited financial statements to the AGM of the company. The auditors of a company are required to give an independent opinion on whether the financial statements which they have audited give a 'true and fair view'. An audit includes 'examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the company's circumstances, consistently applied and adequately

disclosed' (Auditing Practices Board, 2009). The audit opinion does not absolve the directors of their responsibilities to ensure that the financial statements give a 'true and fair view.'

Financial statements presenting a true and fair view are prepared applying GAAP (in Ireland either UK and Irish GAAP or IFRS) whilst audits are carried out having regard to independently established auditing standards (in Ireland, International Auditing Standards as published by the Auditing Practices Board (APB)).

#### **Text box 1: The case of Lloyd Cheyham Ltd. v. Littlejohn & Co.**

Lloyd Cheyham invested in a company, Trec Rentals Ltd a trailer hiring business, based on accounts audited by Littlejohn & Co. However soon after investing in the company the company was put into liquidation. Lloyd Cheyham took a court case against Littlejohn arguing that the auditors had been negligent in the auditing of the accounts. In particular, the plaintiffs alleged that the way in which the cost of replacing the tyres of the trailers was provided for in the accounts was inadequate in that they only took the cost into consideration when it crystallised whereas it should have been taken into consideration when the loss accrued and there was no statement in the accounts that a substantial sum would have to be paid for the replacement of the tyres. Littlejohn maintained that it followed proper standards when conducting the audit.

Justice Woolf held that the auditors owed Lloyd Cheyham a duty of care as they knew that the accounts were being relied on by them. However, on the facts, there had been no breach of duty because the accounts as prepared had given a true and fair view of the company's affairs.

Justice Woolf argued that while accounting practices are not rigid rules, they are very strong evidence of the proper standard to be adopted and, unless there is some justification, a departure from them should be regarded as a breach of duty.

Lloyd Cheyham & Co Ltd v Littlejohn & Co Queen's Bench Division [1987] BCLC 303 Unreported.

Penman (2007) analyses the quality of financial statements using a framework that examines all of the links in the chain that produces high quality financial statements.

First, he considers whether the quality of accounting standards is adequate. For example, a revised version of IAS 39 *Financial Instruments: Recognition and Measurement*, implemented for

accounting periods beginning on or after 1 January 2005, required 'that an impairment loss is recognised only when it has been incurred' (IASB, 2003, IN20). Professor Patrick Honohan comments that this

"Reduced the degree to which expected but not yet incurred loan losses could be provisioned. It had the effect of understating

expected losses and potentially reducing the transparency of accounts as an indicator of future regulatory problems. For example, the gap between provisions and expected losses would tend to grow at the beginning of an economic slowdown” (Honohan, 2010, p. 72).

As discussed later, this perceived weakness in accounting standards is currently being addressed by the IASB which is considering moving away from ‘an incurred loss model’ to ‘an expected loss model’ of accounting for loan losses.

Second, Penman considers whether audit quality is sufficient. Poor auditing can allow the company to violate accounting standards or commit outright fraud. Audit failure can be mitigated by, for example, the supervision and regulation of the auditing profession, the independence of the auditor and the proper functioning of an audit committee of the board of directors. The recent transposition of the Statutory Audit Directive by the European Communities (Statutory Audits)(Directive 2006/43/EC) Regulations 2010 imposes particular obligations on audit committees with regard to audit quality and the monitoring of auditor independence.

In Ireland, the Irish Auditing and Accounting Supervisory Authority (IAASA) was established pursuant to the provisions of Part 2 of the Companies (Auditing and Accounting) Act, 2003 (the Act). IAASA's objectives under section 8 of the Act include the supervision of how the prescribed accountancy bodies regulate and monitor their members and the promotion adherence to high professional standards in the auditing and accountancy profession (see <http://www.iaasa.ie/about/index.htm>).

Third, Penman considers whether the company is applying accounting standards correctly. Accounting standards sometimes allow choices of accounting treatment and generally require the exercise of judgement. Judgement is required in financial statements, reflecting the underlying uncertainties of business. For example, directors have a choice whether to value non-current assets such as property, plant and equipment at depreciated historical cost or at a revalued amount. The directors exercise judgement regarding some financial statement items, such as depreciation and accruals, leading to the inclusion of estimates in the financial statements. Financial statements which present ‘a true and fair view’ are therefore subject to judgement and estimation which can sometimes lead to ‘earnings management’. This may involve overstating revenues, understating expenses, keeping liabilities off the balance sheet and recognising assets that are of questionable value. A one-size-fits-all model of accounting is attractive in that it minimizes opportunities for manipulation but it also decreases the value of the information presented.

Fourth, Penman considers whether directors disclose enough information about their company's operations and finances for the reader to be able to make economic decisions about the business. Historically, businesses have opposed additional disclosures, arguing that they are costly and/or provide information to their competitors. Accounting standards provide the basic framework on which a high quality financial accounting system can be based. However, accounting standards evolve slowly to meet emerging problems and are not always ready to meet the challenge of reflecting new economic circumstances in financial statements. The quality of financial statements is also critically dependent on accounting

standards being appropriately applied by directors.

### **The internationalisation of accounting standard-setting**

Historically, accounting standards were devised and approved on a national basis. In Ireland we adopted the standards set by the Accounting Standards Board (ASB). The role of the ASB is to issue accounting standards in the United Kingdom. It is recognised as a standard setting body in the UK for the purposes of Section 256(1) of the UK Companies Act 1985 and in Northern Ireland for the purposes of Article 264(1) of the Companies (Northern Ireland) Order 1986. There are no similar statutory provisions in the Republic of Ireland (see ASB, 1993, p. 6).

Chartered Accountants Ireland makes a contribution, currently in the region of €300,000 per annum to the FRC (representing approx. 1.5% of the FRC's operating costs) to support its standard setting activities, including accounting standard setting by the ASB and auditing standard setting by the APB. The only direct financial contribution to the IASB from the Republic of Ireland in 2009 was from the Central Bank & Financial Services Authority of Ireland which contributed £6,729 to the IASB in that year.<sup>1</sup> In its 2009 Annual Report, the International Accounting Standards Committee Foundation notes (p. 50) that 'the European Commission has proposed a €4 million per year contribution for 2011 — 2013. Funding efforts are proceeding in EU Member States and other European countries'.

IAASA is one of several observers at the ASB and therefore can attend but not participate in the decisions of the

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<sup>1</sup> This compares with £44,655 from, for example, the Bourse de Luxembourg, £87,690 from the Accounting Standards Review Board 'on behalf of New Zealand stakeholders' and £800,000 from the United Kingdom 'from a levy system organised by the Financial Reporting Council' (IASC Foundation, 2009, pp. 46-50).

ASB. However, since their inception, the Republic of Ireland has not had any members of the ASB or of the IASB.<sup>2</sup>

Chartered Accountants Ireland issues accounting standards applicable in the Republic of Ireland based on the Financial Reporting Standards of the ASB.

This absence of a separate standard-setting infrastructure is appropriate given Ireland's size. It also means that accounting standards are applied on an all-Ireland basis and that Irish accounting standards comply with best international practice. These standards are known as UK/Irish GAAP.

In 2005 the EU adopted<sup>3</sup> a slighted modified version of International Financial Reporting Standards (IFRS) for the consolidated financial statements of listed companies in EU member states.

In Ireland, this means there are two layers of accounting standards:

- Companies quoted on a recognised EU stock exchange must apply EU-adopted IFRS of the International Accounting Standards Board (IASB) in preparing their consolidated financial statements. If such entities use IFRS this must be noted in the financial statements.
- Company law allows for the use of either UK/Irish GAAP or IFRS for the

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<sup>2</sup> The Financial Reporting Council (FRC) and the ASB's *Urgent Issues Task Force* (UITF) have had several Irish members since their establishment. These include Declan McSweeney (AIB) and Vincent Sheridan (VHI) on the FRC and Dr. Patricia Barker (Dublin City University), Una Curtis (KPMG), David Devlin and John McDonnell (both PwC) on the UITF. Since November 2007, the Board of the FRC has had no member from the Republic of Ireland (Source: FRC Reports and Financial Statements/Annual Reports, 1990-2009).

<sup>3</sup> EU Regulation (EC) No 1606/2002, S.I. 116 2005 implemented this change by adding S149A (1) and S150A (1) to the Companies Act, 1963.

parent company accounts of listed entities and the individual and group financial statements of other entities.

Both standards constitute 'a true and fair view' within Ireland.

**Text box 2: investigations into the quality of accounting and auditing in financial institutions  
(in particular Anglo Irish Bank)**

At the time of writing, a number of investigations are underway regarding the extent to which the actions of directors and/or auditors breached their obligations under company law and (by extension) accounting standards. For example, the Complaints Committee of the Chartered Accountants Regulatory Board (CARB), the body established by the Institute of Chartered Accountants in Ireland (ICAI) to regulate its members, has appointed Mr. John Purcell, former Controller and Auditor-General as Special Investigator into a wide range of issues concerning directors' loans and other matters at Anglo Irish Bank. His role is to investigate possible breaches of ICAI Bye-Laws and rules of professional conduct by its members and/or member firms. The Director of Corporate Enforcement is also undertaking an investigation into Anglo Irish Bank and has indicated that he 'is reasonably optimistic that his office can gather sufficient evidence to refer a case against Anglo Irish Bank to the DPP for prosecution' (RTE, 2009).

The report by Professor Patrick Honohan on *The Irish Banking Crisis Regulatory and Financial Stability Policy 2003-2008* concludes that

In an important sense, the major responsibility lies with the directors and senior managements of the banks that got into trouble . . . It may also be the case that auditors and accountants should have been more alert to weaknesses in the banks' lending and financial position. While these aspects have not been independently researched for this Report, they merit further investigation (Honohan, 2010, p. 7).

The increased globalisation of capital markets has resulted in a need for international accounting standards. In an increasingly globalised world, it is clear that financial statements of companies operating under different accounting regimes are not comparable (see text box 3). This led to the development of the International

Accounting Standards Board (IASB) whose stated objective is the development of 'a single set of high quality, understandable, enforceable and globally-acceptable International Financial Reporting Standards' (see [www.iasb.org/The+organisation/IASCF+and+IASB.htm](http://www.iasb.org/The+organisation/IASCF+and+IASB.htm)).

**Text box 3: the effect of different national standards on measures of profitability**

A 1993 case exposed the effects of different national accounting standards. Daimler Benz was the first German company to be listed on the New York Stock Exchange. Under German listing rules, Daimler Benz was required to use German accounting standards and under US listing rules it was required to use US accounting standards. In 1993, Daimler Benz reported a profit of DM 615 million under German accounting standards and a loss of DM 1,839 under US accounting standards.



As a consequence of the EU's decision to adopt IFRSs for companies listed on a recognised stock exchange over 7,000 listed companies in the EU 27 apply EU-endorsed IFRSs in preparing their financial statements. The Accounting Regulatory Committee (ARC) of the European Commission considers whether to adopt IFRSs of the IASB for application in the EU.

Each Member State is represented at the ARC.<sup>4</sup> Unusually, but not uniquely, the 'most frequent composition' of the Irish delegation includes a member of the Chartered Accountants Ireland (as a technical advisor) as well as the Department of Enterprise, Trade and Innovation. All other Member States (except Lithuania and Slovenia) are most frequently represented only by Government departments.

The ARC has currently adopted all the accounting standards of the IASB with the exception of some parts of an early version of *IAS 39 Financial Instruments: Recognition and Measurement*. As a result of lobbying from major European financial institutions, the ARC recommended that the European Commission only partially adopt IAS 39, effectively 'carving-out' two elements of IAS 39<sup>5</sup>. While the technical aspects of the 'carve-out' are of decreased significance given subsequent and proposed amendments to IAS 39, the ARC's decision in this regard is indicative of the political context of standard-setting.

Similarly, in October 2008, under pressure from the EU Commission, the IASB revised its asset classification

rules with retroactive effect in order to permit banks to reclassify their financial instruments, recognising fewer assets at fair value. In doing so, the IASB did not adhere to its normal consultation principles (outlined below), and its chairman Sir David Tweedie considered resigning (Jetuah, 2008; Chasan, 2009).<sup>6</sup> This lends further credence to the view in the academic literature, particularly in Europe, that accounting standard-setting is a political process (these arguments are summarised by Bushman and Landsman, 2010).

Mary Schapiro, the president of the SEC, has cited this lack of freedom from political interference as a reason for the US to delay IFRS adoption:

"When it comes to international accounting standards, it's critical that these standards are converged in a way that does not kick off a race to the bottom. American investors deserve and expect high standards of financial reporting, transparency, and disclosure -- along with a standard-setter that is free from political interference and that has the resources to be a strong watchdog. At this time, it is not apparent that the IASB meets those criteria, and I am not prepared to delegate standard-setting or oversight responsibility to the IASB".<sup>7</sup>

The IASB is the accounting standard-setting body of the IASC Foundation (soon to be renamed the 'IFRS Foundation'). The IASC Foundation

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<sup>4</sup> Details of the composition of the ARC are available at [http://ec.europa.eu/internal\\_market/accounting/docs/arc/arc-members\\_en.pdf](http://ec.europa.eu/internal_market/accounting/docs/arc/arc-members_en.pdf).

<sup>5</sup> The two elements relate to the fair value option as it applied to liabilities and the disallowance of fair value hedge accounting for portfolio (macro) hedging of deposits.

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<sup>6</sup> Corroborated by Tweedie in his plenary address to the American Accounting Association Annual Meeting (New York, August, 2009), attended by one of the authors.  
<sup>7</sup> <http://levin.senate.gov/newsroom/supporting/2009/PSI.SchapiroResponses.012209.pdf>, pp. 4-5.



describes itself as 'an independent, not-for-profit private sector organisation working in the public interest'.<sup>8</sup> The IASC Foundation appoints, monitors, funds and reviews the effectiveness of the IASB. The International Accounting Standards Board is not a democracy. However, it does have a consultation process which it argues provides 'public accountability'. When the IASB is considering a new accounting standard, it normally issues a Discussion Paper outlining potential alternative accounting treatments and invites public comment. Following consideration of the responses to the Discussion Paper, the ASB then issues for public comment an 'Exposure Draft' setting out a specific proposal in the form of an accounting standard. This is then followed by the issue of an accounting standard. There is evidence that those who participate in accounting standard-setting consultation processes are mainly accounting firms, representative professional accounting bodies and the preparers of financial statements (e.g. Gilfedder and Ó hÓgartaigh, 1998; Georgiou, 2002, 2004 and 2010). However, the IASB appears to make a particular effort to seek out the views of investors and analysts who they see as the 'primary users' of financial statements.<sup>9</sup> In Ireland, representations to the IASB are generally made through the individual accounting bodies (for example, the Accounting Committee of Chartered Accountants Ireland).

#### **Text box 4: Global accounting bodies**

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) in the United States represent the two main blocs of accounting standards globally. The accounting standards of the IASB have been adopted by over 100 countries including most of the major non-US economies. The FASB develops accounting standards that are applied by companies listed on US capital markets, the largest equity market in the world.

As noted by the IASB<sup>10</sup>, in 2006, the IASB and FASB agreed a Memorandum of Understanding ('MoU') for advancing convergence of IFRSs and US Generally Accepted Accounting Principles ('GAAP'). The purpose of the MoU is to foster convergence between IFRSs and US accounting standards, developing 'high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting'.<sup>11</sup> This has been an area of international political concern, with the G-20 leaders setting a deadline of June 2011 on the achievement of a single global set of accounting standards.

While some elements of convergence between US accounting standards and IFRSs have been achieved, there are two major areas of disagreement between the IASB and the FASB which render international accounting harmonisation increasingly challenging and uncertain: the accounting treatment of financial instruments and insurance contracts (these are discussed in more detail below).

<sup>8</sup> [www.ifrs.org/The+organisation/IASCF+and+IASB.htm](http://www.ifrs.org/The+organisation/IASCF+and+IASB.htm)

<sup>9</sup> [www.iasb.org/News/Features/Spotlight+on+investor+outreach.htm](http://www.iasb.org/News/Features/Spotlight+on+investor+outreach.htm)

<sup>10</sup>

<http://www.ifrs.org/Use+around+the+world/Global+convergence/IFRS+global+convergence.htm>

<sup>11</sup> <http://www.ifrs.org/NR/rdonlyres/874B63FB-56DB-4B78-B7AF-49BBA18C98D9/0/MoU.pdf>

### The future of UK/Irish accounting standard-setting

In August 2009, the UK ASB proposed that it would, in future,

“work under the IASB framework and . . . converge to the fullest extent possible consistent with the needs of UK entities. As a consequence of the Board’s proposed approach, the separate body of literature currently referred to as UK GAAP will cease to exist. That said, the ASB is not relinquishing the right to set UK GAAP, but all existing literature would be superseded.” (ASB 2009, para. 1.1)

The ASB proposes that the UK framework would be as outlined in Table 1.

**Table 1:** The UK ASB’s proposed accounting regime

Type/Nature of reporting company	Accounting Regime
Publicly accountable company	Tier 1: EU Adopted IFRS
Non-publicly accountable company	Tier 2: IFRS for SMEs
Small company (as at present)	Tier 3: FRSE

The ASB argues that there are a number of advantages to moving to International Accounting Standards Board IFRS for publicly accountable and non-publicly accountable companies:

1. Reporting will be simplified by having proportionate reporting arrangements depending on accountability and size.
2. Moving to one set of accounting standards (IFRS) would reduce the burden associated with having multiple sets of accounting standards. This would also assist with

education and professional development for auditors and accountants.

3. Improved comparability of accounting standards over international borders helps build investor and creditor confidence and improve capital flows.
4. Moving to IFRS enables the UK and the Republic of Ireland to devote their standard setting resources to influencing the IASB and ensuring that IFRS satisfies the needs of constituents in the region.

### The content of accounting standards

The International Accounting Standards Board currently has 38 accounting standards these are available at [www.iasb.org/IFRSs/IFRS.htm](http://www.iasb.org/IFRSs/IFRS.htm). This section looks at the implications of selected IFRS standards for different companies in Ireland: small and medium companies and public benefit entities (not-for-profit companies). In addition it looks at accounting for: financial instruments, and insurance contracts. Accounting for financial instruments and insurance contracts are areas of continuing differences between international and US accounting standard-setters. The discussion that follows is based on publicly-available documents setting out the position of the IASB at the time of writing: this position may change as a matter of course as a result of the IASB’s deliberation processes.

### Accounting by small and medium-sized companies

The vast majority of companies in the Irish economy are small and medium-sized entities. The Companies Registration Office (CRO, 2008, p. 12) states that over 99% of companies in Ireland fall into this category.

Companies that are not listed on a stock exchange vary greatly in size and economic importance. The IASB's proposed classification of companies divides on the basis of public accountability rather than size. This could result in some very large companies using IFRS for SMEs (also referred to by the IASB as 'IFRS for Non-Publicly Accountable Entities'). These could be large private companies or family companies. The IASB suggests IFRS for SMEs is a high quality reporting framework, providing an adequate level of transparency for such companies.

EU-endorsed IFRS was developed with large listed companies in mind and is definitely not an appropriate reporting framework for non-publicly accountable entities. IFRS for SMEs is a stand-alone standard that is derived from the full IFRS standards but simplified for non-publicly accountable entities. Many of the more onerous requirements of IFRS which are really intended for large publicly listed companies have been dropped or simplified in IFRS for SMEs. Aidan Lambe (2010), Chartered Accountants Ireland Director of Technical Policy, described the IFRS for SMEs, if adopted, as, 'one of the most significant changes in accounting for the last twenty years.'

The accounting treatment of financial instruments, for example, is greatly simplified in IFRS for SMEs as compared to the full IAS 39 *Financial Instruments: Recognition and Measurement*. IFRS for SMEs runs to about 230 pages and contains everything that is required for accounting for SMEs. (In contrast, IAS 39 extends to 100 pages, excluding the IASB's basis for conclusions. The text of the full corpus of accounting standards issued by the IASB extends to over 2,500 pages.)

Financial Reporting Standard for Smaller Entities (FRSSE) is a standard developed by the Accounting

Standards Board in 2002 and updated several times since then. It is intended for companies that qualify as small companies under the UK or Irish Companies Acts. The Irish criteria for small<sup>12</sup> companies are to meet two of the following three tests in the previous two consecutive years: assets less than €1.9m; turnover less than €3.8m and less than 50 employees. Like IFRS for SMEs, the FRSSE is intended as a stand-alone standard for small companies that simplifies financial reporting by excluding small companies from reporting obligations that are not appropriate to them. There is evidence that the use of the FRSSE is not prevalent in Ireland (McAleese, 2000, 2001).

Unfortunately, FRSSE is based on UK/Irish GAAP and is inconsistent with IFRS in a number of areas. The Accounting Standards Board's proposal would still leave a large number of Irish companies reporting under a simplified version of UK/Irish GAAP. The ASB has noted that field testing of IFRS for SMEs by the Association of Chartered Certified Accountants (ACCA) did not produce any great problems and that even small companies may be able to use IFRS for SMEs in the longer term (ACCA, 2008).

The EU has also been studying financial reporting by small companies as part of its review of the accounting directives. An EU (2009) study into the administrative costs of EU Accounting Law found that the most significant burden reduction could be achieved by exempting micro entities from the application of the Fourth Council Directive<sup>13</sup> on drawing up annual accounts. The estimated burden saving in the EU associated with the

<sup>12</sup> Companies (Amendment) Act, 1986 S8.2 as amended by S.I. 93/396. Figures converted to Euro.

<sup>13</sup> 78/660/EEC of 25/7/78 implemented in Irish Law by the Companies (Amendment) Act, 1986.

exemption amounts to €5.79bn. Micro entities are the smallest companies. For this proposal they have to meet two of the three following criteria: assets of not more than €500,000; net turnover of not more than €1,000,000; not more than ten employees. The proposal has been agreed by the European Parliament and is currently with the Council of Ministers. If approved at European-level, it would be a matter for individual Member States to decide whether or not to apply the exemption in their own jurisdictions.

### **Accounting by Public Benefit Entities**

Public benefit entities (not-for-profit) are entities whose principal objective is not the generation of profit. IFRS-based standards are not designed to apply to public benefit entities such as charities, cooperative societies and credit unions. The ASB has proposed that it would develop a public benefit standard which would set out where different accounting is required for public benefit entities.

The ASB envisages that credit unions will meet the proposed definition of 'publicly accountable' due to the nature of their activities. This would be a significant step for many smaller credit unions for which full IFRS would potentially be unduly complex. As there is currently no size test for tier 1 entities, this could place a very considerable burden on small credit unions. Ultimately, the Registrar of Credit Unions will have a role in determining the financial reporting requirements for credit unions.

Smaller cooperative societies could be in a similar position to credit unions in that they may be forced to apply full IFRS on the basis of their public accountability. Financial reporting by cooperatives is currently under review as part of a wider consultation on legislation relating to Industrial and Provident Societies (Department of

Enterprise Trade and Employment, 2009).

### **Accounting for financial instruments**

Financial instruments comprise a wide range of assets and liabilities, including cash, amounts receivable from customers, loans receivable and payable, ordinary and preference shares and derivatives (items which derive their value from another item) such as options, futures contracts and forward rate agreements. The accounting treatment of financial instruments has been a source of consistent controversy in the light of the financial crisis. It continues to be a matter of difference and debate between the IASB and the US FASB (IASB, n.d.).

The International Accounting Standards Board's original accounting standard in the area of accounting for financial instruments was IAS 39 *Financial Instruments: Recognition and Measurement* (issued in March 1999). The Standard requires that financial instruments be treated in financial statements based on the company's intentions with regard to the instrument.

- Financial instruments which were held for trading or available for sale were valued in the financial statements at their fair value.
- Loans and receivables and held to maturity investments are valued at amortised cost.

Amortised cost allocates the cost of the instrument to the income statement between accounting periods using the effective interest rate on the instrument. Conventional loans are held in the accounts of financial institutions at amortised cost subject to any impairments (as discussed later).

Fair value is defined by the International Accounting Standards

Board (1993, para .11) as 'the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction'. Opponents of fair value have argued that valuing financial instruments at fair value allows the short-term volatility of the markets to disrupt company balance sheets, even when the company does not intend to sell those assets in the short-term (see, for example, G20, 2009, p. v). Fair value has thus been blamed for over-stating the true value of companies.

However, Ryan argues that

"some parties have tried to pin the blame for the subprime crisis on fair value accounting . . . This is untenable. The subprime crisis was caused by firms, investors and households making bad operating, investing, and financing decisions, managing risks poorly and, in some instances, committing fraud", not by accounting" (2008a, p, 1607).

Nonetheless, he goes on to state that this does not mean that guidance from accounting standard-setters to preparers of financial statements 'regarding fair value measurements in illiquid markets cannot be improved'(Ryan, 2008a, p.1608).

A further criticism of IAS 39 arises from the accounting standards governing the recognition of loan losses (or impairments). Under current accounting rules, the IASB (2003, paras. 58-59) only allows the recognition of loan losses when there is 'objective evidence' based on 'observable data' that the loan will not be recovered. 'Losses expected as a result of future events, no matter how likely, are not recognised'. The IASB accepts that

"... This has resulted in the incurred loss model being criticised during the global financial crisis for recognising expected losses too late" (IASB, 2009b, p. 4).

As a result of these criticisms, the IASB is amending IAS 39 in three phases (see Table 2).

**Table 2:** The current status of the IASB review of IAS 39 *Financial Instruments: Recognition and Measurement*

Phase	Exposure Draft
<p><b>Phase 1:</b> a review of the classification and measurement rules relating to financial assets and financial liabilities.</p> <p>(In November 2009, the IASB published the finalised IFRS 9 <i>Financial Instruments</i> for financial assets only – the accounting treatment of financial liabilities is still under discussion).</p>	<p><i>Fair Value Option for Financial Liabilities</i> published May 2010 – comment period to 16 July 2010.</p>
<p><b>Phase 2:</b> a review of the recognition and disclosure of loan asset impairments, including how provisions for loan losses and changes in asset quality are treated in financial statements.</p>	<p>Published November 2009 – comment period to 30 June 2010</p>
<p><b>Phase 3:</b> a fundamental reconsideration of the accounting treatment for hedge transactions.</p>	<p>Deliberations ongoing, target for first quarter of 2010 not met, new target is now mid-2010</p>

*Phase 1: The classification and measurement of financial assets and financial liabilities*

In November 2009, the IASB published IFRS 9 *Financial Instruments*, which covers the classification and measurement of financial assets only. IFRS 9 classifies financial assets based on the business model within which they are held and the certainty of the cash flows associated with the asset.

All other financial assets should be measured in the financial statements at their fair value.

The accounting treatment under IFRS 9 attempts to reflect in the financial statements the risk relating to financial assets. Financial assets which are held with a view to collecting the contractual cash flows and where those contractual cash flows are relatively certain as to the timing and amount of their receipt are in the

financial statements at amortised cost (as in Exhibit 1). Financial assets which are not held with a view to collecting the contractual cash flows and/or where the cash flows relating to the asset is more uncertain will be valued in the financial statements at fair value. The riskier the asset, therefore, the more likely it will be valued at its fair value.

In its submission to the IASB on these proposals, the European Commission expressed ‘significant concerns that the proposals set out in the Exposure Draft will, for some categories of reporting entities, result in an inappropriate application of fair value accounting – which would de facto become the default category . . . Such an impact should be avoided, as it results in an inappropriate broadening of reporting under fair value rules that risks exacerbating income volatility and undermining financial stability.’<sup>14</sup>

<sup>14</sup> <http://www.iasb.org/NR/rdonlyres/B9C94177-6E3F-4CEE-83E9-0481254FC736/0/CL199.pdf>

At the time of writing it is therefore unclear whether the Accounting Regulatory Committee of the European Commission will endorse IFRS 9. At its meeting of 11 November 2009, differing views were expressed as to the merits of endorsing the Standard in advance of the IASB's remaining proposals regarding financial instruments.<sup>15</sup>

While the EU Commission has expressed concerns about the continued application of fair values by the IASB, the FASB (2010, p. 1) has issued a proposed accounting standards update which would require

- (i) presentation of both amortized cost and fair value on an entity's statement of financial position for most financial instruments held for collection or payment of contractual cash flows and
- (2) the inclusion of both amortized cost and fair value information for these instruments in determining net income and comprehensive income.

This proposal is likely to lead to a more widespread use of fair value accounting in the United States, albeit with a disclosure of amortised cost. The FASB proposal explicitly extends the application of fair value accounting for financial instruments where the IASB proposes that they be accounted for using amortised cost. In other words, the FASB and IASB proposals are directly at odds in this regard.

This suggests that the approach adopted by the IASB in IFRS 9 is not supported by the FASB and the EU Commission for contrasting reasons. The FASB (with which the IASB is looking to harmonise) favours fair value. The European Commission (which endorses IFRSs for use in the EU) is not enthusiastic. It seems

increasingly unlikely that the IASB will be able to satisfy both.

IFRS 9 does not become mandatory until annual periods beginning on or after 1 January 2013. (The Standard allows, but does not require, early application for 2009 year-end financial statements.) The contrasting reactions to IFRS 9 on both sides of the Atlantic suggest that its provisions may be amended before they are ever applied.

At the time of writing, the classification and measurement of financial liabilities is a matter of ongoing discussion. The main issue with regard to accounting for financial liabilities relates to the treatment of changes in those liabilities due to changes in the creditworthiness of the company. As IAS 39 currently stands, the cash flows arising from long-term financial liabilities are discounted to reflect the fact that cash flows received in the future are worth less in today's money (due to, for example, interest rates, inflation and risk in the period before the liabilities are paid). If a company's creditworthiness disimproves, the risk associated with the company increases and the discount rate (the rate by which future cash flows are divided) increases. This means that the amount by which the company's long-term liabilities are divided increases and the present value of the liabilities in the company's balance sheet decreases. A company's creditworthiness decreases, the value of its liabilities decrease and it shows a gain in the income statement (and an increase in profit). This accounting treatment – required under IAS 39 – lacks logic.

As a result, the IASB has issued an Exposure Draft in May 2010 proposing that changes in the value of liabilities which arise from changes in the company's own creditworthiness should not be recorded in the income statement (and should therefore not effect profit) but in a statement

<sup>15</sup>[http://ec.europa.eu/internal\\_market/accounting/docs/arc/2009-11-11\\_ARC\\_IFRS9\\_en.pdf](http://ec.europa.eu/internal_market/accounting/docs/arc/2009-11-11_ARC_IFRS9_en.pdf)



showing a wider set of gains and losses (the statement of comprehensive income). The ED was open to comment until 16 July 2010.<sup>16</sup>

This proposal is largely uncontroversial and is likely to be implemented.

*Phase 2: Loan asset impairments, including how provisions for loan losses and changes in asset quality are treated in financial statements*

A study published by the SEC in December 2008 (SEC, 2008) suggests that, for most financial institutions, the main problem during the financial crisis was not fair value accounting but the losses incurred on their loans and other assets. Conventional bank loans are not held at their fair value under international accounting standards. Therefore, fair value is not the accounting problem in the context of these loans: the accounting problem is when losses (called 'impairments') on those loans are recognised.

Under current accounting rules, the IASB (2002, paras. 58-59) only allows the recognition of loan losses when there is 'objective evidence' based on 'observable data' that the loan will not be recovered. 'Losses expected as a result of future events, no matter how likely, are not recognised'. To give 'a true and fair view' as required by law, these are the accounting standards which the directors apply and on which the auditors base their opinion.

The IASB accepts that  
"the impairment model  
under current IFRSs is an  
incurred loss model.  
Under the incurred loss  
model, loans may be

written down (impaired)  
only when evidence is  
available that a loan or  
portfolio of loans will not be  
repaid in full . . . This has  
resulted in the incurred  
loss model being criticised  
during the global financial  
crisis for recognising  
expected losses too late."  
(2009, p. 4)

The IASB proposals regarding loan loss impairments are contained in an Exposure Draft issued in November 2009.<sup>17</sup>

The IASB is proposing to move away from the incurred loss model to an expected loss model. Under the expected loss model banks and other financial institutions would recognise expected losses on loans earlier. Credit loss expectations would be updated in each accounting period.

While this accounting treatment will require banks and other financial institutions to recognise loan losses earlier, giving relevant information earlier, these loan losses will be based on expectations and estimates to a greater extent. The proposed accounting treatment will also allow banks to build up a provision over the life of the loan for the expected credit losses.

*Phase 3: a fundamental reconsideration of the accounting treatment for hedge transactions.*

The IASB has not yet issued a proposal with regard to the accounting treatment for hedge transactions. Some of the original requirements of IAS 39 in this regard were not supported by either the European

<sup>16</sup> The IASB has issued a 'snapshot' in this area which is intended to be more accessible to readers. It is available at <http://www.iasb.org/NR/rdonlyres/35CED5D6-82ED-4B65-B5BB-ED21E516AA37/0/SnapshotEDFairValueOptionsforFinancialLiabilities.pdf>

<sup>17</sup> The IASB has issued a 'snapshot' in this area which is intended to be more accessible to readers. It is available at <http://www.iasb.org/NR/rdonlyres/B01BB410-D2C8-42B3-A873-8675AE919E21/0/SnapshotFIImpairment5November.pdf>

Commission or the FASB. Consequently, this is likely to be a difficult area on which to reach a consensus internationally.

### **Insurance contracts**

Given the level of insurance and reinsurance activity in the Irish Financial Services Centre (IFSC) the accounting treatment of insurance contracts is potentially very important for Ireland.

In 2004, the IASB issued IFRS 4 *Insurance Contracts*, an interim standard that permits a wide variety of accounting practices for insurance contracts. The IASB admits that 'many of these practices differ from those used in other sectors and make it difficult to understand insurers' financial statements'.<sup>18</sup>

As a consequence, the IASB intends to develop a standard replacing IFRS 4. In 2007, the IASB published a discussion paper *Preliminary Views on Insurance Contracts*. Fair value is once again at the heart of the IASB's deliberations: the discussion paper proposes that insurance liabilities be measured at "current exit value", being the amount that an insurer would expect to pay at the end of the accounting period to transfer its remaining contractual rights and obligations immediately to somebody else. This gives rise to a number of difficult practical and conceptual issues which remain unresolved.

Both the IASB and the FASB hope to finalise a common standard on insurance contracts by the end of 2011. They have, to date, reached different conclusions on several important technical issues and this deadline appears to be a challenging target given the complexities of the issues involved.

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<sup>18</sup>[www.iasb.org/Current+Projects/IASB+Project/s/Insurance+Contracts/Insurance+Contracts.htm](http://www.iasb.org/Current+Projects/IASB+Project/s/Insurance+Contracts/Insurance+Contracts.htm)

### **IFSC Investment Funds**

IFRSs do not provide guidance for industry specific issues. For example insurance companies, investment companies and pension schemes all have accounting issues that are not addressed in general purpose accounting standards. Under UK/Irish GAAP these issues are addressed by Statements of Recommended Practice (SORPs). These statements are developed and maintained by specific industry bodies. The SORPs are not formally part of the ASB's extant literature. However, the ASB oversees the development of SORPs through its policy and code of practice on SORPs and provides a negative assurance statement for each SORP confirming that nothing in the SORP conflicts with UK/Irish GAAP. No equivalent industry specific guidance is currently available under IFRS. The ASB proposes that SORPs should only remain where there is a clear and demonstrable need arising from sector specific issues not covered by guidance in accounting standards.

At the time of writing, the ASB is planning to issue an exposure draft regarding the SORP for Investment Companies: the exposure draft will clarify the ASB's position with regard to the key accounting and standard-setting issues in this area.

### **Conclusion**

Over the last 10 years the developments in accounting standards have been dominated by an international impetus to develop and adopt international accounting standards. This project was advanced by the EU's adoption of IFRS for listed companies in 2005. The next phase of this project is to adopt IFRS for non-listed entities. The development of IFRS for SMEs has made this change much more acceptable for medium sized entities. There are still potential problems in adopting IFRS for small companies and the ASB has proposed that a subset of UK/Irish GAAP should remain for small companies. The

adoption of IFRS is a positive move towards one set of high quality accounting standards for all Irish companies. However, some sensitivity towards small companies and other non-commercial entities will be required to ease the transition for them.

Accounting standards provide a basic framework for high quality financial reporting. Accounting standards, by their nature, require directors to exercise judgement which will result in the financial statements that reflect as well as possible the underlying economic position of the company. Recent Irish corporate failures have led to an increased emphasis on the responsibilities of directors and auditors in this regard.

The financial crisis has demonstrated that there were weaknesses in the requirements of accounting standards with regard to bank disclosures of their loan books and the accounting for impairments on those loans. This has led to a stronger spotlight on the context and content of accounting standards by national governments and international agencies. In particular, there has also been a political and commercial drive to harmonise accounting standards between the US and the rest of the world (IFRS). While there has been significant progress in this regard, as discussed, important differences have arisen between the approaches of the FASB and the IASB with regard to the use of fair values in financial statements. The departure of Robert Herz as Chairman of the FASB on 1 October 2010 may signal a change in the FASB's approach in this regard. However, in the short-term, his departure creates some additional uncertainty regarding the timing and direction of the FASB's consideration of standard-setting proposals at least until the appointment of the new Chairman and an additional two members of FASB, scheduled for early 2011.

It therefore remains to be seen if, as David Tweedie, the Chairman of the IASB argues, 'there is clear momentum towards accepting IFRSs as a common financial reporting language throughout the world' (including the U.S.).<sup>19</sup>

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