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Economic and Monetary Affairs

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**IFRS Endorsement
Criteria in Relation to
IFRS 9**

STUDY for the ECON Committee

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DIRECTORATE GENERAL FOR INTERNAL POLICIES
POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

IFRS Endorsement Criteria in Relation to IFRS 9

STUDY

Abstract

IAS Regulation 1606/2002 introduces three criteria for the endorsement of an international accounting standard, a 'true and fair view' criterion, qualitative criteria, and a 'European public good' criterion. In this study, these criteria are described against the background of European accounting law and academic accounting research. Then, the paper evaluates whether the new IFRS 9 standard on accounting for financial instruments meets these criteria. We conclude that the standard cannot reasonably be rejected on grounds of the IAS Regulation.

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LIST OF ABBREVIATIONS

ACCA	Association of Chartered Certified Accountants
CFA	Chartered Financial Analyst
EBA	European Banking Authority
ECB	European Central Bank
ECJ	European Court of Justice
ECOFIN	Economic and Financial Affairs Council
EEC	European Economic Community
EFrag	European Financial Reporting Advisory Group
EIOPA	European Insurance and Occupational Pensions Authority
EPG	European Public Good
ESMA	European Securities and Markets Authority
EU	European Union
FEI	Financial Executives International
FRC	Financial Reporting Council (of the U.K. and the Republic of Ireland)
GDP	Gross Domestic Product
IAS	International Accounting Standards
IASB	International Accounting Standards Board
ICAEW	Institute of Chartered Accountants in England and Wales
IFRS	International Financial Reporting Standards
LAPFF	Local Authority Pension Fund Forum (U.K.)
OCI	Other Comprehensive Income
QC	Queen's Counsel
S.E.C.	Securities and Exchange Commission (U.S.A.)
TFV	True and Fair View

EXECUTIVE SUMMARY

Background

The IASB completed its work on IFRS 9 in July 2014. The new standard is supposed to replace large parts of the currently applicable IAS 39 for financial years beginning in 2018. IFRS 9 is the result of different forces participating in the IASB's due process. Different participants in the process favoured different accounting regimes where a market-based regime and a cost-based regime represent the extreme positions that were taken. Net benefits of the different accounting regimes vary across the different parties. Therefore, the **present version of IFRS 9 is a political compromise** and, thus, a 'market equilibrium'. It reflects a balanced 'mixed measurement' approach that incorporates the different views of the participants in the debate. The **new standard will not fundamentally change the current accounting treatment for financial instruments under IAS 39**. The most significant change most likely comes from the new expected loss approach to the impairment of loans.

At the next stage, the European Union (EU) has to make a **decision about the endorsement of IFRS 9**. The European Parliament will be involved in this decision and has veto power in this process¹. The **endorsement decision must comply with EU Regulation 1606/2002** (IAS Regulation). Article 3(2) IAS Regulation introduces three distinct endorsement criteria that need to be met cumulatively by any new IFRS:

- The standard is not contrary to the **'true and fair view'** (TFV) principle as outlined in the EU Accounting Directives², **and**
- The standard is conducive to the **European public good** (EPG), **and**
- The standard meets the **criteria of understandability, relevance, reliability and comparability** required of financial information which is needed for making economic decisions and assessing the stewardship of management.

Previous endorsement decisions were checked for their observance of all three criteria. The literature has not agreed on a unanimous interpretation of these three criteria. In fact, **all three criteria are vague by nature and provide EU institutions with substantial discretion in the endorsement process**. The political discretion that the EU has over the endorsement process provides the EU with substantial *ex ante* power over the IASB's standard-setting process. We observe that several EU institutions (EFRAG, EBA, EIOPA, ESMA) made use of their power and intervened into the IASB's development of IFRS 9. The IASB was responsive to these interventions and changed the standard multiple times before its final pronouncement in July 2014.

Empirical evidence from the IAS 39 carve-out decisions suggests that any non-endorsement is associated with **significant economic costs caused by impeding global comparability of IFRS financial statements**. Overall, the design of the EU's endorsement process, therefore, provides a setup where the ***ex ante* influence over the IASB's standard-setting is an economically more desirable way of changing IFRS accounting rules than *ex post* intervention during the endorsement process**.

¹ For an overview of the procedure, see Botzem, Figure 5, page 27.

² The two directives that the IAS Regulation 1606/2002 continues to refer to are Directive 78/660/EEC and Directive 83/349/EEC which have in the meantime been repealed and replaced by the Accounting Directive 2013/34/EU. However, the wording of the true and fair view principle remained more or less unchanged in Article 4(3) of the new Accounting Directive 2013/34/EU. In the following, we refer to all three Directives as **'the Accounting Directives'** in their respective historic context, noting that the relevant provision is now Directive 2013/34/EU.

Assessment of the Endorsement Criteria in Relation to IFRS 9

The True and Fair View (TFV) Criterion

There is significant disagreement among academics and regulators about the interpretation of the TFV principle. The Accounting Directives have evolved substantially over time and Member States have implemented them differently into national law. On the one hand, the TFV is viewed to be a dynamic criterion that largely refers to common accounting practice accepted by market participants. According to this view, IFRS 9 clearly meets the endorsement test. On the other hand, the TFV can be understood as being reflective of the general spirit and the individual norms of the Accounting Directives. Most notably, a 1996 ECJ verdict names the **prudence principle** as **the core of the European TFV principle**.

The prudence principle can only be understood in the context of the Accounting Directives in their entirety over time. Against this background, it becomes clear that prudence does not require a pure cost basis for financial accounting. In fact, Member States have extensive options to permit or require fair value accounting for financial and non-financial instruments under today's Directives (see overview in Table 1). Our analyses show that IFRS 9 does not go further in permitting or requiring fair value accounting relative to the Directives. Therefore, even under a TFV criterion that is largely determined by the prudence principle, IFRS 9 cannot reasonably be rejected on these grounds.

The Qualitative Criteria

The four qualitative criteria are of a **technical nature**. Their definitions are well established in the accounting literature and so is their operationalisation in accounting research. Yet, **many criteria conflict with each other** with the most prominent trade-off probably being the one between relevance and reliability. Therefore, the overall assessment of the criteria requires individual judgment and weighting of different interests (for example, of shareholders and lenders). In our analysis at least some aspects of IFRS 9 score high on many of the four criteria. We conclude that the qualitative criteria do not provide convincing grounds for rejecting the endorsement of IFRS 9.

The European Public Good (EPG)

The IAS Regulation introduces the European public good (EPG) as a key endorsement criterion without providing a clear-cut definition. Economics and political sciences offer different definitions of the public good and these **definitions are partially incompatible**. The Maystadt Report proposes that the criterion be interpreted in light of a standard's effect on **financial stability** and the EU's **economic development**. We observe that prudential supervisors from Europe did not express significant concerns about the impact of IFRS 9 on financial stability and, when assessing the standard in its entirety, we **do not foresee such an adverse impact**. The operationalisation of the economic development is at least as vague as for the EPG. In our view, the only feasible way to assess the EPG is by means of a comprehensive **cost-benefit analysis** that considers the reactions of different stakeholders to the proposed standard.

Any cost-benefit analysis will not lead to a unanimous conclusion since, by definition, costs and benefits will be borne by different parties affected by the final standard. In the case of IFRS 9, for example, implementation costs will be greatest for the insurance industry where IFRS 4 is still under revision by the IASB with significant changes to some of the IFRS 9 policies to be expected in relatively short term. The key benefits of IFRS 9, for instance its greater understandability, will be obtained by other parties. Ultimately, it is a purely **political decision** how to weight these different costs and benefits of different parties. Overall, we still conclude that IFRS 9 is likely to be conducive to the European public good, not at least because it is a better standard than its widely criticised predecessor IAS 39.

On these grounds, we recommend that the EU endorses IFRS 9.

Table 1: Legal Provisions in the Area of Accounting

Accounting Regulatory Committee (ARC) ³		
European Financial Reporting Advisory Group (EFRAG) ⁴		
Accounting and IAS		Banks and Insurance
11 th Cross-border Branches disclosure Directive ⁵		Bank Branches Obligations Directive ⁶ Annual Accounts and consolidated Accounts of Banks Directive ⁷
IAS Regulation: International Accounting Standards <u>Application Regulation</u> ⁸ [endorsement procedure + Council Decision ⁹]	IAS <u>Adopting Regulation</u> ¹⁰ [=EU IAS/IFRS Standards]	Fair Value Directive ¹¹
	IAS Financing Regulation ¹²	
Accounting Directive ¹³		Insurance Accounts Directive ¹⁴

Source: EP, based on *EU Mapping: Systematic overview on economic and financial legislation*, Brussels, 2014.

³ See http://ec.europa.eu/internal_market/accounting/governance/committees/arc/index_en.htm on this group.

⁴ See http://ec.europa.eu/internal_market/accounting/governance/committees/efrag/index_en.htm.

⁵ Eleventh Council Directive 89/666/EEC of 21 December 1989 concerning disclosure requirements in respect of branches opened in a Member State by certain types of company governed by the law of another State, *OJ L 395*, 30.12.1989, p. 36; consolidated version; <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:01989L0666-20120706&from=EN>.

⁶ Council Directive 89/117/EEC of 13 February 1989 on the **obligations of branches** established in a Member State of credit institutions and financial institutions having their head offices outside that Member State regarding the publication of annual accounting documents, *OJ L 44*, 16.2.1989, p. 40; <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:31989L0117&qid=1396284278324&from=EN>.

⁷ Council Directive 86/635/EEC of 8 December 1986 on the **annual accounts and consolidated accounts of banks** and other financial institutions, *OJ L 372*, 31.12.1986, p. 1; consolidated version; <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:01986L0635-20060905&qid=1396283910993&from=EN>.

⁸ **Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards**, *OJ L 243*, 11.9.2002, p. 1; consolidated version; <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02002R1606-20080410&qid=1396284041379&from=EN>.

⁹ **Regulatory Procedure with Scrutiny** (not yet adapted to Articles 290/291 TFEU): Council Decision 1999/468/EC, *OJ L 184* of 17.7.1999, p. 23; amended by Council Decision 2006/512/EC, *OJ L 200* of 22.7.2006, p.11; consolidated version; <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1999D0468:20060723:EN:PDF>.

¹⁰ Commission Regulation (EC) No 1126/2008 of 3 November 2008 **adopting certain international accounting standards** in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council, *OJ L 320*, 29.11.2008, p. 1; consolidated version; <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02008R1126-20130331&qid=1396284101551&from=EN>.

¹¹ Directive 2001/65/EC of the European Parliament and of the Council of 27 September 2001 amending Directives 78/660/EEC, 83/349/EEC and 86/635/EEC as regards the **valuation rules for the annual and consolidated accounts** of certain types of companies as well as of banks and other financial institutions, *OJ L 283*, 27.10.2001, p. 28; <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32001L0065&qid=1396283814819&from=EN>.

¹² Regulation (EU) No 258/2014 of the European Parliament and of the Council of 3 April 2014 establishing a Union programme to support specific activities in the field of financial reporting and auditing [**Financing Regulation**] for the period of 2014-20 and repealing Decision No 716/2009/EC, *OJ L 105* of 8.4.2014, p. 1; <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0258&qid=1444836499116&from=EN>.

¹³ Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the **annual financial statements, consolidated financial statements and related reports of certain types of undertakings**, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC, *OJ L 182*, 29.6.2013, p. 19; consolidated version; <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02013L0036-20150101&qid=1445004281879&from=EN>.

The **Accounting Directive** repeals the **Fourth Council Directive 78/660/EEC** of 25.7.1978 based on Article 54 (3) (g) of the Treaty on the annual accounts of certain types of companies; and **Seventh Council Directive 83/349/EEC** of 13.6. 1983 based on the Article 54 (3) (g) of the Treaty on consolidated accounts.

¹⁴ Council Directive 91/674/EEC of 19 December 1991 on the **annual accounts and consolidated accounts of insurance undertakings**, *OJ L 374*, 31.12.1991, p. 7; as amended; consolidated version (2006); <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:01991L0674-20060905&qid=1396283962386&from=EN>.

1. THE EU ENDORSEMENT OF IFRS

KEY FINDINGS

- Article 3(2) Regulation (EU) 1606/2002 (IAS Regulation) introduces three distinct endorsement criteria (true and fair view, conducive to the European public good, and qualitative criteria) that need to be met cumulatively by any new IFRS.
- Previous endorsement decisions were checked for observance of all three criteria.
- The literature has not agreed on a unanimous interpretation of the three criteria. In fact, all three criteria are vague by nature and provide EU institutions with substantial discretion in the endorsement process.
- The political discretion that the EU has over the endorsement process provides the EU with substantial *ex ante* power over the IASB's standard-setting process.
- Several EU institutions (EFRAG, EBA, EIOPA, ESMA) made use of their power and intervened into the IASB's development of IFRS 9. The IASB was responsive to these interventions and changed the standard multiple times before its final pronouncement in July 2014.
- Empirical evidence from the IAS 39 carve-out decisions suggests that any non-endorsement is associated with significant economic costs by impeding global comparability of IFRS financial statements.
- Overall, the design of the EU's endorsement process provides a setup where the *ex ante* influence over the IASB's standard-setting is an economically more desirable way of changing IFRS accounting rules than *ex post* intervention during the endorsement process.

1.1. Endorsement Criteria

Regulation (EU) 1606/2002 (IAS Regulation) introduced the endorsement of International Financial Reporting Standards (IFRS) in the European Union (EU). Since IFRS are prepared by a private body, i.e. the London-based International Accounting Standards Board (IASB), the Regulation established an EU endorsement process for all IFRS pronounced by the IASB. The process requires, *inter alia*, the evaluation of each accounting standard against a set of pre-defined criteria before the standard can become effective for European firms. The endorsement process¹⁵ ensures that the EU maintains its influence over financial accounting rules that are binding for listed EU firms and avoids an unconditional delegation of standard setting to a private body over which the EU has no formal influence.

Under Article 3(2) IAS Regulation, an international accounting standard can only be endorsed if

- it is not contrary to the principle set out in Article 2(3) of Directive 78/660/EEC and in Article 16(3) of Directive 83/349/EEC (the '**true and fair view**' (TFV) principle)¹⁶,
and

¹⁵ For an overview of the procedure, see Botzem, Figure 5, page 27.

¹⁶ The two Directives that the IAS Regulation 1606/2002 continues to refer to (Directive 78/660/EEC and Directive 83/349/EEC) have been replaced by the Accounting Directive 2013/34/EU. However, the wording of the true and fair view principle remained unchanged in Article 4 of the new Accounting Directive 2013/34/EU. In the following, we refer to all three Directives as 'the **Accounting Directives**' in their respective context.

- it is **conducive to the European public good (EPG)**, and
- it 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.

Table 2: Legal Texts on Endorsement Criteria (in particular TFV)

Directive/ Regulation	Text
Article 2 (2) Accounting Regulation (EU) 1606/2002	<p>2. The international accounting standards can only be adopted if:</p> <ul style="list-style-type: none"> - they are not contrary to the [TFV] principle set out in ex-Article 2(3) of Directive 78/660/EEC and in ex-Article 16(3) of Directive 83/349/EEC [now Article 4 (3) of Directive 2013/34/EU] and are conducive to the European public good and, - they meet the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.
Article 2 (3) 78/660/EEC ¹⁷	[4 th Company Law Directive; repealed] 3. The annual accounts shall give a true and fair view of the company's assets, liabilities, financial position and profit or loss.
Article 16 (3) ¹⁸ 83/349/EEC	[7 th Company Law Directive; repealed] 3. Consolidated accounts shall give a true and fair view of the assets, liabilities, financial position and profit or loss of the undertakings included therein taken as a whole.
Article 4 (3) Directive 2013/34/EU	<p>1. 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.</p> <p>Member States may require undertakings other than small undertakings to include other statements in the annual financial statements in addition to the documents referred to in the first subparagraph.</p> <p>2. The annual financial statements shall be drawn up clearly and in accordance with the provisions of this Directive.</p> <p>3. The annual financial statements shall give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss. Where the application of this Directive would not be sufficient to give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss, such additional information as is necessary to comply with that requirement shall be given in the notes to the financial statements.</p> <p>4. Where in exceptional cases the application of a provision of this Directive is incompatible with the obligation laid down in paragraph 3, that provision shall be disapplied in order to give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss. The disapplication of any such provision shall be disclosed in the notes to the financial statements together with an explanation of the reasons for it and of its effect on the undertaking's assets, liabilities, financial position and profit or loss.</p> <p>The Member States may define the exceptional cases in question and lay down the relevant special rules which are to apply in those cases.</p> <p>5. Member States may require undertakings other than small undertakings to disclose information in their annual financial statements which is additional to that required pursuant to this Directive.</p> <p>6. By way of derogation from paragraph 5, Member States may require small undertakings to prepare, disclose and publish information in the financial statements which goes beyond the requirements of this Directive, provided that any such information is gathered under a single filing system and the disclosure requirement is contained in the national tax legislation for the strict purposes of tax collection. The information required in accordance with this paragraph shall be included in the relevant part of the financial statements.</p>

Source: EU Official Journal.

¹⁷ See <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:31978L0660&from=EN> for the text of the repealed Directive.

¹⁸ See <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31983L0349:en:HTML> for the text of the repealed Directive.

The IAS Regulation does not offer a more precise definition for either one of the three criteria and neither do the Accounting Directives. Concepts like the TFV or the relevance and reliability of accounting numbers are controversially discussed in financial accounting research with different definitions of each concept being used simultaneously. Therefore, a clear-cut application of the endorsement criteria is not possible and EU institutions are left with considerable discretion regarding their decisions on the endorsement of IFRS.

This paper aims to develop a framework against which to judge IFRS 9. In particular, the paper outlines the different dimensions by which an endorsement criterion can be interpreted and examines how IFRS 9 fares in relation to these different dimensions.

1.2. Key Endorsement Decisions

The application of the endorsement criteria in previous decisions provides some evidence of how the criteria were interpreted in the practice of EU law-making. The European Commission makes those decisions publicly available on its website¹⁹. Until today, all standards that were pronounced by the IASB were eventually endorsed by the EU and thus became binding accounting law for EU firms. This observation emphasises that the endorsement process plays a more proactive role by granting the EU a credible threat towards the IASB and thereby greater power to intervene *ex ante* in the process of standard setting. The reclassification amendments to IAS 39 and IFRS 7 at the peak of the financial crisis in October 2008 are one example of the significant influence the EU has over the IASB²⁰. Yet, there are three notable exceptions where a new standard was at least controversial in the endorsement process and where, in two cases, the endorsed standard differed from the original standard pronounced by the IASB.

Table 3: History of Controversial Endorsement Decisions

Accounting Standard	Issue/Controversy	Endorsement Concern
IAS 39	Fair value option for liabilities	<i>'Article 42a of the Fourth Company Law Directive (Directive 78/660/EEC²¹) does not allow full fair valuation of all liabilities; the main category of liabilities excluded from fair valuation is companies fair valuing their own debt. Companies are therefore not allowed to use the full fair value option.'</i> ²² .
IAS 39	Hedge accounting	<i>'[The carve-out] reflects criticism by the majority of European banks, which argued that IAS 39 in its current form would force them into disproportionate and costly changes both to their asset/liability management and to their accounting systems and would produce unwarranted volatility.'</i> ²³ .
IFRS 8	Segment reporting	<i>'The impact assessment carried out by the Commission did not sufficiently take into account the interests of users.'</i> ²⁴ .

Source: Authors' research.

The history of endorsement decisions demonstrates that all three criteria are binding in the assessment of an accounting standard:

- The first controversy about the full fair value option for liabilities related to the TFV principle (criterion (1)). The EU decision highlights that the TFV was interpreted in

¹⁹ See http://ec.europa.eu/finance/accounting/ias/index_en.htm.

²⁰ See André et al.; Bischof/Brüggemann/Daske, 2014.

²¹ The directive has been replaced by Directive 2013/34/EU. The new Directive continues to prohibit the full fair value accounting for liabilities (see Article 8), i.e., the endorsement concern is still valid.

²² European Commission (2004).

²³ European Commission (2004).

²⁴ European Parliament.

light of the two European Accounting Directives that did not permit a complete fair value balance sheet in achieving the TFV.

- The second controversy about hedge accounting related, at least indirectly, to the EPG (criterion (2)). The reasons presented to justify the carve-out related to economic outcomes such as artificial market volatility, which are potentially harmful for the European economy. In this decision, the EU also referred to the potential implementation costs for the financial industry, suggesting that a cost-benefit analysis is one means of operationalising the assessment of the EPG.
- The third controversy was regarding the decision usefulness of the management approach underlying IFRS 8 for financial statement users such as analysts. This concern is what the relevance criterion (criterion (3)) typically captures in accounting research.

The history of **enforcement actions** also shows that carve-outs place an additional burden on firms that have equity shares cross-listed on the U.S. capital market (approx. 80 major European firms as of 2014). **The S.E.C. only accepts any firms' IFRS reports as being equivalent to U.S. GAAP-based financial statements if the firms make no use of any EU carve-out.** Therefore, cross-listed firms tend to emphasise in the footnotes to their financial statements that their IFRS application is consistent with both EU regulation and the original IFRS as pronounced by the IASB. **The more an EU-version of the IFRS deviates from the original IFRS, the higher will be the costs of achieving simultaneous consistency through firms' accounting choices.**

1.3. Public Perception of the Endorsement Process

From its inception, the endorsement process itself has been subject to public debate among researchers, practitioners and regulators. In order to consider potential implications of the IFRS 9 decision *ex ante*, it is important to be aware of these perceptions.

At its core, **the endorsement process seems to conflict with the overall objective of European IFRS adoption** and the EU's financial reporting strategy because this latter strategy seeks to establish greater comparability of financial statements worldwide and to ease the acceptance of EU firms' financial statements on capital markets outside the EU (most notably in the U.S.). But both, comparability and acceptance of European financial statements, are at risk when the endorsement decision leads to carve-outs or other deviations of the EU-version of IFRS from the original IASB-issued standards. That is, the decision *not* to endorse a standard is economically costly; prior evidence has shown that equity shares of EU firms had abnormal decreases in value when the decision about the IAS 39 carve-outs became publicly known in 2004²⁵. The literature views this conflict as a strategic dilemma that the EU faces in its decisions.

An alternative would be a formal process resulting in the mechanical endorsement of all IASB pronouncements when a predefined set of precise criteria is met ('check-list' or 'tick-box' approach). Yet, **if the process was indeed mechanical, the EU would lose much of its political power over the IASB**, which has steadily increased over the last decade. The reason is that the IASB could exactly predict at which point the predefined set of criteria would be technically met, and from that point onwards, the EU would lose any further influence. Therefore, in the current equilibrium, the endorsement criteria must provide EU institutions with at least some flexibility to deny the endorsement, while, at the same time, should lead to the IASB changing the standards beforehand in response to feedback from EU institutions, rather than those changes being implemented throughout the endorsement process.

²⁵ See Armstrong et al.

Against this background, it is important to note that the IASB's development of IFRS 9 was a five-year process starting in 2009 where several EU institutions became involved at different stages; this involvement did have an impact on the eventual standard. For example, institutions such as EFRAG, EBA, EIOPA or ESMA frequently participated in the IASB's due process²⁶ during which the IASB changed the standard significantly multiple times. When conducting our background research for this paper, we have also examined the participation of EU institutions in the IFRS 9 due process and the IASB's responsiveness to comment letters. Based on these observations, we conclude that the **IASB has taken positions brought forward by EU institutions seriously**. In fact, we argue that the IASB's behaviour is purely rational as the private body itself struggles to gain legitimacy and funding²⁷, which are both severely threatened by a standard's failure in the EU endorsement process. Consistent with our view, observers of the S.E.C.'s role in the convergence project claim that the **IASB's responsiveness to EU interests explains why the project is currently put on hold by the S.E.C.**²⁸.

There is a wide consensus in the accounting literature that the present endorsement criteria lack precision and there is a **considerable unresolved debate about the correct interpretation of these criteria**²⁹. But while many commentators view the broad endorsement criteria as being **too vague for establishing legal certainty**³⁰, **it is the vagueness of the criteria that largely establishes the political discretion necessary for the EU to have influence over the IASB *ex ante***. Uncertainty about the criteria impedes the IASB's ability to exactly anticipate the outcome of the process and, thus, gives EFRAG and other EU institutions more leverage in negotiations.

At the same time, the vagueness of the criteria makes the endorsement process susceptible to firms lobbying for special interests. For example, some call the application of the endorsement criteria in regards to IAS 39 of '*dubious merit*'³¹. Former French President, Jacques Chirac's famous letter to then-President of the European Commission, Romano Prodi on the subject of hedge accounting provides evidence that there needs to be political support at the highest level for an accounting standard to be put on hold during the endorsement process³². Thus, it is probably fair to emphasise that the EU's previous endorsement decisions led to the public impression that the process provides solely a means for national politicians to become involved *ex post*, i.e., after the IASB's due process, and allows them to cater to vested interests.

Overall, and at the most general level, we caution against a premature decision not to endorse any standard, as such a decision would

- almost certainly lead to substantial economic costs and
- potentially hamper the EU's influence over the IASB in the future.³³

In light of this evidence, the endorsement criteria need to be regarded with great care and the following chapters aim to provide a framework for such an assessment.

²⁶ The Maystadt Report proposes that the activities of EU institutions be bundled and coordinated by one institution alone (e.g., EFRAG) to further enhance the EU's influence over the IASB's standard-setting, see Maystadt.

²⁷ See, for example, Danjou/Walton; Sunder.

²⁸ See Zeff (2012); Katz.

²⁹ See Alexander (2006); Wüstemann/Kierzek (2005, 2006); Alexander/Eberhartinger.

³⁰ See Wüstemann/Kierzek (2005, 2006); Schmidt et al..

³¹ Nobes/Parker, p. 226.

³² See Walton; Whittington.

³³ While some jurisdictions have already endorsed IFRS 9 (e.g. Canada, see <http://www.osfi-bsif.gc.ca/eng/fi-if/rq-ro/gdn-ort/adv-prv/Pages/freifrs9.aspx>), in others new IFRS will automatically become legally binding. Our observation is that many jurisdictions are closely following, if not awaiting, the EU's endorsement decision.

2. THE TRUE AND FAIR VIEW CRITERION

KEY FINDINGS

- The TFV criterion is derived from the EU Accounting Directives.
- There is significant disagreement among academics and regulators about the interpretation of the TFV principle. Different Member States have implemented the principle differently into national law and the underlying Accounting Directives have evolved substantially over time.
- On the one hand, the TFV is viewed to be a dynamic criterion that largely refers to common accounting practice accepted by market participants. Under this view, IFRS 9 clearly meets the endorsement test.
- On the other hand, the TFV can be understood as being reflective of the general spirit and the individual norms of the Accounting Directives. Most notably, a 1996 ECJ verdict names the 'prudence principle' as the core of the European TFV principle.
- The prudence principle can only be understood in the entire context of the EU Accounting Directives. Against this background, it becomes clear that prudence does not require a pure cost basis for financial accounting. In fact, Member States have extensive options to permit or require fair value accounting for financial and non-financial instruments under today's directives.
- Our analyses show that IFRS 9 does not go further in permitting or requiring fair value accounting relative to the Accounting Directives.
- Therefore, even under a TFV criterion that is largely determined by the prudence principle, IFRS 9 cannot reasonably be rejected on these grounds.

The first endorsement criterion states that IFRS shall not be contrary to the principle set out in *ex-Article 2(3)* of Directive 78/660/EEC (4th Company Law Directive) and in *ex-Article 16(3)* of Directive 83/349/EEC (7th Company Law Directive), that is: '*The annual accounts shall give a true and fair view of the company's assets, liabilities, financial position and profit or loss.*'; when these Directives were repealed by the Accounting Directive 2013/34/EC, the wording was taken up in Article 4(3) in a broader context, see Table 2. In the accounting literature, this principle is known as the true and fair view principle (TFV). In this chapter, we

- review the understanding of the TFV under the 4th and 7th Company Law Directive,
- evaluate the interpretation of the TFV criterion in the endorsement process against this historical background, and
- assess whether and, if so, to what extent the TFV comprises the prudence principle, as is frequently argued in the academic literature and in political debates.

2.1. The Lack of a Common TFV Interpretation under the EU's Accounting Directives

In line with the European Union's objective to establish a common market (*ex-Article 2* EC Treaty, now internal market in *Article 3(3)* Treaty on EU, *Article 26 ff.* Treaty on the Functioning of the EU), the Commission started a process of *harmonising* national European

accounting law. The effort resulted in the 4th and 7th Company Law Directives. The goal of these Directives was to create a '*level playing field*' in a single market while still accepting differences in national implementation. It was the 4th Directive in 1978 that initially introduced the requirement for company accounts to provide a TFV.

While its historical origins lie in U.K. case law³⁴, the principle is undefined and without a clear predecessor. Its great importance comes from the fact that

- through the Accounting Directives it has become, from a legal point of view, one of the leading accounting principles for EU Member States³⁵, and
- the different perceptions of its meaning and significance since its introduction into law '*are symptomatic of different cultural, legal and accounting attributes*'³⁶ in the EU. Even today, after almost 40 years in existence, these different perceptions on what constitutes TFV remain significant.

These different perceptions are aggravated by different terminology and different legal standing that national legislators used in the integration of the TFV principle into national law³⁷. Given that EU institutions accept largely heterogeneous and, in part, even contradictory measurement options into national accounting laws³⁸, it seems clear that the EU had a broad understanding of the TFV principle. In addition, there is no ECJ decision that would pronounce an opinion on the consistency of different national interpretations of TFV in regard to the Accounting Directives.

Germany and the U.K. represent the extreme ends of the opposite approaches to TFV. In the U.K. interpretation, which is based on accounting practice under British case-law tradition with an emphasis on professional judgement of the accounting profession, the 4th Company Law Directive of 1978 gives TFV '*an overriding importance, over and above "the provisions of this Directive"*'³⁹. For British lawyers, TFV is a '*dynamic concept*'⁴⁰, and '*legislators or standard setters can affect its meaning by constraining practice, as can companies by making policy choices*'⁴¹. Thus, the **U.K. interpretation attaches an importance to TFV that justifies deviations from other accounting rules (i.e., a TFV 'override')**. These deviations occur frequently in U.K. accounting practice with 1,141 observations noted just for the five-year period from 1998 to 2002⁴².

To the contrary, in the German Roman law-based tradition the methodology of legal interpretation requires gaps and ambiguities in the law to be closed in the context of the law itself. Thus, the more specific ex-Article 31 on valuation principles (such as prudence), and the individual legal accounting rules of ex-Articles 34-42 of the 4th Company Law Directive 78/660/EEC were used to interpret the TFV⁴³. Hence, by definition **a TFV is achieved if an account fully complies with all the individual rules outlined/prescribed/stated in the Directive and, thus, allows no room for any override**. Informational shortcomings that might arise from too prudent application of measurement rules shall rather be addressed in qualitative footnote disclosures⁴⁴. These

³⁴ Alexander (1993), p. 61.

³⁵ Ordeltelheide, p. 81.

³⁶ Alexander (1993), p. 72.

³⁷ See Aisbitt/Nobes.

³⁸ Ordeltelheide, p. 85.

³⁹ Alexander (1993), p. 61.

⁴⁰ Arden, para. 14.

⁴¹ Nobes, p. 85.

⁴² See Livne/McNichols.

⁴³ See for example Ordeltelheide's discussion on whether the percentage-of-completion method in long-term production is in accordance with 4th Company Law Directive.

⁴⁴ See Moxter; Ordeltelheide.

different approaches have implications for the role of prudence in the interpretation of the TFV principle, as it is **only under the latter German view where the TFV explicitly comprises the prudence principle**⁴⁵.

The two different approaches to TFV involve different risks of 'misreporting': The U.K. position risks excessive violations of rules and earnings management based on TFV overrides, while the German position risks that a strict application of the rules may fail, in abnormal circumstances, to provide an adequate picture of the firm. We note, however, that empirical evidence indicates that there is a sufficient degree of flexibility in preparing financial statements under either approach, as any accounting rule offers some leeway for managers⁴⁶. Under the 'incentives-based view' that is now broadly established in the accounting literature⁴⁷, it is clear that even a restrictive accounting system leaves considerable room for judgements. A number of large sample-based empirical studies have consistently documented that **the less flexible Germanic accounting systems allow/have significantly more earnings management in reporting practice than the more flexible British system**⁴⁸. The robust findings illustrate that the TFV override is not of first-order importance for actual financial reporting outcomes.

We finally comment that the European Commission, through statements of its Contact Committee on Accounting Directives and its former Head of Unit for Accounting Standards, Karel Van Hulle, took two noticeable stands in the debate: First, it made it clear that the TFV principle must be applied to the specific company⁴⁹, and *'Member States cannot introduce rules or standards which would be contrary to the rules in the Directive, otherwise the harmonisation objective would be seriously impaired'*⁵⁰. The statement puts at least some limit to the 'dynamic concept' of TFV interpretation and to the view that *'in short: true and fair is what British accountants declare it to be'*⁵¹. Second, Van Hulle commented that the introduction of TFV is an *'admission of modesty on behalf of the regulator'*, because **'no regulator is perfect and the accounting rules and standards which have been designed for the majority of cases can never take account for all cases which may arise in practice'**⁵².

2.2. The Role of the TFV Interpretation in the IFRS Endorsement Process

The IAS Regulation's direct reference to the Accounting Directives' TFV principle sheds a different light on the problem of the TFV interpretation. While practical implementation of the Accounting Directives resulted in some equilibrium over the years with different Member States following different interpretations, the endorsement process requires a uniform interpretation of the TFV criterion. In short, the question is reduced to whether the criterion fails whenever a new IFRS is inconsistent with any part of the Accounting Directives or whether the criterion is a dynamic, albeit less precise one.

⁴⁵ For example, Ordelheide argues that *'if it is one's opinion that the valuation principles of Art. 31 are characterized by a certain degree of prudent income determination – and this this seems conceivable – one has to accept a similar prudent solution in order to reduce open areas and ambiguities.'*, p. 83.

⁴⁶ See e.g. Ball et al.; Burgstahler et al.; Ball.

⁴⁷ See Burgstahler et al.; Leuz et al.; Daske et al. (2008) and (2013); Christensen et al.

⁴⁸ See e.g. Leuz et al.; Daske/Gebhardt/McLeay.

⁴⁹ See European Commission (1998).

⁵⁰ Van Hulle (1997), p. 714. See also the European Commission's (1998) Interpretative Communication providing clarification of Article 2(5) of the 4th Company Law Directive: *'In the interest of harmonisation, Member States may not use the last sentence of Article 2(5) in order to introduce an accounting rule of a general nature which is contrary to provisions of the Directive, nor can they use this sentence to create additional options allowing for accounting treatments which are not in conformity with the Directive'*.

⁵¹ Ordelheide, p. 82.

⁵² Van Hulle (1997), p. 719.

Evidence from prior EU legislation is inconclusive:

- On the one hand, the EU endorsed IFRS 3 early in the process and the standard became binding European accounting law in 2005. The standard does not allow for the systematic amortisation of purchased goodwill, which was, and still is, incompatible with the wording of Articles 34 and 37 of the 4th Company Law Directive. The EU's assessment that the standard still meets the TFV criterion clearly implies that IFRS do not need to map one-on-one into the Accounting Directives in order to be able to establish a TFV.
- On the other hand, the amending Directive 2003/51/EC aligned with a narrower view. The Directive amended the original Accounting Directives in 2003 by permitting the broader use of fair values in national accounting laws. The change was explicitly motivated by the need to facilitate the endorsement of IFRS. It was argued that the change in the fair value rules was necessary for the spirit of the Directives to be in general accordance with IFRS so that a TFV could be reasonably achieved through IFRS application⁵³. Directive 2003/51/EC, thus, suggests that individual accounting rules outlined in the EU's Accounting Directives do matter for the interpretation of the TFV principle.

The only ECJ ruling on this matter also supports the narrower view. In the context of the Tomberger/Wettern Case in 1996, the ECJ clarified that the '*Application of that [i.e. the true and fair view] principle must, as far as possible, be guided by the general principles contained in Article 31 of the Forth Directive*'⁵⁴. That understanding follows a more restrictive interpretation of Article 2(5), which would mean that TFV '*cannot act as the basis for the establishment of fundamentally different accounting principles and rules contradictory to the explicitly stated principles and rules of the EC Directive*'⁵⁵. Following the ruling, consistency with at least Article 31 must (appears to) be necessary for a TFV to be achieved. This is one key source of commentators emphasising the importance of Article 31's prudence principle for the endorsement process⁵⁶.

Yet, the Tomberger/Wettern case was a highly specific one. The court even noted that '*it should be emphasised at the outset that [...] the question arises in the context of highly specific circumstances*'.⁵⁷ **Even though the Court referred to the principles in Article 31 of the 4th Company Law Directive (such as prudence), the Court's actual verdict resulted in earlier recognition of dividends (which goes against prudence).** The ECJ also seems to accept that there can be different national meanings and not only one binding interpretation of TFV. The Court did *not* conclude that the unapproved dividends should be treated as revenue (para. 25), but rather that it is **not contrary to TFV** for a national court to consider that the profits in question must be entered in the parent company's balance sheet⁵⁸. Nobes (2006) interprets this statement as evidence that there can be multiple TFVs, consistent with the view that there is not '*the*' TFV, but rather '*a*' TFV. Accordingly, '*endorsement of an IFRS can be quite proper even if a non-IFRS treatment could also give a TFV*'⁵⁹.

⁵³ Directive 2003/51/EC, Recitals 6-8.

⁵⁴ See Judgement of the European Court of Justice, Case C-234/94, p. I-3133, para. 18.

⁵⁵ See Ordelheide, p. 83. In other words, '*The gateway of Art. 2 (5) seems to narrow for all derivations of British accounting from the accounting principles and rules of the Fourth Directive.*', pp. 83-84; see also European Commission (1998).

⁵⁶ For example, see Wüstemann/Kierzek (2005, 2006).

⁵⁷ See European Court of Justice, Case C-234/94, p. I-3133, para. 15.

⁵⁸ See Nobes, p. 82.

⁵⁹ Nobes, p. 82.

2.3. The Role of the Prudence Principle for the Application of the TFV Criterion

For IFRS 9 endorsement, the most critical issue with the TFV criterion is **the new standard's potential failure to comply with the prudence principle**. As outlined above, compliance with the prudence principle outlined in Article 31 of the 4th Company Law Directive (and Article 6 of the new Accounting Directive 2013/34/EU) is viewed as a pre-condition for a standard to comply with the TFV principle. Our discussion of prior endorsement decisions and academic evidence on TFV interpretation in individual Member States shows that this link can be challenged on very reasonable grounds. In particular, the link hinges on whether the TFV principle itself embodies the prudence principle since the IAS Regulation does not directly require the latter principle to be tested in the endorsement process. Yet, in line with our task, the following discussion is based on the assumption that IFRS 9 will need to follow the prudence principle for meeting the TFV criterion.

An obvious reason for placing importance on prudence is the dissatisfaction with the role of accounting standards (and, most notably, IFRS) in the financial crisis. The G20 in its 2009 London Summit⁶⁰ explicitly urged the standard setters to improve the standards on valuation and provisioning. The perception was that a lack of prudence in IFRS helped create the over-expansion of credit, unrealised profits, and, therefore, unjustified bonuses and dividends⁶¹. In particular, the role of fair value accounting in the crisis was heavily debated even by the highest ranks of political leaders⁶². However, empirical findings in the accounting and finance literature that have emerged in the years following the crisis paint a more balanced picture. Based on this evidence, **the Basel Committee concluded in a recent report that there is (still) no evidence that would support the notion that fair value accounting triggered or even exaggerated the crises**⁶³.

One should also note that fair value accounting is not only about the recognition of unrealised gains, but at the same time requires the early recognition of expected losses. Overwhelming evidence in the accounting literature suggests that **early anticipation of future losses is key to regulators being able to implement corrective measures in time**⁶⁴. Yet there are significant delays in taking impairments and write-downs of assets measured in other ways than fair-value in times of crises⁶⁵. Recent research also provides evidence that the **public fair value debate in the media and by U.S. congresspersons was rather fostered by the vested interests of the banking industry to avoid the reporting of losses**⁶⁶. More generally, when analysing banks' lobbying activities against fair value accounting, it has been shown that it was the *opaque* banks that were most actively calling for more prudent accounting practices⁶⁷. Overall, this collective evidence convincingly suggests that **the objectives behind the prudence principle** outlined in the Accounting Directives (e.g., financial stability) **may rather be majorly achieved through fair value reporting. Vice versa, too strict of a historical cost regime potentially endangers these objectives to an even greater extent.**

⁶⁰ See G20 (2009), para. 15.

⁶¹ See e.g., different reports on the effects of accounting rules on the financial crisis: Global Financial Stability Report of the International Monetary Fund; de Larosière et al., para. 73-79; Marteau/Morand; as well as Bieg et al.

⁶² See André et al.

⁶³ See Bank for International Settlements for a comprehensive literature review. An S.E.C. report of 2008 on 'Mark-to-Market Accounting' commissioned by the U.S. Congress came to a similar conclusion, see also <https://www.sec.gov/spotlight/fairvalue.htm>.

⁶⁴ See e.g., Beatty/Liao; and Bushman/Williams. Bushman provides an overview.

⁶⁵ See e.g. Vyas.

⁶⁶ See Bischof/Brüggemann/Daske (2014); and Becker et al.

⁶⁷ See Hodder/Hopkins.

Consistent with this view, there is no other EU legislation or ECJ judgement that would directly link the prudence principle to pure historical cost accounting. In fact, **the EU seems to accept that different Member States have different interpretations of prudence**⁶⁸. For the assessment of IFRS 9, it is therefore useful to consult the accounting literature that defines prudence (often called 'conservatism') in two different forms:

- **unconditional conservatism** (*ex ante* and unrelated to news), which mechanically measures assets at an amount lower, and liabilities at an amount higher, than their current value, and
- **conditional conservatism** (*ex post* and driven by news on asset values), which incorporates bad news into asset and liability valuation in a more timely fashion than good news⁶⁹.

Robust evidence indicates that **it is conditional conservatism that fosters lower cost of capital, increases investments, and supports economic growth**⁷⁰. Yet, the Continental European countries whose accounting systems were most restricted to historical cost show empirically *low levels of conditional conservatism in actual reporting outcomes*⁷¹. Again, **viewing prudence in the light of historical cost accounting does not necessarily lead to 'prudent' reporting outcomes in practice**⁷².

Apart from academic evidence, the Accounting Directives do not limit asset and liability measurement to amortised cost. Article 7a of the 4th Company Law Directive and Article 8 of the new Accounting Directive 2013/34/EU provide a number of options for Member States to permit the use of fair values even beyond the scope of financial instruments. If strict compliance with individual rules of the Accounting Directives leads to prudent reporting and ultimately establishes a TFV, fair value measurement *per se* cannot contradict the TFV principle. The new Accounting Directive's Recital 9 is more explicit: *'systems of fair value accounting provide information that can be of more relevance to the users of financial statements than purchase price or production cost-based information. Accordingly, Member States should permit the adoption of a fair value system of accounting by all undertakings or classes of undertaking'*.

After all, the question comes down to whether the scope of fair value accounting required by IFRS 9 is compatible with the EU Accounting Directives. To address this question, it is helpful to begin by considering the existing reporting practice of European banks under IAS 39. The evidence is summarised in Table 4 below. The data indicates that the two amortised cost categories still account for approximately 75% of bank assets and that the use of the fair value option is actually quite limited (less than 1% of total assets for the median bank).

⁶⁸ See e.g. Evans.

⁶⁹ See Watts.

⁷⁰ See e.g. Bushman/Piotroski; Garcia Lara et al.; Kim/Zhang.

⁷¹ See e.g. Raonic et al.; Bushman/Piotroski.

⁷² A potential reason for this finding could be that the exercise of prudence allows the creation of hidden reserves or excessive provisions by holding back profits in one year that may lead to their release in a subsequent period (either automatically because the accruals reverse (e.g. Dechow), or by intentional selling of undervalued assets and the reporting of exaggerated results).

Table 4: Use of IAS 39 Measurement Categories by European Banks

Measurement Category	Assets			
	Mean	Median	Min	Max
Loans & Receivables	71.9%	75.7%	4.5%	98.9%
Held to Maturity	1.7%	<.01%	0%	33.6%
Σ Amortised Cost	73.6%	77.7%	4.5%	98.9%
Trading Securities	7.8%	3.1%	0%	79.4%
Derivatives	2.7%	1.2%	0%	29.6%
Fair Value Option	4.7%	0.9%	0%	88.6%
Σ Fair Value	15.3%	8.9%	0%	94.3%
Available-for-Sale Assets	8.0%	5.4%	0%	54.8%

Source: Own data (320 firms, 2006-2010), % of total assets.

If we apply this evidence to IFRS 9, most IAS 39 *Loans & Receivables* and *Held to Maturity* assets will likely meet the requirements for amortised cost accounting, while IAS 39 *fair value* assets will generally continue to be reported at fair value. IFRS 9 adoption will, therefore, increase fair value usage only modestly, if at all, with the average level of fair value usage being substantially lower than the level of amortised cost. Accounting rules for liabilities will cause even less change to the measurement bases. It is also important to note that **the largest class of fair value assets are trading securities and derivatives**. It is this class of instruments **for which many Member States**, including Germany, **already prescribe fair value accounting under national accounting law**⁷³ (*i.e.* in accordance with the Accounting Directives).

Overall, if we benchmark IFRS 9 against the rules embodied in the Accounting Directives, it is not possible to argue that the new standard systematically deviates from either the general spirit of the Directives or the individual rules on asset and liability measurement. We can only apply the prudence principle in the context of these Directives. There are extremely restrictive interpretations of the prudence principle in the academic literature that seem to suggest that fair value accounting *per se* is an imprudent reporting practice. However, not only are these interpretations purely theoretical, but they are also inconsistent with the general consensus in the accounting literature of what meaningfully constitutes a prudent ('conservative') accounting system. Therefore, these interpretations cannot play a role in the assessment of the IFRS 9 endorsement. Thus, **IFRS 9 meets the prudence principle** as it exists under the present Accounting Directive 2013/34/EU.

2.4. Conclusions

We conclude that the endorsement of IFRS 9 cannot reasonably be rejected on the grounds of the TFV criterion (of Article 3(2) IAS Regulation). Overall, we are not convinced that current EU legislation or available ECJ jurisprudence require annual accounts to comply with the prudence principle to achieve a TFV. Yet, there are prominent views in the literature and in the political debate that make this point. However, even if the TFV criterion

⁷³ At least for financial institutions.

embodies the prudence principle, the latter principle can only be interpreted in light of the current Accounting Directive. In terms of asset and liability measurement, IFRS 9 will not lead to significant deviations from the accounting rules included in the Accounting Directive (at least in the form of Member State options). When prudence is interpreted taking into account the Accounting Directive, IFRS 9 cannot be judged to result in a violation of this principle.

We still acknowledge that there is an **obvious need to limit managerial discretion in accounting valuation**. The recent financial crises have demonstrated that accounting valuation, among other actions, can lead to excessive dividend pay-outs, bonus payments or risk-taking. Yet, empirical evidence consistently shows that **such excessive behaviour is not successfully prevented through a purely cost-based accounting regime**. To the opposite, such a regime has the most adverse consequences for the stability of financial markets. It also makes us suspicious in the light of the past crises that **it has been the financial industry and their associations that have persistently been lobbying for cost-based accounting regimes**. Therefore, we recommend that regulators consult other institutions, such as the enforcement authorities or prudential supervisors, when aiming to restrict excessive manipulation of accounting figures. The suspension of fair value accounting, e.g., through the rejection of IFRS 9, would not help to achieve this goal.

3. THE QUALITATIVE CRITERIA

KEY FINDINGS

- The four qualitative criteria understandability, relevance, reliability and comparability are of technical nature. Their definitions are well established in the accounting literature and so is their operationalisation in accounting research.
- Yet, many criteria conflict with each other, the most prominent trade-off probably being the one between relevance and reliability.
- Therefore, the overall assessment of the criteria requires individual judgment and a weighting of different interests, for example, of shareholders and lenders.
- In our analysis, at least some aspects of IFRS 9 score high on some of the four criteria.
- We conclude that the qualitative criteria do not provide convincing grounds for rejecting the endorsement of IFRS 9.

The second endorsement criteria refers to *'the technical criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management'*. In this chapter, we

- present available definitions for these 'technical' criteria' or, in the language of standard setting, *'qualitative characteristics'*, as well as their operationalisations in the scientific literature,
- outline possible conflicts among these criteria when drafting accounting standards, and
- at the end of the chapter, conclude on the implications of this analysis for an IFRS endorsement advice based on these technical criteria, using IFRS 9 as an application case.

3.1. Understandability

All available definitions of the criterion *'understandability'* require assessing whether the information resulting from the application of a standard will be **understandable by a knowledgeable user** and **not unduly complex**⁷⁴.

The scientific literature has only operationalised the criterion *'understandability'* in the context of controlled laboratory experiments. Under laboratory conditions, one is able to analyse whether different types of *presentations* of accounting information make a difference in users' understanding of that piece of information. On the downside, it remains questionable how generalisable those insights from the lab are to a real world setting (i.e., its external validity)⁷⁵. Yet, empirically disentangling the form and style of the presentation of a specific piece of information from its content and other influences is almost impossible

⁷⁴ Barth, p. 9: *'Understandability is the quality of information that enables users who have a reasonable knowledge of business and economic activities and financial reporting, and who study the information with reasonable diligence, to comprehend its meaning'*; see also IASB (2015a), para. 2.33-35; and EFRAG, para. 191.

⁷⁵ See Koonce et al. for a fair value related example.

when using real world data (i.e., its internal validity)⁷⁶. Accordingly, we note that the scientific literature does not give any guidance on how one can judge whether a new IFRS standard will lead to understandable and less complex information. We, can, therefore, only provide a subjective judgement based on our own perception of the standard's understandability and complexity.

3.2. Relevance

All available definitions of the criterion 'relevance' require relevant information to have an **impact on the economic decisions of users**, either through **predictive values**, i.e., by helping users to evaluate past, present or future transactions or other events that impact the firm's future cash flows, or through **confirmatory values**, i.e., by helping users to confirm or correct their prior expectations about the firm⁷⁷.

The definition assumes that we understand how users incorporate accounting information into their decision-making and that we can judge what impact an accounting standard will have on users' economic decisions. Another challenge is the co-existence of **many different user groups** (e.g., equity vs. debt investors, compensation committees, labour representatives, prudential supervisors, etc.), when each user group follows a distinct approach on how to formalise expectations and assess financial reporting information.

The accounting literature has tried to operationalise 'relevance' through a number of empirical proxies and in the context of different research designs, primarily with 'value relevance' and 'earnings quality' designs. In the **value relevance literature**, *'an accounting amount is defined as value relevant if it has a predicted association with equity market values'*⁷⁸. Researchers use the level of stock prices or changes in returns as valuation benchmarks against which to assess how well a specific piece of accounting information reflects information potentially used by investors⁷⁹. Under this design, it remains unclear what is the *mechanism* behind the association observed⁸⁰. This is one key reason why the relevance of 'value relevance' studies for standard setting purposes is highly controversial⁸¹, in spite of the voluminous evidence documented in the literature⁸².

In the **earnings quality literature**, which also attempts to capture the 'relevance' of accounting information⁸³, researchers use three categories of earnings quality proxies:

- the magnitude of earnings management,
- investor responsiveness to earnings, and
- external indicators of earnings misstatements.

Nevertheless, all of these approaches share the limitation of needing actual data available to apply them in practice and that the evaluation is at a very high aggregation level.

⁷⁶ See e.g. Gassen (2014).

⁷⁷ Barth, p. 9: *'Relevant information is capable of making a difference to a financial statement user's decisions. Relevant information has predictive value, i.e., it helps users to evaluate the potential effects of past, present, or future transactions or other events on future cash flows, and confirmatory value, i.e., it helps to confirm or correct their previous evaluations'*; see also IASB (2015a), para. 2.6-7; EFRAG, para. 7.

⁷⁸ Barth/Beaver/Landsman, p. 79.

⁷⁹ See Barth/Beaver/Landsman.

⁸⁰ For example, Gassen (2008), p. 6, points out that value relevance *'targets the alignment between accounting and market information per se, without addressing the question whether accounting information is (potentially) useful to market participants in valuation-related decisions or whether it merely constitutes an echo of information from more timely sources which were already impounded into prices'*.

⁸¹ See Holthausen/Watts; Barth/Beaver/Landsman.

⁸² See Harris/Muller; Song et al. for IFRS-related studies.

⁸³ See e.g. Dechow et al.

3.3. Reliability

Despite its central role, the criterion 'reliability' is a '*complex and elusive construct of accounting information*', where '[e]ven expert accountants do not necessarily agree on the nature of reliability characteristics'⁸⁴. In addition, '[r]eliability is difficult to specify precisely in accounting standards and practice, and it is difficult to examine directly with research'⁸⁵. Many of these differences stem from different national backgrounds, with some jurisdictions viewing reliability as comprising the prudence principle. There still seems to be the minimum consensus that the following characteristics should be considered when judging the 'reliability' of accounting information:

- completeness,
- free from material error and bias, and
- faithful representation.

Traditionally, the Conceptual Frameworks of the FASB and IASB have stated that reliability, in combination with relevance, determines the usefulness of accounting information and that there must be the right balance between relevance and reliability⁸⁶. The IFRS Conceptual Framework no longer refers to reliability by name, but rather emphasises two characteristics of reliability, i.e., *representational faithfulness*, and *verifiability*⁸⁷; **information must be complete, neutral and free from error**. The IASB argues that the term 'faithful representation' describes those latter aspects better than the term 'reliability'. This is largely consistent with the view of the U.S.-based accounting literature on reliability⁸⁸. EFRAG, while using different terminology, uses a similar list of characteristics in their assessment of IFRS 9⁸⁹.

Reliability concerns regarding accounting information arise because the managers preparing financial statements respond to reporting incentives by '*interpreting or applying standards in a non-neutral fashion*'⁹⁰. In other words, a voluminous academic literature and common experience of regulators and market participants show that **managers use the inherent discretion in all accounting systems to their advantage**. Conservative accounting standards are supposed to counterbalance this potential bias⁹¹. The difficulty, however, is that the extent of reliability issues, and the way managers use their discretion (e.g., through opportunistic accounting choices or through the structuring of transactions), '*depend[s] on the interaction between preparers' specific incentives (including auditing and enforcement) and the accounting standards*'⁹². In addition, different reliability concerns frequently arise under different accounting alternatives, and there is a trade-off in how one judges the relative importance of these reliability concerns under each alternative. For example, in accounting for financial instruments, during economic downturns, under

⁸⁴ Maines/Wahlen, p. 400.

⁸⁵ Maines/Wahlen, p. 399.

⁸⁶ FASB (1980); IASB (2010), para. 4.65.

⁸⁷ IASB (2010): '*Verifiability helps assure users that information faithfully represents the economic phenomena it purports to represent. Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation. Quantified information need not be a single point estimate to be verifiable. A range of possible amounts and the related probabilities can also be verified.*'

⁸⁸ Barth/Beaver/Landsman; Linsmeier.

⁸⁹ EFRAG, para. 128: '*Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully what it either purports to represent or could reasonably be expected to represent, and is complete within the bounds of materiality and cost.*' Para. 129: '*There are a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation, and completeness.*'

⁹⁰ Maines/Wahlen, p. 400.

⁹¹ See, for example, Watts/Zimmermann (1986).

⁹² Maines/Wahlen, p. 400.

amortised cost there is discretion in determining whether an impairment should be taken, and under fair value accounting, there is discretion in determining the lower market value when the instrument is not traded. In economic upturns, there is the same discretion in determining market values under fair value accounting, while under amortised cost there is discretion in selling and realising only those instruments that have accumulated positive value changes, while continuing to hold those assets with negative value changes ('cherry-picking'). Therefore, both valuation principles, *ceteris paribus*, potentially lead to overvaluation of assets in the balance sheet, under both economic scenarios. Therefore, we not only need to identify potential *reliability concerns* that arise from IFRS 9 adoption, but also need to balance those concerns with simultaneous concerns under alternative accounting solutions.

3.4. Comparability

There are two conceptual levels at which the 'comparability' criterion can be defined. Traditionally, comparability requires preparers to account for similar economic transactions in the same way (across firms or over time), and for different economic transactions in different ways (**preparer perspective**)⁹³. More recent definitions instead define the former requirements as 'consistency', and regard *consistency* as a *component of comparability* that helps to achieve comparability⁹⁴. 'Comparability' tends to be more broadly defined as enabling *users to identify* similarities and differences between two sets of economic phenomena (**user perspective**)⁹⁵. Thus, this definition adds the requirement for accounting rules not only to depict similar economic transactions in a similar way and different economic transactions in different ways, but also to enable users to *externally identify* similarities and differences from the aggregated information that is presented in the annual reports. Overall, the new definition places additional weight on information presentation and disclosure in financial statements.

Scientific studies that research comparability typically judge the extent of comparability by relating aggregate summary measures of the accounts (such as earnings or book values) to aggregate proxies for economic outcomes (such as stock returns)⁹⁶. However, this approach is not suitable for judging a standard *ex ante*, because the data necessary becomes only available after adoption of the standard and the empirical proxies for comparability are at too high of an aggregation level to judge the effect of an *individual* standard.

Threats to comparability due to inconsistent accounting practices conceptually emerge primarily from

- the availability of explicit accounting choices and options,
- the usage of managerial discretion inherent in standards, and
- inadequate presentation and disclosure of the actual *usage* of these options.

Therefore, we base our analysis of whether IFRS 9 meets the requirement of 'comparability' on these conceptual sub-criteria.

⁹³ Schipper, p. 62: '*similar things are accounted for the same way, either across firms or over time*'. Her definition includes consistency, but does not explicitly state the '*difference*' component; see also EFRAG, para. 152.

⁹⁴ Barth, p. 9: Consistency '*refers to the use of the same accounting policies, either from period to period within an entity or in a single period across entities*'; see also IASB (2015a), para. 2.25.

⁹⁵ Barth; DeFranco et al.; Barth/Landsman/Lang/Williams; see also IASB (2015a), para. 2.24.

⁹⁶ DeFranco et al.; Barth/Landsman/Lang/Williams; Yip/Young, p. 1769. The concepts they use to operationalise '*comparability*' are '*similarity of accounting functions*', '*accounting system comparability*', '*value relevance comparability*', or the '*degree of information transfer, as measured by the association between the earnings surprise of an announcing firm and the contemporaneous stock price movements of other firms*'.

3.5. Trade-Offs in Technical Criteria and in Decision Usefulness vs. Stewardship

Information produced under the technical criteria should be useful for making economic decisions and assessing the stewardship of management. The general definition of the criteria shows that

- there exist inherent *trade-offs* in the four criteria and there are sub-characteristics that need to be *considered* and *balanced* in any standard, and
- there may be additional *trade-offs* when these criteria are applied for the intended *purpose* of a standard.

Table 5: Trade-offs in the IAS Regulation's Technical Criteria

Trade-Off	Description
Relevance vs. Reliability	Some information may be conceptually highly relevant for economic decisions, but so unreliable to measure that its relevance may get greatly impaired in practice and it is subject to manipulation.
Neutrality vs. Prudence/Conservatism	Faithful representation requires information to be presented neutrally in an unbiased manner, yet strict definitions of prudence require asymmetric treatment of good vs. bad news.
Relevance vs. Comparability	To adequately portray a variety of economic transactions, a range of reporting options may be necessary, but allowing reporting options will potentially impair comparability across firms.
Completeness (Reliability) vs. Understandability	Completeness requires extensive reports with high levels of disaggregation, while understandability requires less complexity and more focused reports.

Table 5 above summarises the most important trade-offs that arise in the assessment of the technical criteria. Additional trade-offs emerge because accounting is a multi-purpose concept that is designed to address the needs of different user groups⁹⁷. For example, the EU endorsement criteria describe the two main purposes as being 'decision usefulness' and 'stewardship'. While, in short, the former is asking for information to predict *future* cash flows (i.e., to improve *price efficiency*)⁹⁸, the latter provides information that is useful in assessing management's *past* actions (i.e., to improve *economic efficiency*)⁹⁹. Thus, the objectives of decision usefulness and stewardship are potentially achieved through different accounting rules¹⁰⁰, with the two different types of efficiencies frequently putting different weight on individual criteria¹⁰¹. Table 6 below summarises the most critical of these conflicts¹⁰².

⁹⁷ Note that the intention behind the IASB's revision of its conceptual framework is to reduce this conflict by exclusively focusing on external users of accounting information. The objective has resulted in the removal of 'stewardship' as a purpose, and the verbal downgrade of 'prudence' in the qualitative characteristics of the exposure draft.

⁹⁸ See Gebhardt et al.

⁹⁹ See Whittington, 2008; O'Connell.

¹⁰⁰ See e.g., Drymiotis/Hemmer.

¹⁰¹ See Gebhardt et al., p. 110.

¹⁰² See Gebhardt et al., p. 110.

Table 6: Trade-offs between Decision Usefulness and Stewardship

Trade-Off	Description
Level of verifiability	While investors can discount less verifiable information <i>ex post</i> , contracts define the use of information <i>ex ante</i> thereby causing verifiability issues which eliminate its usefulness in contracting and stewardship.
Transactions vs. expectations	Past transactions are relevant for decision usefulness to update own prior expectations; for stewardship, past transactions assess whether management fulfilled its goals; hence, accounting information that is built on past transactions is more important for stewardship.
Transitory items	Transitory items are probably not well suited for decision usefulness because they make forecasting more difficult, but for stewardship, transitory items can provide information about how management handled its responsibilities.
Timeliness	Decision usefulness benefits more from timely information than stewardship since the latter puts more weight on the confirmatory function than on timely provision of information.

3.6. Conclusions

These deliberations demonstrate the great challenges involved in testing an accounting standard for the four technical criteria prescribed by the IAS Regulation. While the definition of each individual criterion is generally accepted among academics (with the exception perhaps of reliability) and each one has been operationalised in research, several of the criteria conflict with each other and involve significant trade-offs. Thus, any endorsement advice based on these criteria is necessarily subjective, and based on individual perceptions of how well a standard *reflects* and *balances* the different criteria. Overall, we can conclude that IFRS 9 does not clearly contradict any one of these principles. Foremost, the less complex structure of the standard (compared with its predecessor IAS 39) will likely improve understandability. Apart from this, there are many accounting issues for which the verdict goes in both directions. Table 7 below summarises the most important of these issues which lead us to conclude that the endorsement of IFRS 9 as a whole cannot reasonably be rejected on the grounds of the technical criteria.

Table 7: Expected Effects of IFRS 9 Adoption on the Technical Criteria

IFRS 9 Accounting rule	Expected effect on:			
	Understandability	Relevance	Reliability	Comparability
Financial asset classification	+	0	0	-
Fair value option	+ (no option for compound instruments)	+	0	-
Compound instruments	+	+	0	+
Own credit risk changes in liability fair values	+	-	0	-
Recycling of OCI Gains/Losses from equity instruments	-	-	+	+
Expected loss model	-	+	-	0
Hedge accounting	+	0	+	-

4. THE CRITERION OF THE EUROPEAN PUBLIC GOOD

KEY FINDINGS

- The IAS Regulation introduces the European public good (EPG) as a key endorsement criterion without providing a clear-cut definition.
- Economics and political sciences offer different definitions of the public good which are partially incompatible.
- The Maystadt Report proposes that the criterion be interpreted in light of a standard's effect on financial stability and the EU's economic development.
- We observe that prudential supervisors from Europe did not express significant concerns about the impact of IFRS 9 on financial stability and, from assessing the standard in its entirety, we do not foresee such an adverse impact.
- The operationalisation of the economic development is at least as vague as for the European public good.
- In our view, the only feasible way to assess the European public good is by means of a comprehensive cost-benefit analysis that considers the reactions of different stakeholders to the proposed standard.
- Any cost-benefit analysis will not lead to an unanimous conclusion since, by definition, costs and benefits will be borne by different parties affected by the final standard.
- In the case of IFRS 9, for example, implementation costs will be greatest for the insurance industry where IFRS 4 is still under revision by the IASB with significant changes to some of the IFRS 9 policies to be expected in relatively short term.
- The key benefits of IFRS 9, e.g., from its greater understandability, will not be obtained by preparers, but by other parties. Ultimately, it is a purely political decision how to weight these different costs and benefits of different parties.
- Overall, we still conclude that IFRS 9 is likely conducive to the European public good, not at least because it is a better standard than its widely criticised predecessor IAS 39.

The third endorsement criterion states that IFRS can only be endorsed if '*they are conducive to the European public good*'. In this chapter,

- we outline the elusiveness of this criterion and offer an interpretation of how it entered the endorsement requirements;
- we summarise approaches in the literature and from other EU public policy areas that attempt to capture the concept;
- we review the accounting standard setters' approach of cost-benefit analyses when drafting and evaluating a new accounting standard and the criteria suggested by Philippe Maystadt, Special Adviser to Commissioner Barnier; and
- we summarise the implications of our IFRS 9 endorsement advice.

4.1. Definition and Intended Use

The IAS Regulation does not explain what is meant by stating that an accounting standard should be '*conducive to the European public good*' (EPG). It is, therefore, open to interpretation. The EU Commission seems to acknowledge that this criterion is of a '*political nature*'¹⁰³. Critics go further in arguing that this criterion is '*inherently incapable of interpretation in an objective or operationally effective way*'¹⁰⁴ in endorsement decisions. Proponents counter-argue that one benefit of the criterion could be to grant a '*more flexible approach taking into account the specifiers of each standard*'¹⁰⁵.

When analysing how the criterion EPG became an endorsement criterion, we observe a shift in semantics in the process which has implications on the feasibility to capture this criterion in an endorsement advice. The precise wording in **Recital 9** of the IAS Regulation reads

*'To adopt **an** international accounting standard for application in the Community, it is necessary [...] that, **in accordance with the conclusions of the Council of 17 July 2000, it is conducive to the European public good.**'*

So the motivation to include this endorsement criteria seems to date back to these intentions of the Council. However, in the minutes to the 2283rd Council meeting referenced above, ECOFIN states in **Recital 3** to their new European accounting strategy that

*'In recognising these international accounting standards, the European Community will ensure that **they** are **in fact** conducive to the European public good and that they can be used by European undertakings with full legal certainty*'¹⁰⁶.

We infer from the words '*they*' and '*in fact*', the content of the surrounding Recitals, and the shift in the Council's strategy to move from local GAAP to supporting IFRS, that the Council may have had different intentions at the time.

- First, the term '*in fact*' indicates that the Commission should make sure to monitor that adopting IAS/IFRS as a *reporting system* really delivers (*ex-post*) the net benefits to the European Union that proponents expected. We think that this statement has to be interpreted against the background of national resistance, at the time, to move away from local GAAP¹⁰⁷.
- Second, the term '*they*' is consistent with our interpretation that IAS/IFRS as a *reporting system* (rather than an individual standard) should deliver measurable benefits.

In sum, while the work assignment of ECOFIN in our interpretation was to ensure that IFRS as a *reporting system* deliver net benefits *ex-post*, the *implementation* in the IAS Regulation rather demanded that in the *endorsement process*, *individual* IAS/IFRS standards should be evaluated *ex-ante* regarding whether they are likely to be conducive to the '*European public good*'.

We note that it is already challenging, even when using 10 years of data, to present robust evidence on whether IFRS as a reporting system had delivered net benefits relative to local

¹⁰³ Van Hulle (2004), p. 369.

¹⁰⁴ Alexander (2006), p. 71. He goes on in arguing '*The phrase was presumably inserted by politicians, for politicians.*' This critique is repeated in Alexander and Eberhartinger, p. 57: '*It is particularly noteworthy that the criterion singled out for emphasis [the European public good] is, as stated above, undefinable, completely unmeasurable and nothing to do with accounting.*'

¹⁰⁵ Expert Group on the IAS Regulation, p. 3.

¹⁰⁶ See Council of the EU, p. 8.

¹⁰⁷ See as an example Hoarau.

GAAP and, thus, were so far '*conductive to the European public good*'¹⁰⁸. Judgement of the effects of *individual* standards (where one has to disentangle the effects of the new standard from the effects of all the other standards) and *ex-ante* - without any data - is even more difficult.

4.2. A Public Interest Perspective

When trying to answer the question of what the EPG stands for, the consensus from many different fields of public policy research is that **although the references to the EPG in EU politics are very frequent**¹⁰⁹, **'there is a lack of clarity in setting out what exactly is meant by a EPG'**¹¹⁰. We make the following observations:

- First, the reference clearly signifies the *European public good*. The EU-level of interest is *distinct* from a reference to a single national interest (e.g. relevant in case of adverse feedback in endorsement mainly coming from one Member State) *and* from the global-level of the IASB¹¹¹ (e.g. relevant when U.S. interests inappropriately affect IFRS in the due process).
- Second, we find that the component '*public good*' is reflected in many official EU languages as '*public interest*'¹¹². This distinction is relevant when operationalising the EPG as an endorsement criterion because **'public good' is a concept rooted in public economics, while 'public interest' is a concept from the political sciences**. They differ in their definition and operationalisation. The majority of EU languages, as we understand, rather follow the concept of '*public interest*' in the IAS Directive.
- Third, political philosophy does not deliver a consensus on whether there exists, and what would constitute, a '*public interest*'. Political scientists are split on whether they follow **normative theories, abolitionist theories, process theories or consensualist theories**, each of which has different implications of what constitutes '*public interest*'. While for some, public interest in policy-making activities is nothing more than a *rhetorical costume for special interests* (Abolitionist), others consider public interest a valuable term that refers to policy debate in which protagonists do consider *morals, principles and community values* in their reasoning, over and above their own special interests (Consensualists)¹¹³.
- Forth, references to other EU policy areas do not provide much guidance. Literature discusses whether the EPG can be formed based on EU values, goals, or (from the rationales of EU policy) including *political, social and environmental* reasons. Accounting standards fall under the EU's strategy to create a Single Market. In general¹¹⁴, accounting standards serve this interest by preventing capital markets from breaking down due to uninformed investors withdrawing from capital markets¹¹⁵ or due to informed investors having insufficient incentives to invest

¹⁰⁸ The European Commission (2015) issued on 18 June 2015 a staff working document on the evaluation of the IAS Regulation providing a summary of the process and output. Further extensive reviews have been conducted recently after 10-year of IFRS usage, see e.g. ICAEW (2015); and the academic literature, e.g. Barth/Landsman/Lang, Barth/Landsman/Lang/Williams, Daske et al. (2008) and (2013); Christensen et al.

¹⁰⁹ See Sapir, p. 89.

¹¹⁰ Zuleeg, p. 7.

¹¹¹ See Effects Analysis Consultative Group, para. 32 and 33, p. 13-14.

¹¹² See the German, French, Italian and Spanish language versions on EurLex (<http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32002R1606>): 'im europäischen öffentlichen Interesse', 'l'intérêt public européen', 'interesse pubblico europeo', 'el interés público europeo'.

¹¹³ See Cochran.

¹¹⁴ See van Mourik, p. 195.

¹¹⁵ See Lev.

because of low-value information sources¹¹⁶. Yet any proposed changes to the existing IFRS (such as replacing IAS 39 by IFRS 9) are unlikely to have such massive effects. Their contribution will be more subtle.

- Fifth, as a consequences of the elusiveness of the criterion, the vast majority of independent accounting scholars understand any 'political' intervention into the standard setting of experts and into the content of technical accounting issues to be purely driven by the vested interests catering to the needs of powerful industries resisting transparency (in abolitionist thinking)¹¹⁷. Based on such concern, ICAEW has developed a framework of issues to consider when justifying or challenging the justification of an action as being in the public interest¹¹⁸. **This ICAEW framework is an honest attempt of the profession to help regulators and politicians in critically judging suggestions put forward on the grounds of being in the public interest. Nevertheless, 'the public interest and the requirement to serve the public, has one meaning for members of the profession and another meaning for members of the public'**¹¹⁹.

4.3. Concepts of Serving the Public Interest

Private standard setters, such as the IASB, also claim to serve the 'public interest' primarily through bringing *'transparency, accountability and efficiency to financial markets'*¹²⁰. Although the IASB outlines in its recently published mission statement that their work serves the public interest by *'fostering trust, growth and long-term financial stability in the global economy'*, their working credo is, nevertheless, that those objectives will be automatically achieved in the long-run by making *financial markets* better, i.e., they have no direct relevance to their standard setting process. Further, the **IASB does not recognise any social responsibilities in its constitution beyond those of establishing a set of high quality accounting standards** that will *'help investors and other participants in the world's capital markets and other users of financial information make economic decisions'*¹²¹.

When operationalising the public interest in setting accounting standards, the standard setters' approach towards this issue has traditionally been to solely focus on the stated objectives of standard setting, assuming that a standard should be in the public interest if it scores high on the technical qualitative characteristics of the framework. More recently, standard setters have tried to conduct a 'cost-benefits' (or '*economic*' or '*effects*') analysis of individual standards.

¹¹⁶ See Grossman and Stiglitz.

¹¹⁷ See for example the interpretation by Alexander (2006), of Jaques Chirac's Letter to Romano Prodi. See also Ramanna (2012) and (2013) on IFRS endorsement and carve-outs in other countries around the world. The ICAEW (2012) contemplates in its report on 'Public Interest' that *'there can be a natural suspicion that the phrase may be used as a smokescreen to garner support for something that is actually in the advocate's own interests.'*, see <http://www.icaew.com/en/technical/ethics/the-public-interest>.

¹¹⁸ See ICAEW (2012), p. 5-8.

¹¹⁹ Dellaportes/Davenport, p. 1089.

¹²⁰ See the IFRS Foundation's Mission Statement: *'Our mission is to develop International Financial Reporting Standards (IFRS) that bring transparency, accountability and efficiency to financial markets around the world. Our work serves the public interest by fostering trust, growth and long-term financial stability in the global economy.'*, <http://www.ifrs.org/About-us/Pages/IFRS-Foundation-and-IASB.aspx>; see also IASB (2015b) where the IASB outlines in details how it perceives to serve the public interest.

¹²¹ See the Objectives of the IFRS Foundation's Constitution, where it states *'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. These standards should require high quality, transparent and comparable information in financial statements and other financial reporting to help investors, other participants in the world's capital markets and other users of financial information make economic decisions.'* IFRS Foundation (2012).

4.3.1. Standard Setters' Cost-Benefit Analysis

Cost-benefit analysis is conceptually rooted in economics and is a widely used tool in public sector decision making, in particular in infrastructure, transport, energy or telecommunications sectors. For example, the EU has its own more than 250 pages guide for cost-benefit analysis of investment projects¹²². It is a variant of classical capital budgeting aiming to start only those projects that deliver a positive net present value. Implementing a cost-benefit analysis requires

- identifying and quantifying (i.e., assigning monetary values) to all expected benefits and costs,
- allocating those components to the relevant periods during which they are expected to be realised, and
- selecting the appropriate discount rate (adjusted for risk and time value of money).

Cost-benefit analysis can be further complicated by potential deadweight losses (might cause excess burden or inefficient allocation of resources), distributional effects (may introduce winners and losers into society), and behavioural effects (might have adverse effects on behaviour of some constituents in society)¹²³. Cost-benefit considerations have also been included in mission statements and conceptual frameworks of private accounting standard setters.

The introduction of these considerations historically originated from the S.E.C., a U.S. governmental supervisory organisation where cost-benefits or '*economic analysis*' is an essential part of its rule-making. The S.E.C delegated its authority to develop accounting standards, along with its cost-benefits concepts, to a private standard setter body, the FASB¹²⁴. The IASB, influenced by the U.S. FASB, recently (re-)established a consultative group that published in 2014 an extensive report on '*effects analysis*'¹²⁵ in standard setting¹²⁶. That report responds to the IFRS Foundation's Trustees *Strategy Review* calling for more (economic) effects analysis (and field testing) in the IASB's due process¹²⁷. **Cost-benefit analysis has since been embedded in the IASB's due process at every major stage; a new IFRS standard or change to an existing standard should only be mandated if its net benefits under the IASB's objectives outweigh its costs.**

The core challenge in application is exactly *how* to conceptualise the benefits and costs of a standard. The existing approaches differ in their ambition on how far such analysis could reach out: The FASB acknowledges that it is **difficult or even impossible** to make this assessment *quantitatively*¹²⁸. The IASB should be more ambitious:

¹²² See European Commission (2008).

¹²³ See Schipper (2010) for an excellent summary.

¹²⁴ The FASB discussed the possible application of cost-benefit analyses to accounting standard setting back in 1991, see FASB (1991). See also Zeff's (1978) early discussion of 'economic consequences' arguments.

¹²⁵ The re-labelling from 'cost-benefit'- to 'effects'-analysis in accounting standard setting follows the in-depth analysis of Schipper, 2010, who suggests that "*effects*" may result in a better description of the cognitive process actually used by standard setters to weigh the consequences of authoritative guidance.', see Schipper (2010), p. 316.

¹²⁶ See Effects Analysis Consultative Group: The core objectives to consider is to improve the quality financial information (para. 12). The IASB is *de jure* by its objectives not required to consider the broader economic consequences of its standards (para. 13); however, *de facto* broad stakeholder participation, the openness of the process, and incentives of effected parties insures that those concerns are heard.

¹²⁷ See IFRS Foundation (2012), C3, second bullet-point, p. 7.

¹²⁸ See FASB (1980), para. 144. See also FASB (1978), para. 23: '*[T]he benefits from financial information are usually difficult or impossible to measure objectively, and the costs often are; different persons will honestly disagree about whether the benefits of the information justify its costs.*'

- First, IASB needs to explain how the suggested changes would improve the quality of financial statements, and why these changes are justifiable.
- Second, they should verify that stakeholders fully understand the *decisions* and the *trade-offs* of these decisions.
- Third, they should collect information and undertake sufficient background analyses to anchor these decisions. That information should be collected from outreach activities and fieldwork at different stages. The instruments to be used should be primarily surveys, case studies and, where possible, simulations.

Overall, the IASB is attempting to *conceptualise* the benefits and costs without incurring the cost of estimating each component *quantitatively*. For that purpose, they have developed a large amount of application guidance¹²⁹. Experts estimate that attempts to go any further than that by trying to fully quantify each benefit- or cost-component would be extremely costly, while at the same time, still be imprecise and incomplete¹³⁰.

As with every new IFRS standard, the **IASB published alongside its final IFRS 9 standard, in their *Basis for Conclusions, their own cost-benefit analysis of IFRS 9***¹³¹. This comprehensive, 387 pages, single-spaced document outlines the core reasons behind the IASB's decisions regarding particular areas of IFRS 9 (e.g. classification and measurement, impairment, hedge-accounting, etc.), and provides explanations of why IASB did not follow alternatives in controversial areas. Nearly 60 pages are dedicated to the analysis of expected effects of IFRS 9 only. The document outlines the major benefits to be expected from the new standard and assesses, based on IASB's outreach activities, the likely costs at initial recognition and on an ongoing basis for preparers and users. The *Basis for Conclusions* can be considered the accumulation of insights gained over the lengthy due process when developing a standard and should not be overlooked in the endorsement discussion.

4.3.2. A Second Layer of Cost-Benefit Analysis in EU Endorsement

The criterion that a standard should be '*conducive to the EPG*' requires a separate, *new* cost-benefit analysis for EU endorsement, and not just a review of the IASB's analysis¹³². We still suggest, operationally, that the IASB's effects analysis should be the *starting point* to understand the IASB's rationales and the trade-offs of their decisions. Differences in the cost-benefit analysis of the EU endorsement can emerge from:

- (A) a disagreement with the *content* of the IASB's cost-benefit analysis,
- (B) a deviation of the '*European*' cost-benefit analysis, and
- (C) a difference in the *components* of cost-benefit analysis considered by a public entity which is rooted in democratic principles and with legal enforcement responsibilities relative to a private sector standard setter.

¹²⁹ See Effects Analysis Consultative Group, p. 33-64.

¹³⁰ See Schipper (2010), p. 314.

¹³¹ See IASB (2014).

¹³² See Schipper (2010), p. 315. Note that only reviews of upstream cost-benefit analyses are also observable in other public policy area. See Schipper (2010), fn. 13, p. 315.

Disagreement with the *content* of the IASB's cost-benefit analysis

With reference to the first point (A) above, we note that, of course, there can be other issues and costs neglected in the IASB's cost-benefit analysis, and disagreement for many justified reasons. Yet, when criticising the content and outlining suggested alternatives, one should *transparently outline the expected benefits and costs of these alternative conclusions*. To be fair, we often see that **IASB decisions are openly criticised, yet these critics too often do not explain or openly discuss the issues that would emerge from proposed alternative options. It is the *incremental costs* relative to the next alternative that matters in decision-making.**

We also predict that **disagreement about technical issues on the basis of clear articulation of issues and reasons** will probably be regarded in the accounting profession and among accounting academics as **the most credible approach to challenging IASB decisions**, be it in the due process *ex-ante* or in endorsement decisions *ex-post*¹³³. Vague references to the EPG, lacking any credible supporting evidence, will be criticised almost by definition as catering to vested interests of powerful industries, even if the political intervention is in fact due to underlying intrinsic belief. This deeply rooted belief is probably reflective of the influential work of Professor Steve Zeff and follow-up studies which have documented that **politicians in the U.S. intervening into the standard-setting process of the FASB can be linked, even at a personal level in terms of campaign contributions, to vested interests of powerful industries and their attempts to keep transparency low**¹³⁴. Up to date, there are *no examples in the scientific literature that document that politicians successfully intervened into the standard-setting process to increase transparency of standards*.

We further observe that the IASB is not required to consider any 'broader' economic consequences, because these are beyond its objectives¹³⁵. On that basis, it has been suggested that the EU would benefit from engaging in broader deliberations with more stakeholders, including those who do not frequently engage in the IASB's or EFRAG's consultations¹³⁶, and that the characteristics of the IASB *'make it a challenge for stakeholders from outside the financial industry to engage with the IASB'*¹³⁷.

We would paint a more balanced picture:

- First, if those wider stakeholders would in fact be adversely affected by *accounting standards*, they would certainly have incentives to engage more with standard setters, which they currently do not do¹³⁸.
- Second, our informed observation - based on following the process for many years and recently based on our own observation in the IFRS Advisory Council¹³⁹ - is that the due process is open to all interested parties, and the feedback is collected transparently through the IASB's webpage. All parties that may have interests in

¹³³ See Giner/Arce. They find that standard setters react primarily to conceptual arguments in standard setting debates.

¹³⁴ See e.g., Ramanna (2008), Zeff (2008) and (2012), and Bischof et al. (2015).

¹³⁵ See Effects Analysis Consultative Group, para. 13, p. 11.

¹³⁶ Botzem, p. 34.

¹³⁷ Botzem, p. 35.

¹³⁸ A reason may be significant barriers to entry based on required technical expertise.

¹³⁹ Holger Daske has been representing the International Association of Accounting Educators and Researchers (IAAER) in the IFRS Advisory Council since this year (<http://www.iaaer.org/>). Note that IAAER is a non-profit organization, there is no compensation for this Advisory Council participation, and academic independence is uncompromised without any question.

accounting are invited to have a word in the process, or are even in a proactive way invited to contribute¹⁴⁰.

- Third, while it sounds certainly persuading to give ‘civil society stakeholders’ a more important role in the process¹⁴¹, we question what their exact contribution and role could be in *financial* accounting standard setting¹⁴². There is certainly a role for specialisation here, similar to setting norms in other areas of life that require specific expertise and have an important impact on society as a whole (e.g. in technical, environmental or medical norms).

As a practical matter of fact, in the case of accounting for financial instruments, it is even difficult for (full-time) specialists like us to fully absorb and comprehend all challenges, trade-offs and details involved with a standard such as IFRS 9. However, an interesting idea could be to **grant transparency activists, individuals who have a credible personal trait to fight for transparency issues, an active voice in standard setting**¹⁴³. If such individuals are persuaded in the process by the standard setter that its intention is truly to improve transparency (and not caused by influence of the financial sector, as often feared) such individuals could more credibly communicate the fight for transparency when the standard setter is challenged by vested interests of powerful preparers. The challenge, however, would be to **find such uncompromised individuals that show an interest in accounting**.

Deviation of the ‘European’ cost-benefit analysis

We note, in reference to the second point (B) above, that the objectives of the EU as a large economic block with around a quarter of the global GDP¹⁴⁴ should, *in general*, not deviate much from the global perspective of the IASB. Exceptions could primarily emerge from an observation in the due process where the **IASB would give in (too much) to vested interests of other economic blocks** and their particular economic set-up, *i.e.* most notably the U.S. To increase credibility, objections in endorsement could in such a case pinpoint particular changes that the IASB’s implemented in response to outside pressure.

Another comprehensible reason for a **carve-out from a standard could be motivated by the particular economic set-ups of an important industry in the EU that would truly be adversely affected**. Carve-outs in other jurisdictions are based on such motivation¹⁴⁵. However, we would urge EU institutions involved in endorsement decisions to critically evaluate *in detail* how different the economic set-up of an industry *really is*. For example, we do not believe that financial institutions that have traded equity and debt in financial markets in the EU (*i.e.* that are subject to IFRS standards) have sufficient differences in their set-up or business activities relative to their non-EU peers that would justify such argumentation with regard to IFRS 9.

¹⁴⁰ For example, various stakeholders in the wider non-financial reporting community have presented their views in the past years’ IFRS Advisory Council Meetings, such as the Global Reporting Initiative (GRI), see <http://www.ifrs.org/About-us/IFRS-Advisory-Council/meetings/Pages/IFRS-Advisory-Council-2016.aspx> and the meetings of the years before.

¹⁴¹ Botzem, p. 35.

¹⁴² We note that there can certainly be a role for wider non-financial socio-economic reporting requirements, such as laid down in the **Non-financial Reporting Directive 2014/95/EU** (amending Directive 2013/34/EU), see http://ec.europa.eu/finance/company-reporting/non-financial_reporting/index_en.htm.

¹⁴³ Note that Board members that are active academics have fulfilled this role in the past to some extent in the FASB and IASB. IASB Member Dr Chungwoo Suh is a Professor of Accounting at Kookmin University, Seoul.

¹⁴⁴ See Eurostat http://ec.europa.eu/eurostat/statistics-explained/index.php/The_EU_in_the_world_-_economy_and_finance.

¹⁴⁵ See Ramanna (2013), p. 22.

Difference in the *components* of cost-benefit analysis

We note, in reference to point (C) above, that the EU could be more specific in what the EU regards as 'constituting the EPG in the case of an accounting standard'. Legislators could specify *additions* or *alternatives* when judging endorsements, relative to the IASB's objectives guiding their development of IFRS. We discuss recent contributions to this discussion in the Sections below.

4.3.3. The Maystadt Criteria

In response to the financial crises and following recommendations of the ECOFIN Council, the previous EU Commissioner for Internal Market and Services, Michel Barnier, commissioned a report by Philippe Maystadt, former President of the European Investment Bank, to answer a number of questions regarding the EU's contribution to the development of IFRS (the *Maystadt Report*). Already the introduction to this report makes it clear that **'policy choices in the field of accounting involve public interest stakes that should be considered more thoroughly'**¹⁴⁶, and that *'EFRAG, which should be Europe's voice in the accounting debate, is a technical committee with views that do not always take appropriate account of these stakes'*¹⁴⁷. The report, therefore, puts even *greater* emphasis on the EPG criterion based on the feedback of certain stakeholders which claim that positions held by EFRAG in its endorsement advice are based on technical analyses of standards that do not adequately assess the economic impact or the contribution of the standards to the public interest¹⁴⁸.

In his policy recommendations, Mr Maystadt recommends that *'the European Union could revise its IFRS adoption criteria by supplementing and clarifying the current criteria of the IAS Regulation'*¹⁴⁹. In particular, he recommends what he considers to be **two components of the public good, i.e., standards should not endanger financial stability and they should not hinder the economic development of the Union**¹⁵⁰. He also asked the Commission to provide guidance for interpreting the EPG criterion¹⁵¹. Follow-up work by Commission Services and the newly instituted Expert Group on the IAS Regulation¹⁵² list in their IFRS endorsement report a number of factors that should be considered in determining what constitutes the EPG¹⁵³:

- Is the standard consistent with *EU competition law*?
- Has the standard *converged with U.S. GAAP* to *'level the playing field'*?
- Have the needs of different types of investors been considered?
- Have the needs of a broad range of users, including regulators, other stakeholder and creditors, been considered?
- What are the broad economic effects of standards on employment or public policy?
- Do standards improve financial reporting?
- Is there a reference to the cost-benefit analysis?

¹⁴⁶ Maystadt, p. 5.

¹⁴⁷ Maystadt, p. 5.

¹⁴⁸ See Maystadt, p. 11.

¹⁴⁹ Maystadt, p. 10.

¹⁵⁰ See Maystadt, p. 10.

¹⁵¹ See Maystadt, p. 10.

¹⁵² The Commission set up the group to

a) evaluate the impact of IFRS within the EU against its original aims, and

b) to take in account the recommendations of the Maystadt Report; see: http://ec.europa.eu/finance/accounting/governance/committees/evaluation/index_en.htm.

¹⁵³ See Expert Group on the IAS Regulation, p. 4.

However, the group acknowledges that **these criteria can lead to additional definition issues**¹⁵⁴. We strongly agree with these concerns.

A standard 'should not endanger financial stability'

The **only tangible new operationalisation of the EPG criteria is the component that a standard 'should not endanger financial stability'**. However, years after the financial crisis, and considering the significant media attention and incentives from regulators and the research community to provide such evidence, there is still **no evidence that can actually document that specific accounting standards have played a significant role in, or have fostered the crisis**¹⁵⁵. Thus, it will be unlikely to present a showcase that would reject IFRS endorsement *ex post* based on fears in view to financial stability. In addition, the counter-argument that could be made is that prudential regulators, i.e. those who *do* have the mandate to ensure financial stability, should counterbalance any potential adverse effects of accounting they may perceive in/via their own regulation (e.g. through prudential filters)¹⁵⁶. To be noted that the IASB, as part of its obligation from the membership in the Financial Stability Board (FSB), has to ensure that the FSB (and prudential regulators) have sufficient time to assess and potentially address how any change in accounting standards should be reflected in prudential regulators' own monitoring systems¹⁵⁷.

We would stress again that introducing this new operationalisation of the EPG criterion in the *Maystadt Report* has increased pressure on the IASB *ex-ante* to place more importance on issues put forward by prudential supervisors. That the IASB recently introduced a *long-term financial stability* wording in its mission statement can be considered a reaction to this pressure. We also observe from the comment letters of both EBA and ECB (in charge of banking supervision in the EU) to EFRAG that their issues have been reflected in the IASB's due process when developing the standard¹⁵⁸. Both are fully supportive of the final wording of IFRS 9.

A standard 'should not hinder the economic development of the Union'

The second new criterion, '*should not hinder the economic development of the Union*', is almost tautological and **an invitation to industries to foster boilerplate defensive arguments of vested interests trying to protect their own profits**¹⁵⁹. For example, the first argument of the financial industry against every regulatory intervention is that new regulation or certain accounting standards will lead to a credit crunch, and thus to lower credit availability for small businesses, ultimately hindering economic growth¹⁶⁰. Another current example is the leasing industry, which strongly opposes a new leasing standard because they are trying to protect their business model of enabling firms to show lower levels of debt than they economically possess.

¹⁵⁴ See Expert Group on the IAS Regulation, p. 4.

¹⁵⁵ See e.g. Bank for International Settlements.

¹⁵⁶ See Committee of European Banking Supervisors.

¹⁵⁷ See Effects Analysis Consultative Group, para. 20, p. 12. For example, EBA notes in their feedback to EFRAG that they are aware of several interactions with the prudential regulatory framework, see feedback letters to EFRAG Draft endorsement advice.

¹⁵⁸ For example, the ECB summarises that '*Furthermore, the ECB is not aware of any objective reason suggesting that IFRS 9 is not conducive to the European Public Good. On the contrary, some aspects of IFRS 9 may be an improvement from a financial stability perspective.*', see feedback letters to EFRAG Draft endorsement advice; <http://www.efrag.org/Front/p328-5-272/IFRS-9---Financial-Instruments.aspx>.

¹⁵⁹ Similar arguments have been put forward for instance in the stock options debate; see e.g. Farber et al.

¹⁶⁰ See e.g. Zeff (2008), p. 210; Beresford.

4.3.4. Inferring Stakeholders' Cost-Benefits from Observable Reactions

One **market-based approach** to derive stakeholders' net benefits and costs of a new standard is to analyse interest groups' response to EFRAG's call for comments to their draft endorsement advice. These responses can expose, although in a biased way, how stakeholders evaluate whether IFRS meet the EU's endorsement criteria.

The likelihood of participation and feedback to the endorsement advice will be driven by stakeholders' relative expected benefits and costs of providing their feedback. Sutton's (1984) classical cost-benefit framework of stakeholder participation in standard setting can also be applied to feedback on EFRAG's draft endorsement advice. In particular, **stakeholders that have significant net costs from the new standard have greater incentives to file adverse endorsement recommendations to a positive EFRAG endorsement advice**. Therefore, one can infer from the *type of respondent* (e.g., preparer, auditor, user, etc.), the *magnitude of letters from organisations of a stakeholder group*, and the *distribution of concerns among different stakeholder groups* to what extent stakeholders in the EU perceive to be negatively affected¹⁶¹.

It is important to note, however, that **stakeholders that expect net benefits from the new standards do not have similar incentives to respond to a positive EFRAG endorsement advice**. Therefore, potential supportive feedback to a positive EFRAG endorsement advice will primarily come from commentators that always provide feedback as part of their job responsibilities (e.g., active national standard setters, important EU institutions such as ESMA, EBA or ECB and the global organisations actively participating in standard setting issues such as ACCA, ICAEW, CFA Institute or FEI).

Overall, we observe from the feedback to EFRAG¹⁶², that the **vast majority of stakeholders consider IFRS 9 as contributing to the EPG. There are only three notable exceptions:**

- the insurance industry because of the pending IFRS 4 adoption,
- some commentators from France¹⁶³, and
- the U.K.-based Local Authority Pension Fund Forum (LAPFF)¹⁶⁴.

Another **market-based approach** to derive shareholders' perceptions of net benefits or costs of a new accounting standard is to study the stock market reactions to events that increase or decrease the likelihood of the standard being published. With regard to the IFRS 9 due process, research provides at least weak evidence for, on average, small positive share price reactions to the IASB announcements¹⁶⁵.

¹⁶¹ Note that such feedback may, or may not be, similar to comment letter participation in the IASB's due process. Current research analysing comment letters to EFRAG illustrates descriptively that the group of respondents is not identical, and therefore, there seem to be idiosyncratic incentives to participate in EFRAG's call re their endorsement advice, e.g., Weiss.

¹⁶² See <http://www.efrag.org/Front/p328-5-272/IFRS-9---Financial-Instruments.aspx>.

¹⁶³ The two institutions that have concern are the French Autorité des Normes Comptables (ANC) and the *Task Force on Long Term Investment* of the Paris Financial Center.

¹⁶⁴ Note that the Local Authority Pension Fund Forum, a private-sector lobbying group, has recently commissioned a series of legal opinions by QC George Bompas questioning the U.K. Financial Reporting Council's (FRC) working interpretation of TFV, see <http://www.lapfforum.org/news/LAPFF-obtains-further-Legal-Opinion-from-George-Bompas-QC>. These opinions have been responded to by the legal opinion of QC Martin Moore, commissioned by the FRC, see <https://frc.org.uk/News-and-Events/FRC-Press/Press/2013/October/Accounting-standards-are-part-of-legally-binding-c.aspx>.

¹⁶⁵ See Onali/Ginesti. Such tests focus by their design on the effects of a new standard on shareholders only.

4.4. Conclusions

The criterion of the EPG is even more vague than the first two endorsement criteria. As discussed in Chapter 1, the vagueness is not necessarily harmful as it potentially increases the power that EU institutions have *ex ante* over the IASB's standard-setting process. Yet, the vagueness complicates a clear-cut *ex post* endorsement recommendation.

In our view, the only feasible way to assess the EPG criterion is by means of a comprehensive cost-benefit analysis that considers the reactions of different stakeholders to the proposed standard. But any cost-benefit analysis will, by definition, not lead to an unanimous conclusion since costs and benefits will be borne by different parties affected by the final standard. **Ultimately, it is a political decision how to weight the different costs and benefits of different parties.**

In the case of IFRS 9, for example, implementation costs will be greatest for the insurance industry where IFRS 4 is still under revision by the IASB with significant changes to some of the IFRS 9 policies to be expected in relatively short term. The key benefits of IFRS 9, however, for example from its greater understandability, will be obtained by other parties. Therefore, there is a probably a net cost for preparers in the insurance industry while there is a net benefit for some users of accounting information.

Overall, we still tend to conclude that, at least, many features of IFRS 9 are an improvement over IAS 39, which would be the alternative if the EU voted against the endorsement of IFRS 9. Therefore, we argue that IFRS 9 is likely to be conducive to the European public good and we recommend the standard to be endorsed by the EU.

5. OVERALL ASSESSMENT

KEY FINDINGS

- For decades, the accounting for financial instruments gave rise to academic controversy that has not been resolved until today. Different participants in the debate favour different accounting regimes with a market-based regime and a cost-based regime representing the extreme positions.
- The IASB's due process for IFRS 9 reflects this controversy. Net benefits of the different accounting regimes vary across the different parties involved in the due process.
- The present (final) wording of IFRS 9 is a political compromise. In that, it reflects a balanced 'mixed measurement' approach that incorporates the different views of the participants in the debate. Thus, IFRS 9 is a market outcome of the standard-setting process and represents the current equilibrium.
- Given that the views of the participants to the due process are largely incompatible, IFRS 9 will still result in significant costs for some parties (and in benefits for other parties). Therefore, it is ultimately a political decision to weight these costs and benefits against each other.
- The only technical issue where costs tend to outweigh benefits are the different adoption dates of IFRS 9 and the (to be) revised IFRS 4 for the insurance industry. The diverging adoption dates will likely result in unusually high implementation costs that are specific to this one industry.

Chapters 2 - 4 provide an individual assessment of each of the three endorsement criteria. For none of the three criteria we find sufficient evidence that could support the rejection of IFRS 9 endorsement. Yet, our discussion has also shown that the IAS Regulation 1606/2002 deliberately provides European legislators with substantial leeway in the endorsement decision and that endorsement is ultimately a political decision of weighting costs and benefits. Our discussion also shows that IFRS 9 provides at least some reasons for concern. In our overall assessment below, we summarise these concerns and discuss the implications for the political decision.

5.1. IFRS 9 as an Equilibrium Outcome

IFRS 9 has been preceded by a decades-long controversy about the accounting for financial instruments, especially in the banking sector. The IASB's work programme on financial instruments dates back to at least 1988 when the then-IASC set up a work project. Despite intense efforts, the *Joint Working Group of Standard Setters* failed in 1999 to provide a set of accounting rules that standard setters worldwide could unanimously implement. While the original version of IAS 39 was adopted in 1998, it underwent significant revision in 2005 already.

The work on the new IFRS 9 started in 2009 right after the EU and the G20 called for a major reform of bank accounting rules. By now, the revision of specific parts of IAS 39 (on issues surrounding portfolio hedges of interest rate risk) is still under discussion. It is thus fair to say that accounting standards on financial instruments are among the most complex and the most controversial ones.

The reasons for the intensity of the debate are obvious:

- The underlying cash flow structures of the instruments are inherently complex and so are many of the transactions that the instruments are used for, where the same transaction can have different economic substance in the different divisions of a universal bank (e.g. asset-liability management vs. trading).
- In addition, reliability issues are of particular importance for many financial instruments that are infrequently traded and thus lack evidence on current values. Any valuation framework (both, cost-based and current value-based frameworks) faces enormous difficulties in providing reliable estimates of valuation benchmarks that sufficiently limit managerial discretion over valuation inputs.
- Accounting research shows that a potential solution is not clear-cut. The benefits of key stakeholders in the debate (e.g. preparers from investment banking vs. preparers from commercial banking, debt investors vs. equity investors, depositors vs. money market investors) vary between the extremes of the debate, *i.e.* a full fair value-based system vs. a strict cost-based system, so that no accounting solution can, by its very nature, be entirely neutral.

The involvement of the specific actors/stakeholders in the debate illustrates that accounting standards have the potential to re-allocate economic resources¹⁶⁶. In fact, accounting research can trace the struggle to find an appropriate accounting measurement basis back to medieval times¹⁶⁷. Regulators favoured different measurement bases at different points in time.

For example, market-based valuation was viewed favourably right before the German *Gründerkrise* in the 1870's, as well as before the *Wall Street Crash and Great Depression* in 1929 and before the 2008/09 *Subprime Mortgage Crisis* and heavily opposed right after these crises. In contrast, the 1980's have seen a debate where the *Savings & Loans Crises* in the U.S. was attributed to amortised cost accounting¹⁶⁸. Even historically, it is therefore hardly possible to find an appropriate consensus in the debate.

Against this historical background, IFRS 9 provides a *current* market outcome¹⁶⁹ and can be characterised as an equilibrium solution. The analysis of comment letters, minutes of IASB meetings, working papers of the IASB staff and the public discussion surrounding the development of the standard documents that the views and concerns of all key stakeholders have been considered in the development of the standard. The outcome is yet another 'mixed accounting model'¹⁷⁰ where fair value-based measurement is combined with amortised cost measurement and where management is still left with substantial accounting choice (e.g. the fair value option, the other comprehensive income (OCI) option, the hedge accounting option). The final standard is therefore balancing largely incompatible interests of different parties and provides a solution that is far from either one of the two extremes.

The standard has all characteristics of a political compromise. While this solution inevitably introduces costs for some of the affected parties, any shift of the standard into one or the other direction would cause additional costs for other parties that would need to be weighed against questionable benefits.

¹⁶⁶ Watts/Zimmerman (1986).

¹⁶⁷ See Richard for the case of France; Georgiou/Jack for Great Britain; Hoffmann/Detzen for Germany.

¹⁶⁸ Zeff (2007); Georgiou/Jack.

¹⁶⁹ See Watts/Zimmerman (1979), on the market for accounting theories.

¹⁷⁰ See Walton for a corresponding characterisation of IAS 39.

Our view that the standard provides a balanced solution is also supported by the fact that the interests of banking associations as the most powerful and best-equipped lobbying groups¹⁷¹ are not entirely reflected in the new standard. These groups favoured a more radical cut-back on fair value accounting which has not been achieved with the current standard that reflects also the interest of users, e.g. of financial analysts in this regard¹⁷².

Overall, IFRS 9 represents a market-outcome equilibrium. It reflects the strength of different parties that participated in the process, most notably:

- the technical expertise of accounting standard-setters and their staff,
- the insights on actual accounting practice from evidence on IAS 39 implementation (and similar standards worldwide),
- the evidence on benefits and costs of different accounting regimes that academic research was able to provide, and
- the economic incentives and lobbying powers of various stakeholders.

During the extensive due process of IFRS 9 many fundamental changes proposed by the IASB (e.g. a nearly complete elimination of the OCI option) were eliminated from the final version of the standard. As a result, IFRS 9 is not very far away from the accounting treatment under IAS 39.

The most fundamental change comes from the new expected loss model for loan impairments that will replace the incurred loss model of IAS 39. After all, it is only fair to conclude that the standard represents the global accounting community's best effort after six years of debate.

5.2. Weighing Costs and Benefits

While it is beyond the scope of this paper to provide a comprehensive cost-benefit assessment of an IFRS 9 adoption in Europe, the following section highlights some of the key concerns that stakeholders brought forward during the IASB's due process. For each remaining issue, we summarise below in Table 8 the main costs and the key benefit.

¹⁷¹ See Alexander (2006) for the EU; Zeff (2008) for the U.S.

¹⁷² Bischof/Daske/Sextroh(2014); see also, for example, CFA Institute.

Table 8: Summary of Key Concerns from the IASB's Due Process

Comment Letter Concern	Cost	Benefit
<ul style="list-style-type: none"> Restriction of the reclassification option 	<ul style="list-style-type: none"> Limitation of managerial flexibility during a crisis (limiting potential regulatory benefits of the option) Potential disadvantage towards U.S. competitors (with potential adverse effects on the EPG) 	<ul style="list-style-type: none"> Restriction of opportunistic earnings management Corrective regulatory actions during a crisis are not impeded by the lack of timely write-downs
<ul style="list-style-type: none"> Restriction of the recycling of OCI gains/losses from equity instruments 	<ul style="list-style-type: none"> Violation of the clean-surplus principle Potential necessity for adjustments of valuation models Lack of informational usefulness for long-term business models 	<ul style="list-style-type: none"> Short-term monitoring is crucial (and certainly practiced internally) even for a long-term business Restriction discourages the use of the option (i.e., limits managerial accounting discretion)
<ul style="list-style-type: none"> Expected loss model 	<ul style="list-style-type: none"> Complexity of valuation models Inconsistency between the IFRS 9 approach and the Basel approach (i.e., costs from parallel systems) Potential increase in volatility Arbitrary distinction between 12-months and lifetime losses 	<ul style="list-style-type: none"> Greater timeliness of loss recognition Positive association with financial stability IFRS 9 model closer to regulatory approaches than the former IAS 39 model Potentially even greater management discretion under an incurred loss model
<ul style="list-style-type: none"> Different adoption dates for IFRS 9 and (revised) IFRS 4 in the insurance industry 	<ul style="list-style-type: none"> Significant implementation costs in the insurance industry Lack of comparability over multiple years Accounting inconsistencies in the transition period between IFRS 9 and IFRS 4 adoption (potentially impeding the informational usefulness) 	<ul style="list-style-type: none"> Not clear

Source: Comment letters from the due process for the IFRS 9 project, www.iasb.org.

The four accounting topics that we summarise in Table 8 have attracted most comments during the IASB's due process for IFRS 9 (and, to lesser extent, to EFRAGs call for comments on its draft endorsement advise). Our findings indicate that, apart from issues concerning the adoption date for the insurance industry, all decisions that the IASB made on these issues involve both, costs and benefits. Again, it is ultimately a political decision how to trade-off these costs and benefits against each other.

The only exception is the divergence in the adoption dates of IFRS 9 and IFRS 4. The timing of the adoption dates will cause significant costs for the insurance industry (as well as for investors when consistency of financial statements over time is adversely affected twice in a row). These costs could, at least in part, be avoided by a simultaneous adoption of both standards. The adoption date (or, more precisely, the industry-specific transition period) is one issue where the EU could use the endorsement criteria to justify a deviation from the original IFRS 9. Since this issue does not relate to the accounting treatment of financial instruments as such, a carve-out at this point would also likely not harm the acceptance of IFRS financial statements on U.S. capital markets.

There were other, more general concerns that participants in the IASB's due process addressed, e.g. the alleged threat to financial stability or the potential increase in volatility. We note that these concerns are not based on any hard evidence from serious academic research but reflect a purely subjective assessment. We are not able to provide a conclusive *ex ante* judgment on the economic consequences of IFRS 9. New accounting standards do not only change the treatment for existing assets and liabilities, the standards potentially also change investment behaviour, *i.e.* the composition of balance sheet structures. It is inherently difficult to predict those behavioural changes and such a prediction would require significant technical efforts that the assessments in the comment letters are lacking.

5.3. Conclusions

IFRS 9 is the result of different forces participating in the IASB's due process. Different participants in the process favour different accounting regimes with a market-based regime and a cost-based regime representing the extreme positions that were brought forward. Net benefits of the different accounting regimes vary across the different parties.

The final wording of IFRS 9, therefore, is a political compromise and, in that, a 'market equilibrium'. It reflects a balanced 'mixed measurement' approach that incorporates the different views of the participants in the debate.

The new standard will not fundamentally change the accounting treatment for financial instruments. The most significant change most likely comes from the new expected loss approach to the impairment of loans.

Given that the views of the participants in the due process are largely incompatible, IFRS 9 will still result in significant costs for some parties (and in benefits for other parties). Therefore, it is ultimately a political decision to weigh these costs and benefits against each other.

The only technical issue where costs tend to outweigh benefits are the different adoption dates of IFRS 9 and the revised IFRS 4 in the insurance industry. The diverging adoption dates will likely result in unusually high implementation costs that are specific to the one industry.

Apart from this latter point, our judgement of IFRS 9 does not indicate that the standard clearly violates one of the three endorsement criteria.

Based on this judgement, we recommend the EU endorses the standard.

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