EC FINANCIAL REPORTING HARMONISATION — the Mask of Comparability

Catriona Paisley
EC FINANCIAL REPORTING
HARMONISATION -
The Mask of Comparability

by Catriona Paisey LLB CA
Department of Accountancy
University of Aberdeen

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FOREWORD

This series of monographs is published by the Research Committee of The Institute of Chartered Accountants of Scotland which is responsible for identifying topics. The series is addressed to all groups with an interest in accounting and financial management and individual monographs are written in such a way as to be understandable to readers who are not already familiar with the existing extensive literature on the subject.

This particular monograph provides an interesting introduction to some of the major themes which characterise financial reporting harmonisation within the European Community. It provides an important insight into some of the difficulties of harmonisation (hence the sub-title "the mask of comparability") and considers ways in which these could be overcome in the future. It will be of use to, among others, accountants, businessmen, lawyers, company directors and shareholders. Students will, of course, also find it helpful.

The Committee commends this monograph for study in the interest of better understanding: the opinions expressed by the author are, of course, her own.

The Institute of Chartered Accountants of Scotland

Jack Shaw
Convener, Research Committee
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PREFACE

The purpose of this monograph, which takes the form of a literature survey, is to consider the European Community's programme of company law harmonisation in the context of some of the important influences on accounting. These may be legal, economic, political or professional.

As a literature survey, it aims to present a set of references and introduce readers to some of the major themes which characterise European accounting harmonisation. The body of literature is large and ever increasing. This survey attempts to encapsulate the essence of the literature for those who wish to explore the issues further and also for those who wish to read one text only with a view to understanding something of the issues involved.

As a discussion of the harmonisation of accounting throughout the European Community, the monograph aims to give an insight into some of the difficulties of harmonisation, progress made to date and possibilities for the future.

The EC First Directive on company law was adopted in 1968 and 22 years later 7 directives have been adopted while a further 6 are at the drafting stage (excluding draft directives for the accounts of banks, partnerships and small and medium sized companies). Two new business forms have also been devised, the European Economic Interest Grouping (EEIG) which came into effect in July 1989 and the European Company Statute which is still under discussion.

The current status of EC directives on company law can be found in two Department of Trade and Industry publications (1989a and 1989b) but a summary of the main directives is given below:
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First directive
This covers the maintenance of companies’ registries, filing accounts and other documents; their availability to the public; and rules to protect third parties against a company’s lack of capacity or that of its organs. Implemented in the UK by the Companies Act 1985.

Second directive
States minimum capital requirements of PLCs. Different designation is to be used by PLCs and other limited companies. Implemented in the UK by the Companies Act 1985.

Third directive
States the conditions which must be met for the merger of PLCs registered in the same member state. Implemented in the UK by the Companies (Mergers and Divisions) Regulations 1987, SI 1987, Number 1991.

Fourth directive
States requirements for annual accounts of limited companies other than banks and insurance companies. Implemented in the UK by the Companies Act 1985.

Sixth directive
Covers divisions of PLCs. Implemented in the UK by the Companies (Mergers and Divisions) Regulations 1987, SI 1987, Number 1991.

Seventh directive
Covers consolidated accounts other than those of banks and insurance companies. Implemented in the UK by the Companies Act 1989.
Eighth directive
Covers the qualification of auditors. Implemented by the Companies Act 1989.

Fifth directive
This will cover the structure of boards of PLCs and requires a distinction to be made between directors who manage and those who supervise the directors who manage. The directive incorporates plans for compulsory worker participation in the management of PLCs.

Ninth directive
This will cover the structure of companies containing a PLC as a subsidiary.

Tenth directive
This will cover mergers between PLCs registered in different member states.

Eleventh directive
This will cover the disclosure obligations of branches of companies established in another member state or in a third country.

Twelfth directive
This will enable individuals to form themselves into a limited company.

Thirteenth directive
This will provide minimum rules for the conduct of takeovers.

In the words of the Department of Trade and Industry (DTI), the Commission's company law programme is aimed at "minimising any difficulties for business operating in more than one Member
State which might arise from the different systems of company law in each country". (DTI, 1989b, p.42) Such an aim is consistent with the ideals of the European Community which was formed in 1958 following the signing of the Treaty of Rome in 1957. The objective of the EC is set out in article 2 of the Treaty:

"The Community shall have as its task, by establishing a common market and progressively approximating the economic policies of member states, to promote throughout the Community a harmonious development of economic activities, a continuous and balanced expansion, an increase in stability, an accelerated raising of the standard of living and closer relations between the States belonging to it." (See Rudden and Wyatt, 1986, for a reproduction of the Treaty of Rome).

In order to achieve this objective, article 3 sets out minimum requirements such as the elimination of customs duties, common agricultural and transport policies, the creation of a European Social Fund and European Investment Bank, and three conditions which are of vital importance to accountants:

- the abolition of obstacles to freedom of movement of persons, services and capital (article 3 c);
- the institution of a system ensuring that competition in the common market is not distorted (article 3 f); and
- the approximation of the laws of Member States to the extent required for the proper functioning of the common market (article 3 h).

Harmonisation of company law and taxation are thus seen as central to the creation of a truly common market because trade cannot take place on equal terms if accounting and tax rules lead to different reported profits, retained income or borrowing capacities.
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Such a view seems to be the political and economic reality of membership of the European Community but what are the consequences for the accountancy profession in the United Kingdom? Will harmonisation enrich UK company law or will it frustrate good accounting practices as The Institute of Chartered Accountants of Scotland feared when, in responding to the proposed amendments to the Companies Bill in 1989, Nigel Macdonald (convener of the Committee responding to the Bill) said:

"The UK has a more highly developed financial market than any other EC member. The complexity and range of financial alternatives available to UK companies therefore require a more imaginative and structured accounting response than elsewhere in the EC.

We seek no more than to preserve the best elements in accounting practice." (As reported in The Accountant's Magazine, March 1989, p.6)

There has been a considerable volume of literature in the area of harmonisation of company law and accounting and the publicity attached to the creation of a single European market in 1992 has added substantially to that volume. This monograph has therefore concentrated on literature produced in the late 1980s. An extensive list of references prior to this time can be found in Nobes (1986).

The monograph also concentrates on financial reporting. Much reference is therefore made to the EC’s Fourth Directive on the accounts of limited companies. This directive has been influenced by, and influences, the legal, business and accounting environments in the EC and so various aspects of the directive are found in all three major sections of this monograph. This is
inevitable as accounting in the EC is influenced by many factors and it is not possible to isolate them completely as they are interrelated. Fuller discussion of the Fourth Directive can be found in Morris (1973) and Gray and Coenenberg (1984).

Much of the EC's planned work on company law harmonisation is in the field of takeovers and mergers. This topic is not covered in this monograph as it is not central to the topic in hand, namely financial reporting. Furthermore, the volume of literature in this area is extensive and would require separate study to cover the issue adequately.

The literature survey is confined to works written in English and is up to date as at 1 March 1990.

Before considering the differences between UK and EC financial reporting, it is necessary to define what is meant by the harmonisation of company and accounting law and this is covered in chapter 1.

Attempts have been made to classify accounting systems according to the characteristics which they possess in order to provide an overview of the international differences. These are considered briefly in chapter 2 and references are provided for those who wish to explore classification issues in greater depth.

Chapters 3, 4 and 5 concentrate on the legal, financial, tax and professional environments in the UK and EC and also include a review of the role of the state and political factors as these are strong influences on the accounting environment in the EC.

Finally, before concluding, the move towards a more European approach towards the harmonisation of financial reporting, as exemplified by the EEIG, European Company and proposals for European accounting standards, is examined in chapter 6.
CHAPTER 1 - THE HARMONISATION OBJECTIVE

What is meant by "harmonisation"?

The Treaty of Rome refers to "harmonisation", "approximation" and "co-ordination" of laws. These terms appear to be used interchangeably and are not defined in the Treaty of Rome. There is a view that these terms are not synonymous (See Smit and Herzog, Volume 3, page 469) but for practical purposes they are similar. Rather than debate semantics, it may be more useful to consider the aims of the EC as stated in the Treaty of Rome in order to determine the purpose of the harmonisation programme.

The full text of the Treaty of Rome can be found in Rudden and Wyatt (1986). Articles 2 and 3 of the Treaty enshrine some of the basic freedoms considered to be fundamental to the EC - freedom of movement of persons, goods, services and capital and freedom of establishment. According to Mathijsen (1985), who was Director-General with the Commission of the EC at the time of writing his book, in economic terms the most important of these is the free movement of goods. It could be argued however that for accountants the most important may be freedom of establishment.

Article 52 of the Treaty of Rome states that freedom of establishment includes "the right to take up and pursue activities as self-employed persons and set up and manage undertakings, agencies, branches or subsidiaries". Mathijsen (1985) is careful to distinguish between freedom of establishment and freedom to provide services. The latter is easier to achieve as services can be provided abroad while keeping one's base in one's own country provided that trade barriers are lifted. For freedom of establishment, however, Mathijsen argues that a more or less permanent base is required in another member state. He feels that the need to protect shareholders and third parties in such instances was instrumental in the movement to harmonise company law. Article 54 outlines the conditions which must be satisfied in order
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to secure freedom of establishment, one of which is, predictably, the co-ordination of safeguards to protect shareholders and others (presumably third parties, mainly creditors and customers).

Additionally, article 58 contains the statement that such safeguards should be made "equivalent throughout the Community". Article 100 seems to go further still by stating that:

"The Council shall, acting unanimously on a proposal from the Commission, issue directives for the approximation of such provisions laid down by law, regulation or administrative action in Member States as directly affect the establishment or functioning of the Common Market." (Rudden and Wyatt, 1986, p.57)

Thus the harmonisation powers appear to be wide, stretching beyond the protection of shareholders and others to any harmonisation necessary to achieve the EC ideals. This width is exemplified by the list of topics covered so far by directives, covering the format of company accounts, consolidated accounts, prospectuses, company capital, internal mergers and admission of securities to listing. With proposals for directives on such issues as the structure and management of PLCs, cross-border mergers, takeovers, procedures for informing and consulting employees, exemptions from the requirements of the Fourth and Seventh Directives for small and medium sized companies and a European company statute, the extent of the EC's involvement in accounting and business is clear.
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Equivalence not uniformity

It is important to note that harmonisation does not mean that the laws of all member states should be identical. Karel Van Hulle's view (1989a, Part 2) is typical of the literature when he says that the objective of accounting harmonisation is not to impose uniform rules throughout the EC but rather to ensure that the financial information published by competing companies in different countries is "equivalent and comparable". He supports his argument by stating that several directives give a range of options over such issues as where to disclose information in accounts and in the choice of valuation basis. Additionally he states that the Fourth Directive laid down minimum requirements to be applied in all countries thus giving the impression that harmonisation incorporates a certain flexibility in financial reporting. He admits however that the Seventh Directive is much more prescriptive in its requirements.

The conclusion must be that harmonisation covers a broad spectrum. Its meaning is not defined by the Treaty of Rome and that treaty uses the term indiscriminately with other near synonyms. Furthermore, no absolute conclusion can be drawn from the evidence of harmonisation so far as different directives appear to "harmonise" to different extents.

The method of harmonisation is in itself interesting. European law comprises four types:

- Regulations which are directly applicable within member states;
- Directives which are binding as to final result but which leave the means of achieving this result in the hands of member states;
- Decisions which are binding on named parties only; and
- Recommendations which are not binding.
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As directives must be incorporated into the national law of member states, each with its own traditions and concepts, uniformity is difficult, if not impossible. Had uniformity been the aim, the only suitable vehicle would have been regulations. It is interesting, therefore, that the two new European business forms referred to in the Preface, the EEIG and European Company, are enacted by regulations, rather than the more usual directives.

Arguments for and against harmonisation

While a detailed examination of the arguments for and against harmonisation of company law is outwith the scope of this monograph it is worth noting that there does not appear to be agreement as to the merits of harmonisation.

In 1969, Professor Dr K Zweigert and B Goldman conducted a study for the Council of Europe into the possibility of harmonising the laws of private limited companies (Zweigert and Goldman, 1969). According to their report, the two major advantages of harmonisation were that it would give legal security to international trade and that it would encourage international co-operation between firms. On a practical level however, they concluded that harmonisation could face two potential problems. Firstly there was a feeling that harmonised laws are often of a hybrid nature with a surfeit of reservation clauses. Secondly European harmonisation was made more difficult because of the wide diversity of business entities throughout the various countries; in other words, defining a private limited company in Europe was no easy task.

Four years later, while considering the same issue, Clive Schmitthoff also felt that the arguments for harmonisation were strong (Schmitthoff, 1973). He feared that if laws were not the
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same throughout Europe, companies would locate in those countries possessing the most lax rules. He also felt that mergers across frontiers should be simplified and a uniform regime for multinationals instituted in order to achieve the EC's ideals. Early views therefore seemed to be broadly in favour of harmonisation, though mindful of the serious practical difficulties which would have to be overcome. Turning to the present, Van Hulle (1989a, Part 2) is of the opinion that the creation of the Single European Market in 1992 will increase the need for comparability of financial information, a view shared by the authors of the Treaty of Rome. Furthermore it can hardly be denied that, politically and economically, harmonisation, however defined, is an inevitable consequence of our membership of the EC.

Another view is expressed by David Tonkin (1989) who argues that the objective of accounting standardisation may be misguided because it misrepresents the nature and structure of the preferences of those who use and produce financial reports. He continues:

"Variability of reporting practice seems to be a persistent, and even fundamental, feature of financial reporting throughout the world and perhaps should not be regarded as an evil to be stamped out. If that is the case, what is needed is more informative disclosure but not standardisation." (1989, p.11)

He advocates therefore that the standardisation programme should be abandoned and a set of precedents constituting acceptable practice be established to provide guidance to preparers and users of accounts.

A middle view is taken by S J Berwin & Co (1989) who argue against the view that accounting rules should be identical on the grounds that equivalence seems to be acceptable in other areas
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(e.g. technical and trading standards are not identical but are recognised in other member states provided that they do not pose a sufficiently serious threat to public health or the national interest) and in any event a case can be made out for flexibility. Their view of flexibility seems to encompass a core of rules to be followed by all plus subsidiary guidelines. In this way it is hoped that there will be little need for companies to have to conform to different accounting and other rules as well as those of their home country. In other words this flexible approach should remove the potential disincentive of having to follow two sets of rules and could increase the opportunities for economies of scale within the EC.

Perhaps one of the more interesting contributions to the harmonisation debate has come from Janet Dine (1989b). While recognising the argument that company law harmonisation is aimed at achieving freedom of establishment by avoiding distortions in the marketplace arising from dissimilar company laws, she questions whether freedom of establishment can be achieved by this type of harmonisation. In order to harmonise, directives must be "detailed and inflexible", yet differences between countries persist. She feels there is a real danger that the law will not accord with business practice. Furthermore, harmonisation has increased the regulatory burden on companies.

Thus recent writings on harmonisation do not present a uniform view. There is no agreement as to the merits of harmonisation as an idea. There is widespread recognition that harmonisation is no easy task and diverse views as to how to remedy the situation. Van Hulle (1989a) feels that increased disclosure in financial reports could improve matters as users would be better able to compare the results of different companies in different countries. Alternatively a statement reconciling national accounts with EC formats could be employed. S J Berwin & Co (1989) advocate a common core of rules supplemented by guidelines. Dine (1989b)
argues for a more radical solution. She feels that harmonisation as presently defined has not, and indeed cannot, create a European outlook, as implementation is by incorporation into national laws which are by no means uniform. A European outlook can only be achieved, in her view, by the use of European rather than national structures such as the EEIG and European Company.

Nobes (1989) also addresses the problems of comparing the results of European companies. His belief is that an understanding of the international differences in financial reporting and even tackling some of the language difficulties which exist will go some way towards aiding comparability of financial reports. He has also examined in detail some of the specific accounting differences which exist and suggested adjustments which informed users can make to financial reports in order to make more meaningful comparisons.

Harmonisation is therefore an area fraught with difficulty. This difficulty is compounded by, and arguably caused by, the differences which occur in the legal, financial, tax and professional fields in each of the member states which are the subject of the three main chapters of this monograph.
CHAPTER 2 - CLASSIFICATION

As was discussed in the chapter on harmonisation, the practical difficulties of harmonisation seem to stem from the underlying differences in the accounting environments of the different countries in Europe, whether these differences relate to the law, financial markets, the accountancy profession or the role of the state.

In an attempt to understand the nature of some of these differences, a number of writers have sought to classify accounting systems. Although scientists and lawyers have attempted the task of classification for some time within their own disciplines, the first attempt by accountants only occurred early this century, in 1911, by Hatfield (1966 - date of reprinting). He saw two broad accounting camps, being the United Kingdom and United States on the one hand and France and Germany on the other.

A much more sophisticated attempt was made in the 1960’s by Mueller (1967; 1968). He distinguished between accounting within macro and microeconomic frameworks. The macroeconomic approach views accounting as an adjunct to national economic policies whereas the microeconomic approach, assuming flexible economic policies, occurs in market-based economies where private business flourishes. Sweden might represent the macroeconomic approach, The Netherlands the microeconomic one.

Two other approaches were identified by Mueller. In some countries, notably the United Kingdom and United States, accounting can be viewed as an independent discipline, independent that is of government and economic theories. In other countries such as France, what Mueller calls uniform accounting prevails. Here, accounting is used by the government to control business through the measurement of performance, the control of prices and the operation of the tax system.
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Expressed simplistically, Mueller's view is that different accounting environments require different accounting systems. If this is true then the whole rationale of harmonisation may have to be questioned. Mueller went on to identify ten sets of accounting environments by considering the stage of economic development and business complexity, the political and legal backgrounds of countries. His classification covered countries worldwide but if only the EC countries are extracted the following breakdown would result:

1. The Netherlands
2. The UK and Ireland
3. West Germany
4. Belgium, France, Greece, Italy, Luxembourg, Portugal and Spain
5. Denmark

Nobes (1989) has questioned Mueller's classification on the grounds that there are only four exclusive groups (i.e. macroeconomic, microeconomic, independent discipline and uniform) and that there is no hierarchy. Thus it is not clear whether countries in different groups bear any resemblance to each other or whether some countries possess characteristics of more than one group.

Other researchers (Da Costa, Bourgeois and Lawson (1978) and Nair and Frank (1980)) have attempted statistically to evaluate the differences in accounting practices in different countries using data derived from a Price Waterhouse study of international accounting practices. A critique of their work is provided by Nobes (1984).

What is interesting about all of the above-mentioned studies is that the United Kingdom is classified differently from our EC neighbours with the one exception of the Netherlands which is
sometimes included in the UK's group. The studies are not without problems however (See Nobes, 1984, p.57). One of Nobes' major criticisms was that they did not try to test any hypotheses but rather attempted to elicit some from the findings. In other words, they adopted an inductive approach to classification.

Having identified the limitations of previous studies in not having a hypothesis to test, Nobes attempted this task by following a deductive approach in 1980, reported in Nobes (1984). (i.e. before implementation of the EC Fourth Directive). His conclusions are presented in chart form in Appendix 1.

Having tested his hypothesis, Nobes updated it after implementation of the EC Fourth Directive but, from an EC viewpoint, the only changes were that Belgium joined the French group and that Spain and Italy were confirmed in the French group. Using this material, Nobes produced a classification of EC countries in 1986 based on "the major background factors of law, tax and predominant users" (Nobes, 1986, p.34) within the EC. He also had to modify his earlier work in order to incorporate certain EC nations which were not included in his original work. His updated classification chart is also shown in Appendix 1.

A glance at Nobes' EC findings in the charts in Appendix 1 shows clearly the diversity of accounting practice within the EC. In his view, the "distance" between any two countries is suggested by how far up the classification it is necessary to go in order to reach a common point. As with the studies outlined earlier in this chapter, it is clear that the United Kingdom has once again been placed in a group far removed from the rest of Europe, other than The Netherlands. What is also clear from Nobes' results is that the rest of Europe is by no means a homogenous group. In Nobes' words, "such a classification...prompts questions about whether harmonisation is desirable and possible." (Nobes, 1986, p.36)
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This question cannot be answered until the fundamental differences between UK and European accounting have been examined in more detail. The following three chapters will therefore consider in turn the differences in the legal systems, financial environments, tax and professional environments throughout Europe focusing throughout on their application to financial reporting.
CHAPTER 3 - LEGAL ENVIRONMENTS

When discussing the harmonisation of company law in Europe it is necessary to examine the background to the legal systems under consideration. Accounting is influenced by laws, professional pronouncements, Stock Exchange requirements, custom and judgements to varying extents in different countries. It is affected by, and affects, the business, economic and social communities in the nation and cannot be viewed in isolation. Company law affects lawyers as well as accountants and, as the law pre-dates accountancy as a distinct discipline, it is not surprising that the tone of the legal system in any country has exerted its influence on the accounting environment.

The purposes of this section are as follows:

- to consider the nature of the relationship between accountancy and law throughout Europe;
- to analyse the differences between the UK and the rest of Europe in the legal field;
- to consider how these differences have influenced the development of accountancy in the UK and the rest of Europe; and
- to consider the differences between Scottish and English law and assess the implications for the UK in the context of harmonisation.

Hand and Bentley (1977) contend that, broadly speaking, there are three sources of law in civilised states, namely:

1. principles laid down in codes (codified systems)
2. precedent (common law systems)
3. writings and opinions of professional experts

These three sources are not mutually exclusive. In codified systems, although the code is binding, it is interpreted in the courts while in systems guided by precedent, statute law, which
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can be viewed as a form of codification, also exists. Thus the character of a legal system is influenced by the degree to which it leans towards one camp or the other and even the most dissimilar systems will display elements in common.

Law in Europe tends to fall within either the first or second camps. The third was influential in Roman Law and in previous centuries but has left its mark on the other two forms rather than continuing to exist in its own right.

Codified systems

All the European countries apart from the UK, Ireland and Denmark fall into this category. (Scotland’s law is difficult to place and will be considered later in this chapter.) Codified systems lay down a set of principles to be followed in all circumstances. Theoretically they make the law reasonably certain as new situations can be catered for. In other words, citizens can discover the law in any area and apply the underlying reasoning to situations not necessarily envisaged when the codes were originally enacted. Of course, codes can be modified and updated, but until that is done old codes prevail.

Judges in codified systems interpret the codes; they do not initiate law. Interpretation of the law does involve judgements however, and it is arguable that the very process of interpreting the law is a form of lawmaking because, over time, the gloss given to law develops and defines it. There have also been indications since the 1970s, (see for example Frommel and Thomson (1975)), that European judges are becoming more willing to consider previous judgements as well as the codes themselves when deciding cases.

Codes are formulated by the legislature but an interesting feature of European law is the degree to which the academic world
influences the law (Frommel and Thomson, 1975). The reasons for this are historical and philosophical. As van Caenegem (1988) shows, much of the codified law of Europe is based on Roman Law, particularly the law of Justinian, which was heavily based on principle. Study of Roman Law was central to the work of the medieval European universities and in Europe lawyers were educated in these universities. European law also moves "theoretically by deductive reasoning, basing judgements on abstract principles" according to van Caenegem (1988, p.88). He continues, it is "more conceptual, more scholastic and works more with definitions and distinctions" than common law and thus lends itself to academic input through study and debate.

Common law

The legal systems of the UK (bearing in mind the earlier reservation about Scot’s Law), Ireland and Denmark fall into this category. Historically this type of law comes from custom and was developed by the courts. The law on any topic can be inferred from the previous decisions of the courts. Prior to the nineteenth century, previous decisions of superior courts were not considered to be binding on later courts but in that century the doctrine of binding precedent evolved. This has brought a degree of certainty into a system which perhaps cannot adapt to new situations as well as codified systems for, if there is no prior case in a particular field, where is the law to be found? Of course it is possible to take the opposite view. It can be argued that it is not appropriate that principles formulated in the past should be used to decide new cases which were never envisaged and which may demand a new approach.

It is not the purpose of this study to consider the merits and demerits of different types of legal systems but a knowledge of
the legal differences throughout Europe can aid understanding of the accounting environments.

The European codes

The distinction between codified and common law systems came to prominence with the publication of Napoleon's French Civil Code in 1804 and Commercial Code of 1807. These codes were adopted with virtually no modification in Belgium, Luxembourg and with some revision in the Netherlands following their occupation by Napoleon. The French Code also influenced the Italian and Spanish Codes. (Frommel and Thomson (1975) provide further details of the development of the codes.) Thus the politics of the nineteenth century strongly influenced the laws of much of Europe.

Germany too had codes but their origins are perhaps less clear given the complexities of the nation's history during the last two centuries. Commercial codes had first appeared in the late seventeenth century and these were influenced by the Napoleonic codes during French occupation of the German states a century later. German unification in 1870 led to further changes. (See Gallhofer and Haslam (1988) for further details.)

The French and German codes contained elements in common. For example, both contained requirements that public companies should publish a balance sheet and profit and loss account, although their formats were not prescribed; shareholders had the right to attend and address general meetings and accounts had to be laid before government agencies. Thus they contained the core elements of modern company law.
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Charts of accounts

Double-entry bookkeeping gave rise to the earliest charts of accounts, basically corresponding to ledgers and the trial balance. During the nineteenth century, with the increased use of balance sheets and profit and loss accounts, more structured charts of accounts were required. Their format was governed by the needs of individual firms and their chosen method of presentation of their financial reports. Nobes (1986) argues that uniform formats for charts of accounts probably first appeared in Germany in 1911, published by Schaer, in order to provide more meaningful data for national cost accounting purposes. These were used during World War One and developed in the post-war period to provide data for controlling the economy. Singer (cited in Nobes, 1986) traces the increase in government control of the economy under Hitler and suggests that the use of charts provided a means of control at a time when the price mechanism could not operate by providing the government with data in standardised format for all companies within a particular industrial sphere and by providing information for central planning purposes.

The Germans introduced charts of accounts into France during their occupation during World War Two and these were retained by the French after 1945. Standish (1988) questions why this seemingly unusual situation continued at a time when one would have expected France to reject all things German. He considers that the increasing popularity of centralised planning in France at this time was significant, being "an instrument for mobilising the energies of the people towards modernising a nation that, though relatively untouched by the physical destruction of the War, was deemed backward industrially". (Standish, 1988, p.4-12-10). Another motivating factor, according to Standish, was the French nationalisation programme after the War, although, as he admits, the British nationalisation programme did not have the same effect.
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Thus charts of accounts and accounting plans do seem to be in keeping with the desire to plan and control the economy centrally by providing a database of industrial activities and costs. In this light, they are consistent with the macro-based classification of continental accounting outlined in the previous chapter. Their influence extends beyond state-owned enterprises to the private sector through their prescribed forms of charts of accounts, definitions of terms, model financial statements and rules for measurement and valuation according to Nobes (1984). Thus, in the words of Nobes, their influence is "all-pervasive" as published financial statements and tax returns, as well as management and cost accounts, follow them.

Influence on accounting

The charts of accounts favoured in Europe play a central role in the economy but they also stem from the traditions of the underlying legal systems. The codified laws are detailed, specific and all-embracing and the charts of accounts follow through this theme. From an accounting viewpoint, the important point to note is that the accounting rules throughout the rest of Europe are law based. They are therefore part of the legal system and can only be changed by that system. This gives them a certain formality and places accountancy firmly between the legislature, with all the political overtones that implies, and the courts. In other words, the legislature makes laws, accountants apply them or check that they have been applied by others and the courts deal with deviations from the law.

This contrasts sharply with the UK situation where, traditionally, accountants have been largely self-regulatory, applying the mainly procedural laws which existed and being guided by professional pronouncements which specified best practice not law. It could be said that the rest of Europe practises law-based accountancy
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while the UK practises profession-based accountancy. The parallel with the two different legal approaches of continental Europe and the UK is unmistakable.

The self-regulatory nature of UK accountancy has given it a role largely independent of the legislature and the courts and has resulted in a system flexible enough to respond to new business developments as they arise. This is the theory at least. The issue of self-regulation is a thorny one. It can be argued that the public interest requires political scrutiny of accountancy and that the flexibility enjoyed by the UK profession allows a variety of accounting treatments giving uncertainty to accounting. It can also be argued that the UK profession does not respond to new developments any more quickly than a legislature. These are important issues because our views will determine whether we prefer the UK status quo or whether we would be willing to adopt a more European approach. These issues will be covered in greater depth in Chapter 5 for the issue of self-regulation, considered to be one of the cornerstones of the UK accountancy profession, has been hotly debated throughout the 1980s and with recent financial scandals, looks set to be a topic for discussion well into the 1990s.

To what extent then does the legal background of a country affect its accounting environment? In order to attempt to answer this question I propose to highlight some of the features of accounting in the different countries of the EC. Two very informative books in this regard are Comparative International Accounting by Nobes and Parker (1985), and Accounting Systems and Practice in Europe by K Michael Oldham (1987). The former contains useful chapters on accounting in France, West Germany and the Netherlands while the latter contains chapters on all EC countries. Other publications also contain summaries of accounting and business in Europe (eg the Investment in... series produced by Peat Marwick McLintock and the series "Doing business in..." in the
1989 and 1990 editions of *Accountancy* but, although interesting, they do not contain the detail of the abovementioned books.

Sources of accounting law
(as derived from Nobes and Parker (1985) and Oldham (1987))

**France**
French Commercial Code, supplemented by companies legislation and the Plan Comptable Générale.

The Plan is a detailed chart of accounts covering classification of accounting items, valuation, costing procedures and the form and content of financial statements.

Interestingly it is supervised by the Conseil National de la Comptabilité, whose president is a senior civil servant. Thus accounting in France is close to the executive.

**Belgium**
Belgian Commercial Code supplemented by decrees which specify financial reporting requirements. The Belgian framework is very similar in practice to that of France. A uniform plan for accounts was adopted in 1979.

**Luxembourg**
Luxembourg Commercial Code supplemented mainly by tax law.

Luxembourg accounting is based on the Belgian framework and therefore has indirectly been influenced by France.
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As these three nations share the same broad accounting traditions, I propose to concentrate on French accounting for the purposes of distinguishing between styles of European accounting.

West Germany

German Commercial Code supplemented by various Corporation Acts which, although similar to UK Companies Acts, are "much more detailed and prescriptive" (Oldham, 1987, p.159) than the latter.

Italy

Italian Civil Code supplemented by tax laws.

The Netherlands

Dutch Civil Code supplemented by legislation.

Denmark

Companies legislation. In the past, "legal requirements tended to be vague and superficial" (Oldham, 1987, p.131) but the legal requirements have recently been made more rigorous as a result of the implementation of the EC Fourth Directive. Tax laws are also important.

Greece

Corporation Acts and tax legislation.

Spain

Commercial Code, a General Accounting Plan (1973), based on the French one, and statutes.

Portugal

Commercial Code and statutes, especially fiscal ones. An Official Plan of Accounts was also adapted in 1983.
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The accounting frameworks of Greece, Spain and Portugal are interesting because they are all at a very early stage of development. Also, since they only joined the EC in 1981, (Greece), and 1986, (Spain and Portugal), EC directives have not yet had such a marked effect on these countries. Implementation will of course, on paper at least, narrow any differences which might exist between them and the other members. What appears to characterise the accounting environment of Greece, Spain and Portugal is, firstly, the high degree of government control over the accountancy profession and, secondly, the influence of tax on financial accounting.

In Greece, for example, the only state-authorised accounting body is Soma Orkoton Logiston which was established in 1955 by the government and supervised by civil servants and professors. The intention was to achieve a profession independent of government but this has not yet materialised. (Oldham, p.174). The accountancy professions in Spain and Greece are also in their infancy and therefore lacking in the influence which comes through establishment.

Tax regulations have been the strongest source of rules of accounting but the Portuguese and Spanish Accounting Plans have provided another vehicle for government control. They contain charts of accounts, specify prescribed formats for financial statements and valuation rules. The Portuguese plan was formulated in anticipation of Portugal's accession to the EC and therefore shows the Portuguese interpretation of the European style of accounting. The Spanish plan, though older (1973), also shows that the Spanish view of the development of accounting which again followed European lines even when membership of the EC was not envisaged.

The style of accounting then which relies on codes, accounting plans and detailed legislation, especially prescriptive tax
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legislation, already prolific in Europe, appears to be so well established as a workable, developed framework that it has proved attractive to hitherto less developed accounting environments. The result is that the UK model looks increasingly isolated.

United Kingdom

With the possible historic exception of Denmark, no other EC nation has remained as free from regulation as the UK. The Companies Act of 1981 marked a watershed in the history of UK accounting, incorporating as it did the EC's Fourth Directive. Prior to that time, legal regulation had covered certain procedural areas such as the rules for the formation and winding up of companies but had not greatly extended to the form and content of company accounts.

Having examined the legal background of the other EC member states, it is now necessary to examine the UK legal background in an attempt to gain an insight into the somewhat unique position which the UK occupies within Europe in the legal/accounting fields.

The first point to note is that the UK is by no means a homogenous unit. This fact is either often ignored by commentators on European accounting or the differences are not examined in depth. As stated earlier, Scotland's law is difficult to place in terms of common or codified legal systems. In many fields it continues to display its traditional principle-based background but in several areas, including business law, it has been strongly influenced by English common law.

Texts on the history of UK law clearly show that the differences between Scots Law and English Law are historical but it then becomes difficult to isolate reasons for this. History can be
affected by politics, religion, economics and a host of other factors all of which contribute to the culture of a country. It is debatable whether law is a mere manifestation of that culture or one of the instigating factors but undeniably the legal background of a country is one of the factors which characterises a country. That view was held by eighteenth century Scots who fought for the Scottish legal system to be preserved for "all time coming" in the Act of Union of 1707. So what is the importance of this in a European accounting context?

Scots' Law shared part of its early history with England. David I (1124-53) was instrumental in introducing English legal practices and feudal law into Scotland and these influences were strengthened in the early 14th century during English occupation after the War of Independence, a period described by Walker (1981, p.99) as "the Dark Age of Scottish legal history". Another influence at this time however was Canon Law. Ecclesiastical courts in Scotland, through the application of Canon Law, introduced Roman Law to Scotland. Later, when Scotland rejected England and developed closer links with France, the Roman influence on Scots Law was reinforced by the fact that Scottish scholars went to universities in France, and later Holland, where Roman Law was studied widely.

Thus, by the time of the Union of the Crowns in 1603 both English and Roman Law had been influential in Scotland. Complete union in 1603 was rejected by the Scots (and also by English lawyers who feared the Roman influence), but English influence was felt once again in 1654 through Cromwell. The Restoration in 1661 of the Scottish parliament and Court of Session ended this, paving the way for the significant developments of Scots law in the 17th century.

Stair's Institutions (1681) "marked the creation of modern Scots law" according to Walker, (1981, p.121) being,
"an original amalgam of Roman law, feudal law and native customary law, systematised by resort to the law of nature and the Bible, and illuminated by many flashes of ideal metaphysic." (Cooper, *Scottish Legal Tradition* quoted in Walker, p.122)

The 18th century saw further developments in the writings of, among others, Bankton, Erskine, Miller and Kames who, like their predecessors, were strongly influenced by Roman and later Roman-Dutch law. Like Roman law, Scots law was developing as a legal system based on principle not precedent and this may account for the relative paucity of reported legal cases at this time. This brief outline of Scottish legal history shows its strong affinity with continental European law.

English law has gradually diminished this affinity in certain areas however. As early as 1707, the Act of Union had provided that laws regarding the regulation of trade, customs and excises should be standardised throughout the UK. In 1856, the Mercantile Law Amendment Act assimilated much of Scottish and English business law. The Partnership Act of 1890 and Sale of Goods Act of 1893 continued this assimilation. Modern company and tax laws are also uniform throughout the UK. The Scottish lawyer's love of principle has been watered down by the increasing need for statutory interpretation following this increase in English-influenced statute. Walker (1981) sees this as a threat to Scots law but within an EC context perhaps the co-existence of Scottish and English law shows that the gulf between so-called "European" and "UK" approaches to company law can be bridged.

Although Scots law and English law have largely been assimilated in the business field, differences still abound in other areas such as family and criminal law. Even if statutes apply throughout the UK there is still a difference in approach between Scotland and England. Although the increase of statute might partially erode
the Scots lawyer's devotion to principle, it still exists at present. It is Walker's belief that if Scotland had preserved her independence, Scots law would have followed the European pattern of codification in the 19th century because of its Roman influence and the work of Erskine and Bell. It follows that European accounting practices, being a logical adjunct to the codified systems from which they sprung, may be more in keeping with the Scottish legal and historical traditions than the anglicised practices which have been adopted by Scottish accountants.

It is unlikely therefore that Scottish and English law can be brought totally into line. Their historical and philosophical bases are different and this fact has been borne in mind by Westminster. As time passes, however, they are moving closer together in some fields, business law and taxation being obvious examples. This seems to provide some hope that different legal systems can retain their unique identity, yet co-exist in an EC context. If Scotland and England can achieve this level of toleration then the UK and the rest of Europe might be able to learn something from the experience.
CHAPTER 4 - FINANCIAL ENVIRONMENTS

In the last chapter we saw that the legal framework within which businesses operate differs widely throughout the countries of the EC. In this chapter some of the other differences in the financial environments of the member states will be examined, together with their impact on accountancy.

Firstly, a comparison between the UK and the rest of Europe will be made in terms of the size and type of firm prevalent in each location and the provision of capital. This leads to a discussion of the sophistication of the financial markets and the importance of the banking community throughout Europe.

Secondly, having gained an insight into the financial environments at home and abroad, their impact on accountancy will be considered.

Financial Overview

Size and type of firms

In 1987/1988 there were over 1.1 million companies registered in the UK (DTI, 1987/1988) of which only 6,600 were PLCs. The vast majority of companies came within the small or medium-size criteria of the Companies Act 1985. Other EC countries tend to have a much smaller number of such companies, with many small, family firms preferring less regulated business forms. Perhaps the most prevalent European business form is the SARL, (Sociétés à responsabilité limitée in France with similar names in other countries and GmbH in Germany) which is a private limited company which is effectively a structure mid-way between a partnership and a UK-type company. SARLs tend to have less rigid rules as regards the number of members and minimum capital and accounting requirements. They also have more flexible Articles of Association and require a less rigid
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management structure than companies (See the Council of Europe Report, Zweigert and Goldman, 1969 for further discussion of private limited companies). SARLs exist in Belgium, France, Germany, Greece, Italy and Luxembourg but not in Denmark or The Netherlands. Although primarily used by small firms who wish to run a business on partnership lines but with the security of limited liability, they can also be used by larger firms in some countries, notably Germany and France.

Apart from the SARL or equivalent, the other significant business form in the EC is the SA (la société anonyme), known in Germany as AG (die Aktiengesellschaft). Prior to UK accession the distinction between these two types of organisation was clear but our accession complicated matters as there was disagreement as to whether the UK's most prevalent business form, the private company, was an SA or a SARL (eg Schmitthoff, 1973). In practical terms this complication was not significant from a UK point of view as our disclosure requirements went beyond the EC minimum but in terms of the influences on accounting the type of business structure may, as Nobes (1989 and earlier) indicates, be important. The existence and popularity of the SARL has meant that traditionally many firms in Europe have disclosed little and the Fourth Directive has resulted in an overall extension of what is considered reasonable disclosure.

The provision of capital

Perhaps the single most influential feature of the UK business environment is the London Stock Exchange. The UK Stock Market is much more accessible than European ones with over sixty percent of the UK gross domestic product coming from quoted companies (Gleed, Baker and Blacknell, 1989, p.83). Figures for stock market capitalisation as a percentage of GDP in 1986 were:
FINANCIAL ENVIRONMENTS

<table>
<thead>
<tr>
<th>Country</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Italy</td>
<td>16</td>
</tr>
<tr>
<td>France</td>
<td>18</td>
</tr>
<tr>
<td>West Germany</td>
<td>24</td>
</tr>
<tr>
<td>The Netherlands</td>
<td>34</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>63</td>
</tr>
</tbody>
</table>


The overwhelming dominance of the London Stock Exchange is also shown by a comparison of the numbers of domestic companies listed on their home Stock Exchange in 1986:

<table>
<thead>
<tr>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>London</td>
</tr>
<tr>
<td>Barcelona and Madrid</td>
</tr>
<tr>
<td>Germany</td>
</tr>
<tr>
<td>Paris</td>
</tr>
<tr>
<td>Copenhagen</td>
</tr>
<tr>
<td>Amsterdam</td>
</tr>
<tr>
<td>Luxembourg</td>
</tr>
</tbody>
</table>


The above figure for London only applies to firms with a full listing. If the second tier London markets were also included, the UK/European gulf would be further widened.

The above information suggests that equity investors are not the dominant source of finance in any of the EC nations except the UK. Even in The Netherlands, where the free market ethos is considered to be paramount, only one third of GDP is generated by companies quoted on the Stock Exchange.
Shareholders then, in theory at least, play a much more significant role in the provision of capital in the UK than elsewhere in Europe. So who provides finance in the rest of Europe? The answer lies in the European banking community. Banks are the single most important source of finance in Europe and their importance is underlined by the fact that they often require a seat on the board of directors in return for lending (e.g. see Busse von Colbe in Gray and Coenenberg (1984)).

In summary, the UK financial environment is characterised by a large number of small private limited companies and an active Stock Market. By contrast, the rest of Europe favours business forms which are less formal and less regulated than UK companies and has a more influential banking community. What are the implications of these differences for accounting?

Impact of the Different Financial Environments on Accountancy

Impact of size and the type of firms

Many small firms throughout Europe can escape the requirement for audit and publication of full accounts because they are not incorporated or are small enough to be exempt from them under the small and medium company provisions of the Fourth Directive. These exemptions have been utilised by several states. For example, in Germany and The Netherlands small firms are not required to be audited. The Netherlands and France permit abbreviated accounts, the former specifying a prescribed format for such accounts.

Although small companies in the UK can publish modified accounts current practice still produces financial statements for small companies which are similar to the accounts of public limited companies. In 1987/1988, for example, only 31% of
companies filed small companies' modified accounts (DTI, 1987/1988). Thus, most UK companies are small, yet most choose to publish full accounts only.

**Impact of a sophisticated Stock Market in the UK**

Nobes' hypothesis is that:

"in countries with a widespread ownership of companies by shareholders who do not have access to internal information there will be pressure for disclosure, audit and "fair" information." (Interpreting European Financial Statements, 1989, p.5)

Such a view might explain the UK's accounting approach which provides more disclosure than those of other member states, but, as Nobes recognises, the UK situation is confused by the presence of influential institutional investors who have the power to demand more information than individual shareholders. As a first step in testing Nobes' hypothesis it is necessary to examine the extent of disclosure throughout Europe. The more difficult second step is to find evidence to "prove" that the increased disclosure, if it does exist, is as a consequence of the shareholder background.
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European disclosure requirements have, or will be, increased considerably following the implementation of the EC's Fourth Directive. Oldham summarises the effect of its implementation on the traditional national reporting requirements of the member states as follows:

<table>
<thead>
<tr>
<th>Country</th>
<th>Accounts to give a true and fair view</th>
<th>Notes to be included as an integral part of the accounts</th>
<th>Amount of new information to be disclosed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>Total change</td>
<td>Total change</td>
<td>Very substantial</td>
</tr>
<tr>
<td>Denmark</td>
<td>Major change</td>
<td>No change</td>
<td>Fairly substantial</td>
</tr>
<tr>
<td>France</td>
<td>Total change</td>
<td>Total change</td>
<td>Fairly substantial</td>
</tr>
<tr>
<td>Germany</td>
<td>Total change</td>
<td>Total change</td>
<td>Substantial</td>
</tr>
<tr>
<td>Greece</td>
<td>Major change</td>
<td>Major change</td>
<td>Very substantial</td>
</tr>
<tr>
<td>Italy</td>
<td>Total change</td>
<td>Total change</td>
<td>Very substantial</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>Total change</td>
<td>Total change</td>
<td>Very substantial</td>
</tr>
<tr>
<td>Netherlands</td>
<td>No change</td>
<td>No change</td>
<td>Small</td>
</tr>
<tr>
<td>Portugal</td>
<td>Total change</td>
<td>Total change</td>
<td>Very substantial</td>
</tr>
<tr>
<td>Spain</td>
<td>Total change</td>
<td>Total change</td>
<td>Very substantial</td>
</tr>
<tr>
<td>UK &amp; Republic of Ireland</td>
<td>No change</td>
<td>No change</td>
<td>Small</td>
</tr>
</tbody>
</table>

(Source - Oldham, p.101)
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As at 1 March 1990, only Italy and Portugal have still to enact legislation to implement the Fourth Directive. The differences highlighted in the above table will lessen as it takes effect but the table does show very clearly the traditional view of disclosure throughout the EC. Only the UK, Ireland and The Netherlands disclosed to a broadly similar extent prior to implementation of the Fourth Directive which seems to give some support for the view that countries with active financial markets tend to have a more disclosure-orientated accounting system. For France, Germany and Italy, the three major powers in the EC in terms of voting rights and parliamentary seats other than the UK, disclosure was only a minimal feature of pre-directive accounting.

*Impact of an influential banking community throughout continental Europe*

Nobes (1989 and earlier) and Morris (1973) both consider the question of who provides finance to companies to be one of the main factors behind the different accounting systems in the EC and both consider banks to be crucial. Nobes considers that this has two effects on financial reporting. Firstly, there will be less pressure for meaningful published financial statements. As stated earlier, banks are an important source of finance in Europe and often require a seat on the board of directors in return for lending. Thus they have access to internal financial reports and do not need to derive information from published ones. Also, as in the UK, prior to lending they require to see detailed business plans incorporating cash flow forecasts, projected future financial forecasts and details of future prospects. The information published by the companies in their annual financial statements is obviously of less value to the banker than these.

Secondly, the importance of banks also affects the concepts underlying the preparation of financial information. Nobes cites
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evidence (1989, p.16) that European accounts are more conservative than those in the UK which he attributes to banks being primarily interested in the "bottom line" profit figure.

Conservatism certainly appears to be a strong theme in European accounting. (See the country by country summaries of reporting practice in Oldham (1987) for examples). In Germany, for instance, fixed assets must be shown at cost; unrealised gains must never be shown. Goodwill must be written off over a maximum of five years. A legal reserve amounting to 10% of the par value of the share capital must be maintained. 5% of profits must be transferred to it annually until this level is reached. Secret reserves are also still commonplace in German companies despite regulations designed to make their creation more difficult.

Although historic cost is the norm for the disclosure of assets in Europe, apart from The Netherlands where replacement value is widely used, most countries are less restrictive than Germany. For example, in France revaluation in accordance with published price level indices is permitted and upward revaluations are in fact permitted in certain circumstances in all EC member states except Germany and Luxembourg. Interestingly Switzerland, not an EC member, also forbids upward revaluation of assets which may be consistent with the dominant role of banks in the Swiss economy.

As regards legal reserves of the type described above for Germany, all EC nations other than the UK, Ireland and The Netherlands have broadly similar requirements. Most countries specify that the reserve should amount to 10% of share capital but in Italy the requirement is 20%. Secret reserves are also common in France and Italy, arising from excessive write-downs of fixed assets and over-provision for contingencies.

The combination of historic cost asset values and the additional reserves employed abroad leads to financial reports which are
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much more conservative throughout Europe (except The Netherlands) than in the UK. If a gulf is discernable at present it is perhaps interesting to speculate how much wider it would be if the recommendations included in Making Corporate Reports Valuable (McMonnies (Ed), 1988), which suggests that assets should be shown at net realisable value, were introduced. It would also be interesting to consider whether the recommendations contained in Making Corporate Reports Valuable would comply with the Fourth Directive. It is this directive to which we now turn.

The Fourth Directive

The foregoing analysis suggests that UK accounting has been characterised by a high degree of disclosure. The table on page 31 also shows the centrality of the true and fair requirement in UK accounting which was not a feature of European accounting (with the exception of the Netherlands) prior to the Fourth Directive. Self regulation has also been important in the UK.

By contrast European accounting can be viewed as being more regulated, more conservative and prone to less disclosure than UK accounting.

The question which must be asked is the extent to which the Fourth Directive has altered these two seemingly divergent approaches.

The table on page 31 might initially suggest that the Fourth Directive has had a minimal effect on UK accounting but this would be misleading. Its impact can be seen in several areas. Nobes and Parker (in Gray and Coenenberg, 1984, p.94) for example highlight some of the changes.
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Probably the main changes have been that the presentation of accounts has become more uniform and extra disclosures have been required in certain areas (e.g., certain Profit and Loss Account disclosures such as on wages and salaries and segmental reporting, the breakdown of creditors into under and over five years and disclosing information about revaluations all stem from the Fourth Directive.) These have been watered down for small companies which can publish less information but for larger companies financial statements have certainly changed. Whether the changes are fundamental or cosmetic is arguable but Nobes and Parker are of the opinion that "the British accounting tradition has substantially survived the implementation of the fourth Directive" (p.94) due to the influence exerted by the UK at the drafting stage. This influence manifested itself in several ways. For example:

- the true and fair override was a UK suggestion
- the accruals convention was recognised whereas continental accounting had stressed prudence
- the directive does not concentrate totally on historic cost as it allows the use of replacement value and fixed asset revaluations, although The Netherlands as well as the UK can take credit for this. The demise of SSAP 16 perhaps renders this innovation less significant than in the past but the abandonment of historic cost is again being mooted (see for example Making Corporate Reports Valuable, McMonnies, (Ed), 1988)

Of the impact of the Fourth Directive then, Nobes and Parker's conclusion (p.85) is that,

"several changes appear to have been made after the first draft of the Directive in order to accommodate British accounting practice. Some of these changes were options and need have no effect on other countries. It is not our
intention here to discuss whether the Directive became better as a result of these changes; merely to note that one of their effects was to make the implementation of the Fourth Directive in the UK a rather easier task."

Having considered the effect of the Fourth Directive on UK accounting, we must consider its effect throughout the rest of Europe. The table on page 31 would suggest that the Fourth Directive has, in theory, increased disclosure requirements throughout Europe. However in practice, it has had a less marked effect because most European firms are either not incorporated or are small enough to take advantage of reduced disclosure requirements, which as was seen earlier, are more widely used in the rest of Europe than in the UK.

So much for compulsory disclosure, but what of voluntary disclosure? The accounts of UK PLCs tend to be characterised by the extent of voluntary disclosures in, for example the Chairman's Statement, image building disclosures such as the current fashion for "green" disclosures and additional items required by other nations such as notes fulfilling US disclosure requirements provided by companies with strong US interests. Although the extent of disclosure by these firms has increased considerably in recent years due to public pressure and commercial considerations as well as the impact of the Fourth Directive, part of the reason may well be rooted in the UK accounting tradition. In other words, UK accounts continue to display a relatively high level of disclosure even when not obligatory (although not as much as many would like of course).

Perhaps traditional disclosure ideas die hard. If this is the case then it is pertinent to ask the extent to which the requirements of the Fourth Directive have been adopted, in spirit as well as in deed, throughout the EC in general as well as in the UK. Do other nations continue to display elements of their traditional
background of non-disclosure just as the UK continues to display elements of its tradition?

The key to this question may be to consider not only what is disclosed but also the manner in which it is disclosed. We saw earlier that the disclosure requirements of the Fourth Directive have required considerable changes in all countries other than the UK, Ireland and Denmark. Detailed studies of the impact of the directive are contained in EEC Accounting Harmonisation: Implementation and Impact of the Fourth Directive, edited by S J Gray and A G Coenenberg, 1984. The following quotes show some of the impact:

Of France

"The notion of formalised notes on the accounts is an entirely new idea from the point of view of the French Accounts Code, even though much of the information has been regularly produced to satisfy the needs of various interested parties.

In spite of this France has enthusiastically gone to town on developing appropriate reporting formats to deal with notes on the accounts. There are 28 schedules included as annexes in addition to the obligatory information concerning derogations and changes in method. The number of schedules that will have to be completed by a Company relates to its classification - every commercial concern will have to do 8, all SA and SARL will have to do 24 and the major companies will do the lot.

In making these dispositions, France has included certain requirements that go beyond the Fourth Directive since all SA and SARL will have to give more information than was basically foreseen." (p.47)
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Of Germany

The requirements of the Fourth Directive have stimulated, among others, the following new directions in research:

"The question as to the benefit of publically disclosed accounting as compared to the costs caused by accounting. In Germany there is increasing discussion on whether the cost-benefit relationship of the accounting rules laid down by the Directive is reasonable."

"Intensification of the debate on accounting concepts, particularly the debate on the continental legal concept as compared to the "true and fair view" concept." (p.61)

Of Denmark

Speaking of the Accounting Act of 1981 which incorporated the provisions of the Fourth Directive into Danish law:

"The implementation of the Fourth Directive into the legislation will codify rules which, in many cases, have already been used in practice. However, the Accounting Act makes it obligatory to publish a larger amount of information. In addition, the Act will result in a number of innovations which cannot be seen as a mere codification of previous practice." (p.32)

There seems little doubt then that the Fourth Directive has, in theory, considerably extended the scope of disclosure throughout Europe but have financial statements also changed in practice?
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True and Fair

In order to answer this question it is necessary to ask why increased disclosure was sought. This cannot be answered without reference to the "true and fair" requirement. David Flint (in an article "A true and fair view: A UK perspective", in Gray and Coenenberg, 1984) traces the development of the true and fair concept and argues that it necessitates a flexible approach to financial reporting when he says (p.101),

"The fact that it is a philosophical concept stating a principle to be observed prevents it from being defined conclusively and completely by a set of prescriptive rules setting out in detail how accounts should be prepared, what information should be disclosed, what basis of valuation should be used, and so on."

One might imagine that if this is the case then the Fourth Directive, with its detailed rules and formats notwithstanding the elements of flexibility incorporated into it, makes a rather strange, and perhaps impossible, bedfellow for the true and fair concept. Flint continues (p.102),

"Because the accounts have to meet the requirements of a principle which has a social dimension, their preparation requires the exercise of judgement in the interpretation of that principle; and so also, the basis, form and content, etc., of the accounts require to be continually reviewed and, if necessary, revised so that the impact of evolution of thought on accountability and disclosure of information can be introduced to practice. This approach is distinguishable from that of some other countries where the legal tradition and societal expectation are different, or where pressures of various kinds are causing a movement from the judgemental approach to a prescriptive one."
The true and fair concept then cannot be easily defined, requires the exercise of judgement and demands such an extent of disclosure as is consistent with truth and fairness. The Fourth Directive provides that supplementary information should be provided where adherence to the requirements of the directive does not of itself provide a true and fair view. Also the directive makes a true and fair view the overriding requirement so that, in exceptional circumstances, provisions of the directive can be ignored if adherence to them would not provide a true and fair view.

The extent of disclosure considered appropriate will, as Flint notes, depend on the objectives of financial reporting and the information needs of users of the reports. A consideration of objectives and users is beyond the scope of this study but a summary of the work in this area can be found in Weetman and Gordon’s literature survey (in Lee, 1988). If it is accepted however that shareholders represent one of the most important, if not the most important, user groups then it is reasonable to contend that the disclosure required to show a true and fair view is prepared at least in part for the benefit of shareholders.

Earlier in this chapter, the importance of the Stock Exchanges within the EC was considered and with it, Nobes’ hypothesis that,

"in countries with a widespread ownership of companies by shareholders who do not have access to internal information there will be pressure for disclosure, audit and "fair" information."

The UK tradition of truth and fairness seems entirely consistent with the extent of UK disclosure and, even if it is impossible to be sure that these ideas have arisen because of the importance of the Stock Market in the UK, it certainly seems that they go hand in hand.
We have seen that the Stock Markets in the rest of Europe are not as widely used as in the UK and the PLC is a less commonly used business form. It follows that shareholders are less prevalent throughout the rest of Europe and this may well explain why the "true and fair view" was not a feature of European accounting prior to the Fourth Directive. In France, for example, the requirement was for "regularity and sincerity", terms which have no precise definition (Dang Pham, "A true and fair view: A French perspective", in Gray and Coenenberg, 1984) but where the former implies compliance with rules and regulations. In Germany, too, adherence to legal accounting regulations and tax rules which are both more detailed than in the UK has been the traditional influence on accounting (W Busse von Colbe, "A true and fair view: A German perspective" in Gray and Coenenberg, 1984). In Flint's view, expressed above, truth and fairness cannot be achieved by regulations alone and other writers are of the opinion that continental Europe has maintained its traditional adherence to regulation and been little affected by the true and fair requirement. Nobes, for example, states that although France has incorporated the notion of "image fidèle" into its law in 1984, "French accounting seemed little altered." (Nobes, 1989, p.16). W Busse von Colbe, speaking of Germany (p.122), says,

"In the Fourth Directive both the Anglo-Saxon "true and fair view" concept and also numerous detailed regulations have been included. Common Law and Roman Law meet each other in the Fourth EEC Directive,...In the UK "the true and fair view" concept of article 2 of the Fourth Directive is obviously ascribed a greater significance than in Germany. But, apparently, both countries feel themselves confirmed in their traditions and tend to interpret the Fourth EEC Directive accordingly."
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Not only is the "true and fair view" an alien concept in the rest of Europe then, it also seems to be subordinate to regulation. This is not surprising when it is considered that the term is not capable of precise definition even in its originating country. It has evolved as a concept over a period of time and could best be described as a view formed by judgement based on an attitude of mind. Take that out of its historical context and it is little wonder that it is not fully understood abroad. Where it has been adopted abroad, it seems that the concept has been "largely met by extra disclosures rather than a change in the presentation of numbers in the financial statements", (Nobes, 1989, p.16) a view also shared by Busse von Colbe (1984).

As both Nobes and Busse von Colbe point out, this has potentially dangerous consequences for the harmonisation process for financial statements may possess a semblance of comparability as the notes to the accounts may look similar yet be prepared on quite different bases. In the past, before harmonisation, at least they did not look comparable; harmonisation may lead to a mask of comparability leading in turn to readers being misled.

The financial environment in a country seems to be important in determining the size of firm, the amount of regulation of the firm and the method of financing the firm. In turn, the method of financing seems to influence the nature of financial reporting, both in the extent of disclosure and in the concepts underlying that disclosure.
CHAPTER 5 - THE STATE, TAX AND PROFESSIONAL ENVIRONMENTS

There are many influences on accountancy and it is sometimes difficult to distinguish between them. We saw in the last two chapters that the legal systems of, and financial environments in, the various member states of the EC have a strong influence on financial reporting. In this chapter, three other major influences on accountancy will be examined.

Firstly, the view of the "state" throughout the EC is highlighted as this will govern the extent of regulation of accountancy.

Secondly, the differences in the taxation systems throughout the EC will be considered. Taxation is the means employed by the state to finance its operations and so reflects the political, social and economic policies of a nation but it can also be used as an agent of control over the economy. Individual firms must be mindful of the tax rules when operating and so tax can in a very real sense influence business and accounting.

Thirdly, financial reporting in the EC has important implications for accountants, especially auditors, and so this chapter also briefly sets out some of the differences between the UK and the rest of the EC relating to the accountancy profession. It is important to be aware of these differences because any further harmonisation of accounting requirements will affect the profession and its future role.

The State

Turning firstly to views of the "state" throughout the EC, the UK can be seen to stand alone. Lasok, in The law of the Economy in the European Communities, (1980), considers the relationship between law and economics and outlines (p.8) four possible degrees of state involvement in the economy, the laissez faire approach, remote supervision, direct participation and a directed
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economy. He then summarises the distinctive characteristics, being those which survive changes in governments, of the economies of member states (note that Spain, Portugal and Greece are not included as they were not members of the EC when Lasok’s book was published):

**France (p.12)** economic planning is strong

**Germany (p.10)** traditionally the dominant characteristic was free enterprise but Germany has recently moved towards economic planning

**Belgium (p.16)** as with Germany, the dominant characteristic was free enterprise but EC membership has led to economic planning

**Italy (p.14)** free enterprise but restricted; there is a strong view that this freedom should not conflict with the well-being of the state

**The Netherlands, Denmark, Ireland & Luxembourg (pp.18-21)** free enterprise and free trade (Netherlands most liberal with no real planning)

These countries display a spectrum of opinion on the role of the state in economic life from the state planning of France to the free enterprise of The Netherlands. The UK does not fit easily into this spectrum however. Lasok considers that the reason for this is the unique nature of the British constitution:
"An unwritten constitution of which the basic precept is the legislative supremacy of parliament is unlikely to supply any economic guidelines of an enduring nature. Any attempt to lay down by legislation fundamental principles for the conduct of the economy would always be at risk and would at any event be at odds with the essentially pragmatic nature of English law." (p.24)

He continues that the electoral system in the UK perpetuates this economic uncertainty. When he wrote his book the UK political scene was dominated by two parties as the centre was still weak. Lasok contends that the two-party system resulted in a lack of consensus on economic policy, with nationalisation, denationalisation, prices and incomes policies, the free market and a host of other conflicting economic policies. The current nature of UK politics makes any predictions about the future of the two-party system impossible but even if it is eroded the British constitution will still leave its mark.

The very nature of the unwritten British constitution may well explain the traditional UK reluctance to formulate detailed statutory regulation of accountancy. Certainly in France and Germany the nature of accountancy regulation has been in keeping with the economic role of the state.

Standish (1988) considers that the charts of accounts and accounting plans introduced into France during German occupation were retained by France after the War because of their value in economic planning. They provided an information base for state economic management and a uniform method of accounting for the expanded public sector following the post-war nationalisation programme in France. In Standish's words (p.4-12-11):
"The state became involved in standardisation of accounting, as a means to develop economic information as a basis for planning and as an adjunct to its extended responsibilities for state-owned enterprise management. These were particular bureaucratic interests, having nothing to do with the possible role of financial information in private sector decision-making. Even so, in assuming this role in accounting standardisation, the state imported values and objectives from a wider cultural environment into the domain of accounting and accountants."

In Germany too the charts of accounts and accounting plans were originated as a method of state control of the economy during a period of economic crisis following the first world war (See Gallhofer and Haslam, 1988). As the formats for financial reporting contained in the Fourth Directive were originally based on German formats, though modified before the directive was finally agreed, the German influence on EC accounting is strong. Nobes (1989, chapter 4) considers the formats permitted by the Fourth Directive and shows their derivation from the formats of the German company, the Aktiengesellschaft (AG).

The French and German financial reporting history suggest that the economic situation and beliefs in a nation may well influence the format and content of financial statements. A closer examination of the French situation suggests that the more fundamental nature of the state may also be significant. Standish (p.4-12-13), accepting that "regulated financial accounting embraces certain ideas about discipline, authority and power", highlights the high degree of centralisation of French government and the dominance of the French bureaucracy. This dominance is perpetuated by the education system, where the study of economic affairs and public administration are seen to be related, and also by the civil service, whose employees often leave to take up high-level posts in business. (Standish, p.4-12-14).
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As Standish admits, (p.4-12-17), the French situation has a "high degree of particularity". It is not found elsewhere in Europe to the same extent and so it would be unwise to draw conclusions from it for European accounting. What it does show however is that in France, where a high degree of bureaucratic centralisation coupled with economic planning and legal codification exists, tight regulation of accounting comes as no surprise. In the UK, which possesses none of these features, accounting is largely set apart from the state. The place of the accountancy profession within Europe will be considered later in this chapter but the indications are that the more powerful the state machinery, the more stringent is the regulation of accountancy.

Taxation

One of the most significant ways in which the state can influence accountancy is through fiscal policy and law. Tax laws are important in a consideration of European financial reporting because financial reports form the basis of the tax computation in many EC countries. The UK situation, where accounts are prepared in order to give a true and fair view with the tax computation being prepared after adjusting the accounts, does not occur in many countries. Thus in much of Europe, in order to gain tax relief, the relevant figures must appear in the accounts. In this way the tax authorities can influence the figures appearing in financial statements. Oldham (1987), in his survey of national accounting systems throughout Europe, highlights the influence of tax in each country. He considers tax to be one of the most influential features in Belgium, France, Germany, Greece, Italy, Luxembourg, Portugal and Spain. Of Denmark he says that accounting has become less tax-orientated in the 1980's but the tax influence remains, particularly for small companies. (p.139). The Netherlands is like the UK and Ireland in that the tax system is somewhat separate.
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The tax influence can be seen in both the profit and loss account and the balance sheet. Appendix 2 contains specific examples of this influence.

The overwhelming impression one gains from a survey of the accounting policies of the EC member states is of conservatism (or prudence), an impression which the tax rules reinforce. As Nobes says, conservatism and taxation are two "enemies of fairness" (1986, p.19). Furthermore, he considers the continental brand of conservatism to be "more stringent" than the UK variety, a view also shared by Gray, quoted in Nobes.

What is the consequence of the tax based nature of EC accounting? This question was considered by the Working Group on Accounting Standards of the Organisation for Economic Co-operation and Development (OECD) in 1987 (OECD, 1987b). The Working Group, at page 9, "identified the incidence of tax considerations on financial reporting as a major institutional obstacle to achieving greater comparability and harmonisation of accounting practices applied in various Member countries".

The Treaty of Rome does not contain specific provision for the harmonisation of direct taxation as it does for indirect tax in Articles 95 to 99. Harmonisation of indirect tax (customs duties and VAT for example) were considered to be necessary in order to ensure the free movement of goods and services by eliminating discrimination in tax rules between home and imported goods. Even here however, as Mathijsen (1985, p.209) points out, the tax provisions do not restrict the freedom of each member state to establish the system of tax which it considers to be most appropriate. Progress towards indirect tax harmonisation and possible approaches are reviewed by Temple (1989) and Reid (1989).
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The harmonisation of direct taxation is covered by the general terms of Article 100 of the Treaty which states that:

"The Council shall, acting unanimously on a proposal from the Commission, issue directives for the approximation of such provisions laid down by law, regulation or administrative action in Member States as directly affect the establishment or functioning of the common market."

Harmonisation of direct tax seems to be a much longer term project than indirect tax. Proposals were first mooted in 1969 but little progress has been made. Perhaps this is inevitable given the notion of sovereignty attached to tax affairs for, once the capacity to determine the raising of revenue has been lost, much of the present power of government has been lost. Since the UK holds a unique view of government and the role of the state, tax harmonisation within the EC is bound to be contentious.

Tax then exerts a strong influence over financial reporting in the EC and looks set to retain its influence for some time to come.

The accountancy profession

The EC's Eighth Directive on the qualification and regulation of auditors, implemented into UK law by the Companies Act 1989, has already imposed a level of regulation on the UK auditing profession which had been hitherto unknown. It sparked off a debate in the UK about the merits or otherwise of self-regulation (e.g. Peat Marwick and KMG Thomson McLintock, 1987, and ICAEW, 1987) and highlighted the differences in the European and UK professions.

The differences between the professions in the UK and EC can be seen in several areas. For example:
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- the type of work done
- the frequency of audit
- the status of the profession

Type of work done

In the UK, there has traditionally been a minimal level of accounting legislation with accounting rules coming from accounting standards and what the profession considers to be "best practice." The overriding requirement of accounts has been that they should show a true and fair view of the company. Thus accountants have been expected to exercise judgement rather than merely check that regulations have been complied with. This contrasts with the work of the European auditor whose task has been to ensure that the detailed accounting and tax rules have been complied with. A detailed knowledge of these rules is therefore required but the question of compliance is largely one of fact rather than judgement.

This difference in the type of work performed by auditors is perhaps underlined by the structure of the profession. In the UK, auditing has been performed by accountancy firms and auditing has been considered by many to be a good training ground for accountants because it exposes them to the sort of issues which they will face in their subsequent careers. In the rest of the EC auditing tends to be regarded as divorced from accounting in general. Generally it is performed by professional national bodies but these are often run by the state. For example, the auditing bodies in France and West Germany (Compagnie Nationale des Commissaires aux Comptes and Wirtschaftspruferkammer respectively) are run by the state, reporting to government departments (the Ministry of Justice and the Federal Minister of Economics respectively). Even the government departments themselves reveal something of the place of audit in these two
countries. In France it can be viewed as a legalistic occupation with the paramount consideration being compliance with the law. In Germany, with its strong economy and banking community, audit is seen as serving the needs of that creditor-orientated business environment.

**Frequency of audit**

In the UK, all companies, whether large PLC's or small, family owned companies must be audited. This may be explained by the shareholder orientation of UK accounting arising from the developed Stock Market and popularity of share capital as a method of financing business. Audit, seen in this light, is a protection mechanism for shareholders whether they be institutional or private investors, remote or family. Audit has also been viewed in the UK as being in the public interest. These views can be criticised of course. It has been argued that most shareholders do not really understand financial statements or the audit report but that argument might point to the need for more understandable financial statements rather than the abolition of current reporting practice and audit altogether. For views on the nature and purposes of auditing, see, for example, Lee, (1986).

Throughout the rest of Europe, the requirement for audit has been less widespread. This is due to the prevalence of different types of business forms, not just companies, in Europe, as has already been discussed. The extent of audit has also been less as many firms fall within the small and medium size categories which allows them to disclose less.

The question of whether companies can send abbreviated accounts to shareholders has already arisen in the UK. There is also at present a proposal under consideration by the Commission of the EC to amend the Fourth Directive on annual accounts and the
Seventh Directive on consolidated accounts with respect to the exemptions for small and medium sized companies (SME's). (See OJ, Vol 32, C287). The proposals would extend the current exemptions available to SME's and make them mandatory on member states. They would radically alter the practice of financial reporting in the UK.

Status of the profession

It is by no means clear what a profession is or whether accountancy is regarded as a profession by the public at large. McIlroy (1986), for example, argues that accountants need to redefine the meaning of professionalism in the context of an increasingly commercial world. A comparison of accountancy with certain other professions, in terms of attributes and status, is made by Armstrong (1987). Arguments can be put that accountancy in the UK is a profession because, for example, the training is rigorous and thorough, it is designed to instill an ethical code and the work involves both a high level of expertise and the exercise of judgement. Remove the ethical and judgemental aspects and it would be much harder to justify that accountancy is a profession. Lee (1987) argues that professional judgement is one of the cornerstones of a profession, differentiating professionals from technicians. He sees accounting based on compliance as a threat to professionalism, which must be of concern to the UK profession in the EC arena.

Oldham (1987) considers the status of auditors in the EC and concludes that the auditor is not always highly regarded. He feels that this may be because of,

1 His lack of exclusiveness in the work he performs.
2 The prescriptive and statutorily limited duties that he undertakes.
The tendency to employ him as a means of certifying the minimum disclosure of information allowed under the company or tax legislation of the country concerned." (p.9)

Thus the status of part of the accountancy profession is under threat if UK accounting becomes more like that of the rest of the EC. It should be pointed out that the above remarks relate to auditing and not accountancy in general. The broader accountancy profession in the rest of the EC is, by and large, well regarded, probably, as Oldham speculates, "as a result of the business community's realisation of the advisory services that (the accountant) can provide" (p.9).

The UK accountancy profession has two concerns regarding EC accounting harmonisation. True, there is an element of self-interest. The status of the profession is obviously of concern to every qualified accountant. There is another reason however, and if accountants are true professionals this other reason will be of more significance. UK accounting is very different from other European accounting for a variety of reasons as we have seen. It is also undergoing a period of self-examination at present with discussion of the need for a conceptual framework (eg Solomons (1989) and Making Corporate Reports Valuable, McMonnies (Ed), 1988) and efforts to set accounting requirements into a wider context (eg the discussion of the nature of assets and liabilities in EDs 42 and 49). It would be a great pity if such examination was thwarted by harmonisation with dissimilar systems. This does not imply either a pro or anti stance on harmonisation. It is simply a call for proper discussion before further harmonisation, if considered desirable, is undertaken.
CHAPTER 6 - THE WAY AHEAD

This review so far has concentrated on the harmonisation programme to date and the difficulties of harmonisation. It is also worth considering the EC's future plans for harmonisation as they show the breadth of the EC's intentions and may show the scope for difficulties ahead. The Department of Trade and Industry (1989a) has produced a list of formal draft proposals of the EC Commission with brief details and the name of a contact point from whom further details can be acquired. An abbreviated list of formal draft proposals as at 1 March 1990 is provided in Appendix 3.

These proposals have not met with universal approval, particularly the proposed fifth and thirteenth directives. For example, Janet Dine (1989a) and S J Berwin and Co (1989) have expressed reservations over proposals for the election of directors and directors' liability as proposed in the fifth directive. As regards directors' liability, it is proposed in the draft fifth directive that directors would be jointly and severally liable for damage sustained by the company as a result of breaches of duty by one or more of them. Accused directors would also have to prove their innocence from fault. This would reverse the present burden of proof as regards fault (i.e. the 'innocent until proven guilty' presumption). This would be a very significant step for the EC as it would herald a move towards EC influence in the common, as well as statute, law. As such, it is opposed in other EC countries as well as the UK.

The Department of Trade and Industry has also expressed reservations about the draft fifth directive, particularly attempts to force companies to adopt worker participation schemes. (See report in the News section of The Company Lawyer, 1990, Volume 11, p.72). Finally as regards the draft fifth directive, The Company Lawyer points out that the directive's proposal to extend the liability of auditors to third parties, including shareholders, is contrary to the recent House of Lords decision in
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Caparo Industries v Dickman which held that auditors cannot be sued in negligence by individual investors. The proposals contained in the draft fifth directive have therefore got important implications for UK law and auditing.

The proposed thirteenth directive has been strongly criticised by the Takeover Panel (see Professional Briefing in Accountancy, November 1989) on the ground that its self-regulatory status could be under threat. For a review of the proposed twelfth directive, see Wooldridge (1989).

Apart from the proposals outlined above, there seems to be a discernable move towards the adoption of pan-European proposals and business forms. The European Economic Interest Grouping (EEIG), effective from 1 July 1989, represented the first such move, the regulation enacting it being approved by the EC in 1985. (Thus references post 1985 contain up-to-date comments on the EEIG.) This, along with the proposal for a European company statute and discussion on the issue of a European standard setting body, shows that EC thinking does not simply revolve around harmonisation of national laws but has moved towards a more genuinely European approach. These three European ideas will be considered in turn.

European Economic Interest Grouping (EEIG)

The aim of this business form is to encourage co-operation between businesses operating in different countries by enabling them to form an EEIG, a business form which allows them to collaborate and provide non-profit making support activities jointly but without having to create a group structure. Indeed, as Oldham (1987) says, it is a "potentially useful form of co-operation grouping, midway between an association and a
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partnership." (p.51) The EEIG is governed by various rules, summarised by Oldham (1987) as follows:

- it must appoint a manager
- it can own property
- it can make contracts, sue and be sued, but it does not have to possess separate legal personality, this being a matter for individual member states. The UK, however, has decided (in The European Economic Interest Groupings Regulations 1989 (SI 1989 Number 638)) to treat an EEIG as a 'body corporate' with the result that certain provisions of UK companies legislation apply to EEIGs registered in the UK. A full list of such regulations is contained in the statutory instrument.
- each member contributes capital; there is no other capital
- it must be non-profit making
- it does not pay tax on its own account; tax is charged on individual members according to national laws
- it can be registered in the country of any one of its members
- minimum regulations exist concerning disclosure requirements, publicity and protection of third parties

The activities appropriate to an EEIG include marketing, research and development, bulk purchasing and the sharing of expertise as they are not directly profit-making. These would give small firms in individual member states some of the benefits of economies of scale without the costs of amalgamation or takeover. The EEIG is obviously a very new business form and it is too early to comment on its success. It has however been described by Israel (1988) as "a major step forward for Community law" as "for the first time Community undertakings will be able to avail themselves of a legal structure adapted to the dimensions of the European market" (Israel, 1988, p.14). As he points out, it thus avoids the difficulties of fitting European developments into
national legal structures. It does this because it is governed by an EC regulation, which is directly applicable in all member states, rather than by a directive.

The editorial in *The Company Lawyer* (1989, Volume 10, p.125) discusses the implications of this use of a regulation, pointing out that the language used in EC regulations is more general than that of UK statutes, with less detail. Although the editorial describes this as a "culture shock" to UK practitioners, it states that the general style gives room for flexibility and creative use of the EEIG structure. Thus reaction to the EEIG has been favourable to date.

**European Company Statute**

The EC Commission first proposed a European company structure in 1975 and the latest proposals were adopted in July 1989. The Department of Trade and Industry issued a consultative document ("Proposal for a European Company Statute", DTI, December 1989) requesting comments by the end of February 1990. The proposal would be enacted by two documents. The legal framework for the establishment of a European Company would be contained in a regulation, and like the EEIG regulation, would be directly applicable throughout the EC thus avoiding the problem of discrepancies arising because of incorporation into national law. The controversial proposals for employee representation would be contained in a directive.

The proposals would allow two or more companies based in different member states to form a European company (Societas Europaea (SE)) by merger, the formation of a joint holding company or a joint subsidiary. The new company would have legal personality throughout the EC and would be governed by the provisions of the European company statute with limited reference
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to national law. As S J Berwin and Co. state (1989, p.47), the intended role of the company is to facilitate cross-border cooperation by means of large scale mergers and associations. Smaller scale ventures would be more suited to the EEIG scheme.

The European Company idea has not met with wholehearted approval, hence the delay in finalising proposals. Problems have arisen over the proposed board structure and the proposals for compulsory worker participation. This latter issue has led the UK to veto the proposed Fifth Directive which deals with this topic but such a veto does not exist with the European Company statute as it can be approved by majority vote only. As regards board structure, there are two proposed options. Either a single board could be formed with a majority of non-executive directors or two separate boards, a Board of Management and a Supervisory Board with the latter appointing the former.

The present government is not in favour of worker participation or the dual board structure but objections come from other sources also. In TR 727, the Institute of Chartered Accountants in England and Wales criticised the proposals. They argued,

"While we would welcome any measures which would streamline and simplify company structure and harmonise it for the benefit of industry and commerce generally, we do not think that the case made by the Commission is convincing.

We believe that considerably more progress in the harmonisation of the laws of member states will need to be achieved before consideration is given to the legal requirements under which a European company ought best to operate for the benefit of the Community at large."
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Smit and Herzog (1990) also highlight some of the difficulties with the European company idea. They consider that there are technical and psychological obstacles. The most major technical one is the problem of each nation retaining its own tax laws while psychological barriers exist because, despite the co-operation ideals of the EC, in practice "a firm from another country may be viewed more as a competitor than as a potential ally". (Smit and Herzog, 1990, Vol 2, p.592).

A more optimistic view is taken by Janet Dine (1989b). She argues that harmonisation to date has not created a "European" outlook and is unlikely to do so since implementation is by incorporation into national laws which are quite different. She believes that a better approach is to create a supra-national organisation with its own law "independent of national idiosyncrasies". Her view (1989b, p.329) is that,

"It would seem that the business community of Europe would greatly benefit from the availability of a European company statute which adopted a minimalist approach and has as an underlying philosophy the facilitation of business rather than its regulation."

She does recognise that a major problem with this approach is the loss of sovereignty on the part of member states but she feels that there would be a corresponding benefit to entrepreneurs. Recognising also that one of the major stumbling blocks to the present European company proposals is the issue of worker participation, she advocates ignoring the "social engineering" proposals of the statute and instead requiring companies to adhere to the laws of the state in which it operates. Indeed, she questions whether companies should be used as a vehicle for social reform as they are interested in profit not social factors although, as she says, it can also be argued that there is a correlation between a company's profit maximisation and other social goals. As regards
more technical issues, such as publicity for meetings, she favours companies following the rules of the state where they choose to be registered. All this leads her to conclude (1989b, p.331) that,

"a European company ought to be subject only to the minimum degree of regulation consistent with the protection of those who will deal with such companies, remembering the nature of company law as enabling law (ie to enable companies to take part in business not to regulate), and the honesty of the vast majority of enterprises."

This view seems to have much to commend it. It preserves national differences while allowing for international co-operation which seems to be at the heart of the EC ideal.

European standard setting

In the autumn of 1989 the Scottish, English and Irish Institutes of Chartered Accountants began to consider whether to support plans for the establishment of a European accounting standards body. A draft paper circulated by ICAEW (reported in the News section of Accountancy, October 1989, p.7) warned that if EC member states do not achieve some form of accounting harmonisation in the near future then the EC Commission could take over this role itself. ICAEW is clear that European standards should not be at the expense of international ones. It feels, however, that the goal of international standards could become closer if they were adopted at European level. The implication is that a European standard setting body should be encouraged to issue standards which comply with those of the IASC.

Such an approach could perhaps circumvent the problem of the UK profession traditionally favouring harmonisation of accounting standards at international rather than EC level but it is not clear whether it would be acceptable to Europe. If it is not
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then there may be dangers for the UK standard setting approach. Andy Simmonds (1989b) for example questions "the wisdom of a 'go it alone' policy whereby we expend time and effort on drawing together the peaks and troughs of European accounting, if the result is unacceptable to our main trading partners elsewhere in the world". He would prefer to see either US GAAP or the International Accounting Standards Committee taking the lead in international standard setting. He worries that if the UK lends support to European standards, our attention will be deflected from international standards with the result that the US' "stranglehold on global standards" will increase.

Karel Van Hulle, an EC official, understands the desire for international standards but feels that the EC is already engaged in a form of standard setting (see the News section of Accountancy, July 1989, p.13) with the Fourth Directive providing the starting point and the Seventh Directive extending the process. In this light, European standards would be a logical conclusion.

It is possible that the creation of European standards could help solve some of the current differences in European accounting. We have seen that the imposition of laws on the content and format of financial statements has not led to accounts which are comparable between nations and that the reason for this may be the underlying differences in the business framework of member states. If accounting policies were harmonised at a deeper level, as they would be if alternative accounting treatments were debated by standard setters and a limited range of acceptable accounting treatments agreed, then users of accounts could perhaps have more confidence that preparers had used recognised options from a limited range rather than the practice advocated by directives as modified by traditional national perspectives.

If European standard setting is to be pursued, it will be necessary to consider whether standard setting should be divorced from law,
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as happens in the UK. This would, of course, represent a move away from the traditional European accounting background.

Rutherford (1989) takes the view that there are problems with too close a relationship between standard setting and the law. In his review of ED 45 on Segmental Reporting (Rutherford, 1989), he is critical of the ED because it is so bound up with the law as set out in companies’ legislation and merely "infills" statutory requirements. While pragmatic, his view is that such an approach "is hardly a triumph of the standard-setter’s art".

Damant (1989) also takes the view that too strong a legal influence on accounting is counterproductive for two main reasons. Firstly, accounting rules embodied in law are inflexible and take years to modify. Secondly, as the capital markets and companies become increasingly international, uniform rules facilitate trade but legally based accounting rules cannot be uniform because of the differences in legal systems. Thus, in Damant’s view, international accounting standards divorced from law are required.

Taking the contrary view, Hubbard (1990) feels that even the European legal influence may not be as much of a problem as it might at first appear. His review of the accounting treatment of post balance sheet events in Germany and the UK contrasts the UK’s independent standard setting approach with the German one where "the GAAP framework is laid down by law which is then subjected to various learned interpretations and commentaries". His conclusion is that, despite differences in standard setting, current German and UK practice on post balance sheet events is "virtually identical". This gives some hope that harmonisation of accounting standards may not be an impossible task.

European standard setting, divorced from law, would of course be more in keeping with the UK accounting tradition than the legalistic approach utilised in the rest of the EC. If European
standard setting developed along the lines of recent UK standard setting (as shown in the EDs on off-balance sheet finance and intangible assets) then it might also lead, in time, to the beginning of the formulation of a conceptual framework for accounting. A framework based on concepts rather than law might therefore provide some form of reconciliation between UK and other European law.

The issue of the future of EC harmonisation was discussed at a conference organised by the EC Commission in January 1990, previewed by Rutteman (1989). The three key questions raised by the Commission for discussion were:

- what subjects not dealt with in the Fourth Directive should be harmonised at Community level?
- should the number of options in the Directive be reduced?
- how can the whole procedure for adopting and changing accounting requirements within the Community be improved?

The issue of European accounting standards falls within the third question. Rutteman's view is that, although there is little enthusiasm for international accounting standards within the EC, the EC would be unlikely to ignore the work of the IASC. From a practical point of view therefore, "International Standards might well form the framework within which European standards are developed, without ever formally acknowledging the point" (Rutteman, 1989, p.15). By this means, the UK approach might be more likely to survive.
CHAPTER 7 - CONCLUSION

The literature surveyed leaves little doubt that there are fundamental differences between the UK and the rest of the EC in their respective legal, financial, political, taxation and professional fields. The question which must be answered is whether these differences can be resolved or whether they are so deep-seated that harmonisation of company and accounting law is impossible.

In the section on harmonisation it was seen that harmonisation means that the laws of member states are brought broadly into line; harmonisation does not mean that they have to be identical. The chapters on the legal, financial and accounting environments can only lead to the conclusion that complete uniformity of accounting regulation and financial reporting is highly unlikely because of the underlying influences on accounting. That was presumably the reason why "harmonisation" rather than uniformity was envisaged by the draughtsmen of the Treaty of Rome.

As has been seen, harmonisation has its dangers. It leads readers of financial statements to believe that the statements prepared in different countries are comparable. The problem with harmonised accounting formats and disclosures is that, because accounts look the same readers will assume that they are the same; in other words they will assume that the thought processes and accounting principles which gave rise to the figures are the same. Nobes (1989) highlighted this danger and has suggested rough and ready adjustments which readers can make to accounts from different nations in order to make them rather more comparable than they are at present. However good the adjustments though, they will always remain rough and ready because the financial statements will never contain sufficient information for readers to manipulate the figures with confidence that their assumptions are correct. It is also unlikely that all readers of accounts will possess the expertise necessary in order to adjust the accounts or even to realise that an adjustment can be done. Thus adjusting accounts
CONCLUSION

is really only going to benefit institutional and other major investors who are likely to do this sort of thing already.

If harmonisation is at best difficult and at worst misleading, what other options are open to us? We are, after all, a fully-fledged member of the EC. The harmonisation of company law was underway prior to our entry and so should come as no surprise. We are therefore committed to harmonisation in some form and have of course implemented, among others, the EC’s Fourth, Seventh and Eighth Directives so we have played our part in the harmonisation process to date. We have also been able to influence it as the incorporation of the true and fair requirement into the Fourth Directive shows. Future developments may cause us problems however, particularly the proposed directive on the reporting requirements of SMEs. Other proposals will also be of significance to company law and Stock Exchange regulation (eg proposals for procedures for informing and consulting employees, the so-called Vredeling directive; proposals for a Fifth Directive on the structure and management of PLCs and proposals for a Thirteenth Directive on takeover and other general bids) but will not impact as much on financial reporting.

There are also potentially pleasing developments from a UK point of view however. The current draft proposal to extend the scope of Fourth and Seventh Directives to certain partnerships and unlimited companies could bring EC accounting more into line with that of the UK. The proposals are designed to ensure that all businesses whose partners have limited liability are subject to the same requirements as companies and that unlimited companies whose shareholders are limited companies cannot escape the Fourth and Seventh Directives. These proposals will go some way to resolving the situation which presently exists whereby small UK companies are subject to more regulation than their counterparts abroad which can operate satisfactorily without forming a limited company.
CONCLUSION

Another pleasing development is that the EC is beginning to use regulations as well as directives to achieve harmonisation. Regulations, being directly applicable in member states, avoid the very real problem of directives having different results in different countries because of the fact that they have to be incorporated into national laws which, as we saw in Chapter 3, are quite different throughout the EC.

Such developments do not, however, alter the fact that harmonisation, as presently envisaged, is unlikely to succeed because of the differences which exist throughout the EC. Perhaps the way ahead should be to recognise this but to look for alternative options which can avoid the difficulties outlined in this survey. One such option might be to turn attention to supranational business forms with their own regulatory framework separate from national ones. The EEIG represents one example which exists at present. Another proposed example is the European Company, considered in Chapter 6. The attraction of such schemes is that they are new, and so suffer from none of the problems associated with the adaptation of existing ideas in member states to conform to a common pattern. They can have their own regulatory framework, governed by EC regulations, which can result in a far greater degree of uniformity than national laws, thus providing a greater likelihood that the EC ideal of facilitation of cross-frontier trade will succeed.

In conclusion, harmonisation along current lines is fraught with difficulty and cannot hope to be truly successful. Alternative approaches are needed so that the best elements of the UK accounting tradition can be preserved in an accounting framework which can serve the needs of the whole community. There is no easy answer for all approaches have to satisfy 12 quite different nations but solutions must be found so that the aims of the EC are not frustrated. One possibility is the European company statute while the EEIG offers an alternative at present. These business
forms are worthy of consideration because they offer the hope that international and domestic frameworks can co-exist, facilitating business across Europe which is at the heart of the EC ideal but recognising that the 12 nations of the EC are not the same and Europe would become a faceless place if they were to become so.
Nobes' classification of accounting systems

1. Nobes classification based on pre Fourth Directive work:

Figure 6.1: A Suggested Classification of Accounting Systems in Practice

Notes:
1. Adjacency is not necessarily supposed to imply similarity. For example, it is not intended to imply that Australia is nearer to the Netherlands than the UK is.
2. The size of differences within a family varies from family to family.
3. Brackets indicate that a system may exhibit differences from others of its family because of lack of development.
4. See Fig. 8.1 for a final version of this chart.

(Source: Nobes (1984), p.67)
APPENDIX 1

Note that Nobes restricted his study to accounting as practised by public companies listed on a Stock Exchange although he admits that this need not be a good indication of accounting practices throughout a country. He concentrates on accounting measurement practices, ignoring disclosure practices and the underlying business environment. Against this background, he presented a hypothesis in the above form.

His hypothesis is that financial reporting practices can be broken down into hierarchical form and grouped according to "families" in order that the relationships and similarities of different national practices can be elicited. For example, he suggests that Australian accounting, belonging to the "business practice, pragmatic British origin" family, is closer to UK accounting than to either Dutch or Canadian accounting.
2. Nobes' modified classification based on post Fourth Directive work:

Classification of EEC Countries in 1980

Measurement Practices

- Micro/Professional
  - Business Economics
    - Netherlands
  - Pragmatic
    - UK
  - Ireland
  - Italy
  - Lux
  - Portugal
  - France
  - Belgium

- Macro/Uniform
  - Code
    - Spain
    - Greece
  - Plan
    - West Germany
  - Law (HC)
    - Denmark
  - Law (Flexible)
Nobes' classification of accounting systems
1. Nobes classification based on pre Fourth Directive work:

Figure 6.1: A Suggested Classification of Accounting Systems in Practice

Notes:
1. Adjacency is not necessarily supposed to imply similarity. For example, it is not intended to imply that Australia is nearer to the Netherlands than the UK is.
2. The size of differences within a family varies from family to family.
3. Brackets indicate that a system may exhibit differences from others of its family because of lack of development.
4. See Fig. 8.1 for a final version of this chart.

(Source: Nobes (1984), p.67)
APPENDIX 1

This classification was based on an examination of 9 factors which could be expected to differ from country to country:

1. Types of user of the published accounts of the listed companies
2. Degree to which law or standards prescribe in detail and preclude judgement
3. Importance of tax rules in measurement
4. Conservatism/prudence (eg valuation of buildings, stocks, debtors)
5. Strictness of application of historic cost (in the historic cost accounts)
6. Susceptibility to replacement cost adjustments in main or supplementary accounts
7. Consolidation practices
8. Ability to be generous with provisions (as opposed to reserves) and to smooth income
9. Uniformity between companies in application of rules.

Nobes' main distinction is between micro-based and macro-based countries, terms derived from Mueller's earlier work. Micro-based systems are characterised by the limited effect of tax laws; systems which, though prudent, are influenced by the "true and fair" requirement and where the dominant user groups are shareholders and investors. By contrast, macro-based systems are characterised by detailed and influential tax rules; strict conservatism and prudence and a dominant user group comprising creditors, bankers and the tax authorities rather than investors. In his classification of EC financial reporting, these distinctions become "micro-professional" and "macro-uniform" where,

"The former involves accountants in individual companies striving to present fair information to outside users, without detailed constraint of law or tax rules but with professional guidelines. The latter type has accounting mainly as a
servant of the state, particularly for taxation purposes."
(Nobes, 1986, p.36)
APPENDIX 2

Profit and loss account – tax influence – some examples

1. Depreciation

Most EC tax authorities publish acceptable depreciation rates. In Belgium, France and Germany for example, the following straight-line rates are acceptable:

<table>
<thead>
<tr>
<th>Category</th>
<th>Belgium</th>
<th>France</th>
<th>Germany</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>%</td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td>Buildings</td>
<td>3-5</td>
<td>2-5</td>
<td>2.5-4</td>
</tr>
<tr>
<td>Plant and machinery</td>
<td>10-20</td>
<td>5-20</td>
<td>10-20</td>
</tr>
<tr>
<td>Office equipment</td>
<td>10-15</td>
<td>10-20</td>
<td>10-20</td>
</tr>
<tr>
<td>Vehicles</td>
<td>20-25</td>
<td>20-25</td>
<td>25</td>
</tr>
</tbody>
</table>

(Source: Peat Marwick McLintock, Investment in France, p.25)

The reducing balance method is also allowed in most EC countries with rates of approximately double the above. Absolute maximum depreciation figures may also be specified in some circumstances (eg Belgium specifies the maximum depreciation figure permitted for cars).

While the figures shown above do not differ widely from those used in the UK, the techniques used to arrive at them do. In the UK, each firm must consider its assets carefully and allocate their cost to accounting periods in a true and fair
manner according to the requirements of SSAP 12. Thus two firms using an identical asset might arrive at quite different depreciation figures depending on the use of the asset within the firm. Such a discrepancy would be more difficult to achieve in much of Europe. The question at issue is really whether we wish comparability and uniformity first and foremost or the elusive truth and fairness.

2. **Bad debt provisions**
   In most EC countries (eg Belgium, France, Italy, Portugal and Spain) tax law does not recognise provisions for doubtful debts, only known ones. Thus debts tend not to be written down until bad. In tax terms the situation is similar to the UK therefore but the accounting is different. In Germany, however, as in the UK, provisions for doubtful debts are made in the accounts.

3. **Stock**
   Tax laws specify permissible valuation methods for stocks (eg AVCO and FIFO in France and Italy; AVCO, LIFO or FIFO in Germany and Denmark). Some tax systems also specify more unusual provisions (eg German tax laws permit strategic raw materials to be reduced by up to 20% of cost in certain cases).

**Balance sheet - tax influence - some examples**

1. **Stock** - see above

2. **Tangible fixed assets**
   The valuation rules adopted throughout Europe are heavily tax based. Germany's are the most strict as only historic cost is permissible. Unrealised gains must never be shown. France allows assets to be shown at historic cost or at a valuation in
APPENDIX 2

accordance with published price level indices. Italy also favours cost but revaluations are permitted in specified circumstances. In Belgium, upward revaluation is permitted if there is a permanent increase in value of tangible and financial fixed assets while in Denmark land and buildings can be revalued upwards in accordance with detailed tax rules. Thus there is a wide range of accounting methods for fixed assets throughout the EC but they share a common tax influence. This influence stresses certainty and verifiability which does not necessarily lead to useful information. Once again a choice has to be made.

3. **Intangible fixed assets**
Most EC countries require purchased goodwill to be written off within five years, although Belgium, Greece, Italy, The Netherlands and Spain will allow a longer write-off period, usually ten years. Thus all display a certain prudence which seems to have been rejected in the UK in the recently published exposure draft on intangible assets.

4. **Reserves**
The requirement for a legal reserve to be kept has already been mentioned, as has the prevalence of secret reserves in several countries.

5. **Deferred tax**
The foregoing summary has shown the extent of the tax influence on accounting within the EC. The impact on financial reporting is that accounting policies accord with tax rules even where other options exist because no tax relief is given for items that are not shown in the financial statements. In many countries for example it is wasteful to depreciate assets by more than the tax-permitted amounts because the excess will never qualify for tax relief. One consequence for financial reporting is that in all member states except
Denmark, The Netherlands, the UK and Ireland no provision for deferred tax is required.
APPENDIX 3

Formal EC Commission draft proposals as at 1 March 1990

- Proposal for a fifth directive on the structure and management of PLCs

- Proposal for a tenth directive on cross-border mergers of PLCs

- Proposal to extend the scope of the Fourth Directive on annual accounts and the Seventh Directive on consolidated accounts to certain partnerships and unlimited companies

- Proposal to amend the above two directives with respect to the exemptions for small and medium sized companies and to the drawing up and publication of accounts in ECU

- Proposal for a directive on procedures for informing and consulting employees ("Vredeling" directive)

- Proposed directive on compulsory winding-up of direct insurance undertakings

- Proposed directive on the annual accounts of insurance undertakings

- Proposed directive on the reorganisation and winding-up of credit institutions and deposit-guarantee schemes

- Proposed thirteenth directive on takeover and other general bids

- Proposed directive amending requirements in respect of the mutual recognition of stock exchange listing particulars

- Proposal for a European company statute (discussed in chapter 6)
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EC FINANCIAL REPORTING HARMONISATION
- the Mask of Comparability

This monograph provides an interesting introduction to some of the major themes which characterise financial reporting harmonisation within the European Community. It provides an important insight into some of the difficulties of harmonisation (hence the sub-title "the mask of comparability") and considers ways in which these could be overcome in the future.

Catriona Paisey, a member of The Institute of Chartered Accountants of Scotland, is a lecturer in the Department of Accountancy at the University of Aberdeen.

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