EUROPEAN
COMMISSION

Brussels, 18.6.2015
COM(2015) 301 final

REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

EVALUATION OF REGULATION (EC) N° 1606/2002 OF 19 JULY 2002 ON THE APPLICATION OF INTERNATIONAL ACCOUNTING STANDARDS

{SWD(2015) 120 final}

1. Introduction

Over ten years after the adoption of Regulation 1606/2002 ("IAS Regulation")[1] and following an initial review of its operation in 2008[2], the Commission decided to assess whether it achieved what it set out to do as part of the Regulatory Fitness and Performance Programme (REFIT)[3]. In parallel, Regulation 258/2014[4] requires the Commission to report both on the findings of the evaluation including, if appropriate, proposals for amendments, and on the governance arrangements of relevant bodies.

The objective of adopting International Financial Reporting Standards (IFRS)[5] issued by the International Accounting Standards Board (IASB) for use in the EU was to improve the efficient functioning of the EU capital markets and the internal market.

Under the Regulation, since 2005, the consolidated financial statements of listed EU companies[6] have been prepared in accordance with IFRS. Member States may extend the application of IFRS to individual annual financial statements and to non-listed companies. The "Transparency Directive"[7] also stipulates that all issuers (including non-EU ones) whose securities are listed on a regulated market located or operating in the EU must use IFRS.

This report summarises the findings of the evaluation and identifies potential improvements. The accompanying Commission Staff Working Document sets out further detail supporting this report.

2. Methodology

The Commission conducted the evaluation which involved seeking the views of stakeholders through a public consultation (August – November 2014, 200 contributions), an informal expert group (18 public and private organisations, 3 meetings in 2014) and the Accounting Regulatory Committee (ARC) which comprises representatives of all Member States. It conducted a review of the literature on the impact of the mandatory adoption of IFRS in the EU and on the performance of IFRS during the crisis. It also drew upon internal experience of relevant international and European bodies. The evaluation took account of Mr Maystadt's

---

[1] Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards, OJ L 243, 11.9.2002.
[2] COM(2008) 215.
[3] COM(2014) 368.
[4] Art. 9(2) of Regulation (EU) No 258/2014 of the European Parliament and of the Council of 3 April 2014 establishing a Union programme to support specific activities in the field of financial reporting and auditing for the period of 2014-20 and repealing Decision No 716/2009/EC, OJ L 105, 8.4.2014.
[5] International Accounting Standards (IAS) were first issued by the International Accounting Standards Committee (IASC), the predecessor of the IASB.
[6] With securities traded on a regulated EU market.
[7] Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC, OJ L 390, 31.12.2004.

recommendations[8] to reinforce the EU's contribution in the international standard-setting arena.

The evaluation sought to compare the situation under the IAS Regulation with what would have been the case if IFRS had not been adopted. However, there was no clear benchmark against which to compare IFRS, as there is no single alternative in the EU and as national or US generally accepted accounting principles (GAAPs) evolved during the period under review.

The evaluation was generally from the perspective of the EU as a whole, without systematic analysis of the interaction of the Regulation with national legislation. The evaluation did not include a technical review of IFRS standards, nor were individual standards analysed from the perspective of the administrative burden they may impose. Neither did it consider possible alternative accounting regimes for EU non-listed companies.

The effects of IFRS adoption during the period under review were difficult to isolate as there were other significant regulatory changes; the effects also varied depending on the national GAAPs used before IFRS. It was also difficult to obtain quantitative data on companies applying IFRS and on costs and benefits. Existing research has mainly focused on larger companies. Finally, respondents to the public consultation were self-selected and did not necessarily constitute a representative sample.

The evaluation does not touch upon auditing. It is widely accepted that high-quality audits are necessary to ensure reliable financial statements. During the period under review, the EU has enhanced its regulatory framework for statutory audits, including independent supervision of auditors and audit firms[9].

3. Findings

3.1. Evaluation criteria

3.1.1. Effectiveness

The objective of the IAS Regulation was to harmonise the financial reporting of listed companies by ensuring a high degree of transparency and comparability of their financial statements in order to enhance the efficient functioning of EU capital markets and of the internal market. The Regulation attached importance to IFRS becoming globally accepted so that EU companies would be able to compete on an equal footing for financial resources in the world capital markets.

[8] Should IFRS Standards be more "European"?; Mission to reinforce the EU's contribution to the development of international accounting standards; Report by Philippe MAYSTADT – October 2013.

[9] Directive 2006/43 on statutory audits of annual accounts and consolidated accounts amended by Directive 2014/56 and Regulation 537/2014 applicable from mid-June 2016.

Transparency and comparability

The Commission found that the IAS Regulation has increased the transparency of financial statements through improved accounting quality and disclosure and greater value-relevance of reporting, leading to more accurate market expectations including analysts' forecasts. It also led to greater comparability between financial statements within and across industries and countries although some differences persist.

Collected evidence suggested that the quality of financial statements prepared under IFRS is good, which implied that the standards are of good quality. Nevertheless, there were criticisms of their complexity. Findings suggested most complexity is unavoidable as it arises from the underlying complexity of business; although standards are not industry specific, they were considered flexible enough to accommodate most business models but there was some concern about their suitability for long-term investors and about the volume of disclosures.

The IAS Regulation recognised that high quality financial reporting depends on proper and rigorous enforcement. Under the Transparency Directive, enforcement of accounting standards is the responsibility of individual Member States; the European Securities and Markets Authority (ESMA) coordinates their activities to enhance supervisory convergence and ensure consistent application of IFRS in the EU.

Collected evidence suggested that there are proper mechanisms in place to ensure adequate enforcement of IFRS and that ESMA plays an important role in promoting consistency and coherence in enforcement across the EU. Nevertheless, some evidence showed that some differences in enforcement persist between Member States. ESMA recently published new guidelines[10] on enforcement which could lead to further improvements in this area but it is too early to assess their impact.

Consistent implementation of standards can depend on how they are interpreted. ESMA refers areas of diversity in practice to the IFRS Interpretations Committee. The Commission welcomes the effective cooperation between the two bodies.

Efficient Functioning of the EU Capital Markets and Internal Market

The Commission found evidence of improved capital market outcomes: higher liquidity; lower costs of capital; increased cross-border transactions; easier access to capital at EU and global level; improved investor protection and maintenance of investor confidence. However, as noted above, the effects of IFRS could not be isolated from other changes affecting capital markets.

The extent to which, if any, the use of IFRS may have exacerbated the financial crisis has been widely debated and the evidence was mixed. Two aspects of accounting fall under the spotlight. The first is the use of current prices (fair values) to value financial instruments.

[10] ESMA/2014/807.

When markets are overly buoyant or pessimistic, values can be exaggerated. By contrast, instruments such as bank loans are reported based on cost, with a constant need to assess whether customers will repay amounts due. During the financial crisis, the applicable standard for loan impairment was widely criticised for having led to “too little, too late” provisioning. Other criticisms concerned a lack of disclosure by some banks. After an extensive due process, the IASB published a new standard for financial instruments in 2014 (IFRS 9) which is currently being assessed for adoption. Overall, the financial crisis highlighted that standards can have broad economic effects (s3.2).

Global Standards

The IAS Regulation envisaged IFRS becoming global standards which would benefit EU companies. Stakeholders believed that the EU’s decision to adopt IFRS provided a major impetus to the credibility and acceptance of IFRS globally. To date, over one hundred countries accept IFRS and the standards are supported by international organisations, such as the G20, Financial Stability Board (FSB), World Bank, International Monetary Fund and the Basel Committee on Banking Supervision.

The United States does not permit its domestic companies to use IFRS which constitutes a significant limitation on their global application. The “equivalence” arrangement whereby the US Securities and Exchange Commission (SEC) accepts financial statements prepared under IFRS for foreign companies is perceived as an important benefit for around 90 large EU issuers with US listings.

In 2002, the IASB and the US standard setter (FASB) began a programme to converge their respective standards. The financial crisis highlighted the importance of this work which was actively supported by the G20 and FSB. In some areas, however, the Boards were unable to achieve common positions.

3.1.2. Efficiency

Overall, the evidence from the evaluation showed that the benefits of the implementation of the IAS Regulation outweigh the costs.

Nevertheless, application of accounting standards does not readily lend itself to traditional cost-benefit analysis as benefits are not quantifiable in money terms; there is little data on costs and there is an uneven distribution of costs and benefits whereby costs are largely incurred by companies preparing IFRS financial statements whereas benefits are shared by them, users of financial statements including investors and the wider economy.

Nevertheless, companies largely supported IFRS which implies that they find the costs commensurate with the benefits. Evidence suggested that the ratio of costs to benefits depends on characteristics of a company such as its size and scale of international operations. Some stakeholders saw merits in extending the use of IFRS by giving an option to companies to adopt IFRS as there would be cost savings, especially for companies in listed groups. Also, some suggested a lighter version of IFRS, with reduced disclosures, for subsidiaries of listed groups. It was noted that the cost of adopting IFRS may represent an obstacle for an initial public offering, especially for small and medium size companies (SMEs).

Users of financial statements largely supported IFRS for improving the transparency and comparability of financial statements.

All stakeholders incur costs during the development and endorsement of standards. Some feedback suggested that, more recently, the trade-off between costs and benefits has been adversely affected by frequent changes to standards, their complexity and the increasing volume of disclosures.

3.1.3. Relevance

Overall, the evidence from the evaluation showed that the objectives of the IAS Regulation remain relevant.

The increasing globalisation of capital markets has made the need for one financial reporting language even more relevant. In 2002, there was no level playing field for listed companies across EU capital markets. This has now been achieved so the debate focuses on whether a level playing field exists globally. As noted, international organisations support IFRS as global standards.

The crisis evidenced the need to understand the effects of regulations on financial markets and on economies. The IAS Regulation specifies that as a condition to being brought into EU, international standards must be conducive to the European public good. The term "public good" is not defined but may be understood to encompass broad financial stability and economic considerations. In particular, it is necessary to assess whether accounting standards could be detrimental to the economy or to particular stakeholders, such as long-term investors. There is also a growing call for regulations to be considered holistically in terms of their cumulative effects.

At the time of the adoption of the IAS Regulation, it was agreed that its objectives were more relevant for listed EU companies which was reflected in the scope of mandatory application which Member States have the option to extend. Some stakeholders considered that the use of IFRS could potentially bring similar benefits, in particular to investors, if their use was extended (e.g. to individual annual financial statements of listed companies not preparing consolidated financial statements). Others highlighted a risk of imposing complex standards on SMEs.

3.1.4. Coherence

Within the IAS Regulation

IFRS adopted by the EU have been codified in a legally-binding Commission Regulation 1126/2008[11] amended for each new standard and amendment. Twice yearly, the Commission draws up a non-binding consolidated version of current standards in all EU languages. Evidence shows a need for improved translations for certain languages, practical difficulties in the consolidation of the standards and some discrepancies between IASB and the EU consolidated texts. An official codification of all IFRS by the Commission could therefore represent a useful exercise.

Some stakeholders also questioned whether there is a need for assurance, beyond the IASB's due process, that new standards or amendments are coherent with the existing body of IFRS.

With other EU legislation

The Commission is committed to help address any points of friction in the interactions between the IAS Regulation and the Accounting Directive. Thus far, adequate interpretation and transposition methods by the Member States have enabled such points to be overcome.

Capital maintenance and dividend distribution rules have also been cited as a source of legal challenge which can arise in certain jurisdictions where Member States permit or require the use of IFRS for individual annual financial statements on which distributable profits are based. Each Member State considers how to address such issues in their national legislation within the framework of the EU capital maintenance requirements.

The IASB's existing *Conceptual Framework* states that the objective of general purpose financial reporting is to provide information about the reporting entity that is useful to existing and potential investors, lenders and other creditors. Although IFRS-based financial information is the starting point for much prudential regulation, the IASB does not include prudential supervisors or regulators on its list of users. Nevertheless, there is a need to ensure that financial information is fit for that purpose whilst recognising that prudential regulators can demand other information to meet their different objectives.

The evidence suggested that although IFRS, regulatory requirements, tax and capital maintenance rules may impose different reporting requirements on companies, such differences are largely considered to be proportionate and legitimate given the array of objectives pursued.

3.1.5. EU added value

In the late 1990s, the internationalisation of companies, the achievement of the single market and the globalisation of financial markets led to the need to find a common accounting

[11] Commission Regulation (EC) No 1126/2008 of 3 November 2008 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council, OJ L 320, 29.11.2008.

language for listed companies. Some of them had to prepare an additional set of accounts under international or US standards because their national accounts were not recognised internationally. The EU decided to apply IFRS for listed companies through a Regulation because difficulties in reconciling different accounting traditions between Member States would have impeded adequate enhancement of the Accounting Directives.

Evidence has shown that the Regulation's objectives have been achieved effectively and efficiently and that they remain relevant. Also, to date, there is still no well-defined alternative to IFRS. Thus the Regulation continues to provide added value to Europe reducing cross-border barriers through a common international accounting language and by allowing for a strong EU voice in the development of international standards.

Evidence showed that the balance between the mandatory scope of application of the Regulation and the option for Member States to extend the use of IFRS at national level ensures proper subsidiarity and proportionality. Member States have implemented the options in diverse ways which take account of their specific economic and legal environments. Compulsory use of IFRS has not been widely extended to non-listed companies or to individual financial statements.

3.2. Endorsement process and criteria

3.2.1. Endorsement mechanism - process

IFRS issued by the IASB are endorsed by the Commission under a comitology process. An endorsement process remains necessary to ensure that the standards developed by a private body meet certain criteria and are fit for the European economy before becoming part of EU law.

The Commission aims to ensure that the endorsement process runs smoothly and efficiently; feedback indicated that most stakeholders consider that it works well. Timing raised some concerns as it introduces regulatory uncertainty. Nevertheless, the need for a proper due process allowing adequate time for stakeholders to contribute as appropriate must be respected.

Another important factor for the endorsement process is that the effects of a standard are fully understood. To date, the IASB has provided limited analysis of the effects of its standards, focussing on the quality of the information provided to users of financial statements. Additionally, the Commission services and the European Financial Reporting Advisory Group (EFRAG) assess the effects of a standard at EU level.

3.2.2. Endorsement mechanism – flexibility

Some European stakeholders consider that the IAS Regulation is lacking in flexibility as it does not allow IFRS to be amended by adding text and has only limited scope for "deleting" ("carving-out") text. In the EU, one carve-out used by a number of banks has been in effect since 2005. Other stakeholders considered that standards issued by the IASB should not be altered for application in Europe. The Maystadt report stated that caution is necessary in this area and most stakeholders supported maintaining the status quo.

The feedback received also expressed the belief that the reform of EFRAG should enhance Europe's influence over the development of standards earlier in the process.

3.2.3. Endorsement criteria

The IAS Regulation sets out a number of criteria that must be met in order for a standard to be endorsed in the EU. The standard should not be contrary to the "true and fair" view principle set out in the Accounting Directive, should be conducive to the public good in Europe and should meet basic criteria related to the quality of information required for financial statements. The Maystadt report noted that two other criteria could be added as components of public good: that the standards should not endanger financial stability and must not hinder the economic development of the Union. Alternatively it suggested issuing a Communication giving guidelines for the interpretation of the public good criterion.

Overall, feedback suggested that the existing criteria work appropriately and, while some stakeholders would like to see other criteria included in the Regulation, there was no clear majority view calling for a particular criterion to be added. Nevertheless, some stakeholders considered that it would be helpful to be more specific about what European public good encompasses while others considered that the term is generic enough to have meaning and allows flexibility in practice. Most stakeholders did not recommend making any changes to the IAS Regulation itself but preferred that the Commission identify areas of focus for EFRAG on a case by case basis.

The challenge is that there should be a shared understanding of terms in the Regulation, including "public good" and "true and fair". In the latter case, some stakeholders recommended that a standard should be explicitly assessed in terms of whether it would lead to prudent accounting which they saw as an important factor in providing a true and fair view. The Commission, together with EFRAG, should produce guidance for improving the understanding of the endorsement criteria.

3.3. Governance

3.3.1. IFRS Foundation

The IFRS Foundation is an independent organisation setting accounting standards for more than 100 countries. Hence, it needs strong governance arrangements to ensure public accountability.

It has a three-tier governance structure aiming at favouring transparency, segregation of duties and adequate oversight. The Monitoring Board of public authorities, including the European Commission, ensures that the IFRS Foundation is subject to public oversight. It can refer matters of broad public interest to the IASB.

In 2013, the IFRS Foundation was mainly financed through contributions. It aims at establishing (compulsory) national financing regimes, proportionate to a country's GDP. This has so far proved challenging as many countries that use IFRS do not make commensurate contributions. Thus, the Foundation continues to rely on voluntary contributions, often from the private sector which may give rise to a risk of conflicts of interests. The EU as a whole, including the Member States contributions, is the main financial backer of the IFRS Foundation, with a multi-year commitment which provides the IFRS Foundation with a stable source of funding and helps it to diminish its reliance on the private sector.

In the period under review, there were a number of positive changes: creation of the Accounting Standards Advisory Forum, with European representation; recommendations to the Trustees from a consultative group on the methodology for field work and effects analyses which will be implemented by the IASB, and the introduction of post-implementation reviews of standards.

In response to demand from stakeholders, including European concerns, the IASB is developing its *Conceptual Framework* which will improve financial reporting by providing a complete and updated set of concepts to use in their future work. An exposure draft has been published on 28 May 2015 and addresses a number of important matters including reinstating the concept of prudence as an important element in financial reporting.

The IFRS Foundation is bound by its Constitution to review its organisational structure every five years. Past reviews significantly improved its governance. The next review will present an opportunity to tackle the issue of the Foundation's funding and decision-making process, including the role of the Monitoring Board.

3.3.2. EFRAG

In July 2014, the Commission reported[12] on the progress achieved in the implementation of the reform of EFRAG following the Maystadt report. The Commission came to a favourable conclusion regarding the progress made to date. The reform took effect on 31 October 2014 when the amended EFRAG Statutes and Internal Rules came into force. It involved establishing a new Board of EFRAG, its new decision-making body, with balanced representation of public and private interests, with a view to strengthening the legitimacy of its positions and contributing to the objective of Europe speaking with one voice.

4. Conclusion and next steps

The Commission is satisfied with the overall quality of the evaluation and in that context finds the overall results adequately supported by the evidence despite limited availability of quantitative data. The key findings showed that the objectives of the Regulation have been met.

[12] COM(2014) 396.

Evidence showed that the reform of EFRAG in the period under review is perceived as important in strengthening the EU voice in the development of IFRS.

Nevertheless, there are opportunities to improve the way in which the provisions of the IAS Regulation are applied and the Commission has identified a number of practical steps which could be taken.

Functioning of the IAS Regulation

- Evidence suggests that the existing **scope of the Regulation** and the options given to Member State are appropriate. As part of the Green Paper on Building a Capital Markets Union[13], the Commission has launched a debate on whether there is value in developing a common EU level, high quality and simplified accounting standard for SMEs listed on Multilateral Trading facilities (MTFs), more specifically SME Growth Markets.

- The Commission supports **IFRS as global standards** and continues to urge the US SEC to adopt IFRS for use by its domestic companies. Convergence is not seen as an end in itself because IFRS should be of high quality and appropriate for European markets, and hence for other jurisdictions in the world. The Commission considers that commitment to IFRS should be evidenced by establishing permanent financial contributions to fund the IFRS Foundation, proportionate to a contributor country's GDP. The Commission therefore urges the IFRS Foundation 2015 Governance review to ensure that the use of IFRS and the existence of a permanent financial contribution are conditions for membership of the governing and monitoring bodies of the IFRS Foundation and of the IASB.

- The effectiveness and efficiency of the Regulation depend on the **quality of the standards** themselves which should continue to be appropriately assessed during their development and endorsement. In particular, any interaction between the IAS Regulation and other EU law based on a holistic view of the overall coherence and effects, the complexity of the standards and volume of disclosure requirements should be considered. The Commission will examine the case for strengthening EU rules relating to dividend distribution.

- The Commission encourages Member States to apply ESMA **enforcement guidelines**. As part of the Green Paper on Building a Capital Markets Union, the Commission will look at whether the powers of the European Supervisory Authorities, including ESMA, to ensure consistent supervision are sufficient and whether more efficient approaches towards supervisory and market reporting, involving ESMA and national authorities as appropriate, could be helpful for market participants.

- To ensure **simplification of legislation and coherence**, the Commission will consider a codification exercise of the legislation endorsing IFRS in the medium term, after

[13] COM(2015)063.

adoption of some major pending standards. The Commission will seek to enhance cooperation with the IFRS Foundation, in particular for translation aspects.

Endorsement process

- The Commission will ensure that its requests to EFRAG for endorsement advice include specific concerns, including matters of public good, on a case by case basis, in order that EFRAG's endorsement advice addresses such matters appropriately. The involvement of Member States at an earlier stage of the process will help to inform the Commission staff of any concerns and EFRAG's reformed governance structure will enhance its ability to address the matters raised. The Commission will develop ideas and working practices through dialogues with ARC, the EFRAG Board, and other EU Institutions.

- The Commission encourages EFRAG to develop its capacities with respect to the analysis of the effects of standards including macro-economic effects. The Commission welcomes the ECB and ESAs, observers of the EFRAG Board under the reformed governance arrangements, actively sharing their views with the Board to facilitate the consideration of some areas such as effects on financial stability.

Governance arrangements for the relevant organisations

- The Commission acknowledges improvements in the IFRS Foundation governance. However, as member of the Monitoring Board, the Commission calls on that body to refocus its attention from issues of internal organisation to discussing matters of public interest that could be referred to the IFRS Foundation.

- The Commission urges the IASB to strengthen their impact analyses, to consider the specific needs of investors with different investment time horizons and to provide specific solutions, in particular to long-term investors, when developing their standards.

- The Commission welcomes the IASB's intention to re-introduce the principle of prudence in the *Conceptual Framework*.

- The Commission endorsed and supervised the implementation of the governance reform of EFRAG in 2014. In order to ensure that the objective of strengthening the EU's influence on the development of international accounting standards is met, the Commission will continue to closely monitor the follow-up of the reform and will report yearly, in line with Regulation 258/2014.