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SERVICE STATISTICS AND THE INTERNATIONAL HARMONISATION OF ACCOUNTING RULES

Christian Roques

EUROSTAT, Luxembourg

Abstract

By the mid 1990's, eleven directives on company law had been enacted and approved by the Council of Ministers of the European Communities. The Fourth Council Directive, which provides guidelines on the form and content of annual accounts of limited liability companies, was approved on the 25th of July 1978 and gave Member States two years to enact the necessary legislation in their own parliaments. A further 18 months was granted during which time the directive was to become applicable. Only a few Member States managed to meet this deadline and, by the mid-90's, apart from the three new entrants to the EU, Germany, Ireland, Spain, Portugal and Italy were the last countries to finally implement the Fourth Council Directive into their national legislation. This delay does not only harm the owners of assets, but statisticians too. It is obviously difficult to guarantee a comparability of figures on "net turnover" for example if this term is not generally accepted by all the Member States. Moreover, this entails more specific problems for collecting statistics on services.

In November 1995 the European Commission adopted a new approach towards accounting harmonisation. In its communication "Accounting harmonisation: a new strategy vis-à-vis international harmonisation"[1], "the Commission stresses the need for the Union to move promptly in order to give users and preparers of accounts a clear signal that companies seeking listings on the US and other world markets will be able to remain within the EU accounting framework". The Commission also stresses the need for the Union to strengthen its commitment and contribution to the international standard-setting process, which offers the most efficient and rapid solutions for the problems of companies operating on a world-wide scale. It is in this context that a green paper has been drafted. If Member States are to allow their large companies to prepare their consolidated accounts on the basis of IAS[2], it is essential that these standards be not in conflict with the accounting directives already in force. This progress will trigger off some important changes in the valuation of certain assets and will as a consequence have a non-negligible influence on the collection of data. Nevertheless, IAS are going much further than accounting directives on certain matters such as the environment for instance and this new harmonisation could improve the quality of statistics especially those on services.

Other developments linked to the harmonisation of accounting rules could change the face of service statistics in the near future. If some developments can be made at the level of cost accounting, there will then be countries having at their disposal an accurate cost and flows information system and other countries who can only provide published accounting information. Such a trend could lead for instance to the use of different types of statistical units, the "KAU" being more suitable than the "enterprise" for cost accounting in that the activity of the kind-of-activity unit is somewhat more homogeneous than the enterprise.

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[1] COM 95 (508) final of 14 November 1995

[2] International Accounting Standards (established by the International Accounting Standards Committee (IASC)

This paper covers the following aspects:

I. European accounting harmonisation and its problems

II. Conformity of IASs and accounting directives: effects on service statistics

III. Future international developments in (cost) accounting and problems of comparability of service statistics

I. European accounting harmonisation and its problems

For business statistics and in particular for service statistics a major problem lies in the differences which are still existing between the various Member States in the implementation of the Fourth Council Directive: the following paragraphs attempt to summarise these problems and to show that statistics on services are particularly harmed in that the valuation and comparison of services is more difficult than the comparison between other industrial sectors.

Belgium:

There are a few significant variations from the directive. The following matters are worth noting.

1. Valuation principles under Belgian law specifically prohibit the use of inflation accounting and replacement costs although information can be provided on the effect of inflation on equity and earnings. These valuation principles do not take into account of the Fourth Council Directive requirement for **"a true and fair view"** which could lead to the use of inflation accounting.

2. Taxation considerations will continue to influence the inclusion or exclusion of items from the profit and loss account, since the Royal Decree dating back to the 8th of October 1976, stipulates that "fundamental distortions" between reported profit and taxable profit should be avoided. This not being totally in accordance with Articles 35 and 39 (e) of the Directive which states that these taxation adjustments should be exceptional and require justification in the corresponding annexes to the annual accounts.

Denmark

The Company Act of 1981 was designed to incorporate the Fourth EEC Company

Directive. It deals with the form and content of the annual accounts and notes thereto, valuation methods, contents of the annual report, publication provisions and audit. It also introduces the categories of small and medium-sized firms for exemption and abridging purpose.
There is virtually no difference between the accounting requirements of Danish law and those of the Fourth Council Directive.

France

There are no significant differences between the combined requirements of French company law and the national accounting plan on the one hand and the Fourth Council Directive on the other due to the implementation in April 1982 of the accounting plan amended to take into account requirements as laid down in the Fourth Council Directive. It came into force on the 1st of January 1984.

The main problem with the Fourth Council Directive concerns the French auditing profession which currently faces the expansion of its members to allow it to carry out the professional audits of all the bodies as required for by the Fourth Directive.
Examples:

- introduction of abridged annual accounts for small and medium sized businesses
- introduction of a compulsory annex of supplementary notes to the accounts covering 32 items of larger companies.
- the requirement for the auditor to certify that the accounts give "a true and fair view", even if this means departing from the regulations contained in the national accounting plan.

Germany

The earlier drafts of the Fourth EEC Company law directive were heavily based upon the German stock Corporation act of 1965 and the emphasis of this origin is still noticeable in many of the detailed requirements of the Directive. However, significant variations exist:

1. The directive's requirement for "a true and fair view" in preference to the strict application of the valuation rules is, conceptually, a reversal of the 1965 Act's requirement that the annual accounts must give "within the limits of the valuation rules, as accurate a picture as possible". The implication is that "a true and fair view" may require departure from, and may even conflict, with the legislation.

2. The principle of a "common basis" regarding reported financial profit and taxable profit has been a significant feature of German accounting and practice; the directive requires the disclosure of the extent to which valuation policies designed to obtain tax relief have influenced the reported profits, and this may well threaten the continued existence of the common basis principle in practice.

3. The directive's option that a company may, subject to the agreement of its national government depart from "historic costs" in the valuation of fixed assets will not be incorporated under German law.

4. The directives main exemptions and concessions are based on the size of an enterprise rather than on whether the enterprise is publicly or privately owned.

Greece

The Greek accounting system is still too fragmented and requires a continuous effort to meet the requirements of the Fourth Council Directive.
Nevertheless, recent government legislation now requires all large Greek companies to undergo an audit and thus increasing the application of the Fourth Council Directive.

Italy

Italy was one of the Member States most affected by the Fourth Council Directive, although comprehensive and far reaching reforms have been under way throughout the 1970's and the 1980's such as the creation of the Commisisone nazionale per le Società e la Borsa (CONSOB) to control the operations and reporting of companies quoted on the stock exchange.

Problems still existing:

1. The Directive's requirement regarding the disclosure of information in the notes to the accounts and in the directors' report represent a considerable variation from current Italian practice, which conforms towards the "faithful" picture of the financial position presented with " clarity and precision", rather than towards a "true and fair view".

2. The CONSOB requirements represent a "halfway house" in that although the application of IASs will improve the quality of the reporting, considerable gaps still remain between the IASs and the requirements of the Fourth Directive.

3. The Directive's exemptions and concessions regarding size of an enterprise run counter to current Italian law. Public and private companies have been treated alike as regards accounting information and publicity requirements, but there is a statutory audit exemption for private companies with a paid up capital of less than 100 million Lire.

4. The criterion used by CONSOB does not correspond with the Fourth Council Directive's criteria regarding balance sheet totals, turnover, and/or number of employees and is also greater than the Directive's balance sheet total criterion.

Luxembourg

Although the law of 4th May 1984 incorporated the requirements of the Fourth Council

Directive into national legislation, the spirit of the Directive was not implemented in practice up to recently. Luxembourg was indeed one of the countries most affected by the requirements of the Fourth Council Directive because of the disparity between the Directive's requirements and previous national laws and practice (previous law dated back to 1915).

The Netherlands

The requirements of the Fourth Council Directive, which provide alternative ways of presenting company accounts did not require significant alterations in Dutch legislation or practice. The necessary legislation implementing the Fourth Council Directive was incorporated in the Civil Code in 1983.

Portugal

Portugal, due to its economic situation and lack of auditing resources has delayed implementing the Regulation up until the 31st December 1996. Portugal has been steadily preparing to meet these requirements by:

- The creation of a nationally organised body of practising accountants, the *"Camara dos Technicos de Contas"*
- The formulation of the Plan of Accounts in 1983
- The creation of a nationally organised body of registered auditors the "*Camar dos Resivores Oficias de Contas"*.

Spain

Measures have been undertaken to raise the standard of accounting, auditing and reporting of financial information: these include:

- A system of VAT recording was established on the 1st of January 1986
- The formulation of a general accounting plan revised to incorporate the accounting requirements of the Fourth Council Directive.
- The establishment of a register of practising accountants.
- The setting up of a Spanish association of accountants (AEECF).

The United Kingdom and the Republic of Ireland

In general, the requirements of the Fourth Council Directive (incorporated into UK legislation by the Companies Act 1981, in Northern Ireland by the Companies Orders 1982 and in the Republic of Ireland by the Companies Act) have not significantly affected the methods in current use under the UK accounting system. This is largely because UK company law already required all limited liability companies, irrespective of size, to have their annual accounts audited and published and/or filed. Similarly, accounting practice has largely tended to ignore differentiation on the grounds of a company's size since the concept of "a true and fair" view has been held to be generally applicable to all types of professional work.

Sweden, Finland and Austria

Before joining the EU, Sweden has tended to keep its company legislation broadly in line with European legislation and has continued to do since its entry in the Union.
The same situation applies for Finland although the auditing profession is somewhat less developed here than in Sweden.
This willingness to follow European rules is particularly evident in the "Nordic Companies Act" legislation, which represented a harmonisation of Danish, Finnish, Icelandic, Norwegian and Swedish Company law.

The most significant deviations from the Fourth Council Directive are:

- The criterion of size for exemption and /or concessions which is unlikely to apply since all limited companies are subject to the same regulations. The exemption clause is likely to be applied only to the smallest companies.
- The taxation influence on the accounts, but this alteration concerns almost all Member States.

Austria did prepare actively its integration in the EU and sticks generally to the requirements of the Fourth Council Directive.

The main problems in the international harmonisation of accounting rules concern mainly tax influence on accounts and size exemptions, plus certain particularities for each Member State. This lack of harmonisation on these items is extremely harmful for service statistics because of the difficulty of getting information on small and medium enterprises and because of the multiplicity of tax processes in Member States. This multiplicity will complicate comparisons on items such as inventories, investments and profits.

II. Conformity of IASs and accounting directives: effects on service statistics

<u>Main differences between the two systems</u>

The number and complexity of the disclosures required for under IAS are in general significantly more demanding than those required for under accounting directives (AD). This is due to the fact that AD provide minimum requirements which aim at establishing minimum levels of comparability whilst ensuring a minimum level of information. The approach of IAS is completely different in that they aim at providing the most comprehensive guidelines possible and uniformity in drawing up individual company accounts.

Rules relating to "creditor protection" and "profit distribution" vary from one country to another and are therefore not specifically taken into account by IAS, which aim at being as international as possible. On the contrary, AD contain specific provisions which deal with these matters. For instance, Articles 34 and 37 of the Fourth Council Directive do not allow profits to be distributed when the level of reserves available for distribution does not exceed the amount necessary to cover the residual amortisation of certain capitalised expenditures.

In a similar way, the derogation's for fiscal considerations allowed for in Articles 35 (1) and 39(1) (e) of the Fourth Council Directive are not permitted under IAS. These Articles allow fixed and current assets to be subject to exceptional value adjustments for taxation purposes only, provided that the amount of these adjustments and the reasons for making them are indicated in the notes to the accounts. IAS do not permit such exceptional value adjustments, as they have been drawn up to deal with situations in which accounting is free from fiscal considerations.

Consequences

IAS are generally more detailed than AD on new accounting matters, but do not consider many national particularities such as various taxation aspects. Bringing closer AD to IAS would as a matter of fact enlarge the EU accounting frames, and lead to less consistency with national accounting rules. This would then require further legislation in Member States.

Detailed description of the incoherence which could lead to major effects on the collection of data for service statistics.

IAS 2: Inventories

IAS 2 states in paragraph 6 that "inventories should be measured at the lower cost and net realisable value". According to Article 39 (1) (b) of the Fourth Council Directive, the lower value at which inventories should be valued is the one which should "be attributed to them at the balance sheet date". The question arises whether the value to attribute at the balance sheet date differs from the realisable value. For principal activities, if the wording differs, in practice the meaning is the same, but for service activities, the value of inventories could be somewhat higher than the one recorded in the balance sheet at the balance sheet date, because some contracts could not be evaluated exactly if they were contracted on a year and implemented on several with a great difference in the provisions of services according to the different years. This could lead to a misevaluation of these inventories (consequence of the notion of lower cost).

IAS 8: Net profit or loss for the period

Difference in the wording exists between "extraordinary items" as defined in paragraph 6 of IAS 8 and the one in Article 29 of the Fourth Council Directive.
IAS 8 strives to limit the extent of extraordinary items in that the larger a business is, the

more often certain events may occur, with the consequence that they may be more correctly classified as ordinary items. For services, extraordinary items are more common than for industrial activities. The implementation of IASs would increase the share of ordinary activities and as a consequence that of turnover.

IAS 9: Research and development costs

According to IAS 9 research costs cannot be capitalised, whilst development costs must be capitalised. Under Article 37 (1) of the Fourth Council Directive, it is not explicitly decided and let up to the national legislation. The more these type of costs will be capitalised the more new industries and high technology services will see their assets increasing. The incorporation of IAS at the EU level would systematise the capitalisation of development costs and the non-capitalisation of research costs which gives a bonus to the businesses oriented towards the systematic marketing of their R&D and disadvantages businesses being focused on pure research aspects without a direct influence on the development of a product: research institutes as well as the economic and strategic analysis in different service of consulting could be as a consequence disadvantage even though it is obvious that pure research is difficult to be assess and thus recorded.

IAS 11: Construction contracts

IAS 11 prescribes in its paragraph 23 that construction contracts are normally accounted for by using the so-called "percentage of completion method". This method means that one should include profits in proportion to the percentage of realisation of a contract in the income statement. This could cause a compatibility problem with the prudence principle, not only for the construction sector, but for all activities, covered by the Fourth Council Directive. Article 31 (1)(c)(aa) of the directive in fact permits the inclusion in income of "profits made at the balance sheet date" only. As stated for IAS 2, the application of the completion method would clarify the recording of earnings for service activities which are very often based on multi-yearly contracts.

IAS 16: Property, plant and equipment

IAS 16 paragraph 48 states that "the depreciable amount of an asset is determined after deducting the residual value of the asset". The Fourth Council Directive does not contain any reference to the "residual value" and in Article 35 (1)(b), the basis for depreciation is indicated as the "purchase price or production cost". Anyway, the difference shouldn't be too harmful since all depreciation calculations are based in practice on the residual value which is the assessment of the market value of a product. The depreciation process starts indeed from the "purchase price or the production cost", but to reach the marketable value of the product.

IAS 17: Accounting for leasing contracts

In accounting for leasing contracts, two main schools can be identified within the EU. On the one hand, there are countries where the concept of "legal ownership" is predominant. Under this concept, a leased asset should not be capitalised in the accounts of the lessee as the legal ownership of the asset remains with the lessor. In other countries, on the contrary, the concept of "economic ownership" prevails, which goes beyond the legal title to the physical object and focuses on the rights and obligations relating to the economic risks and benefits.

In the IAS 17 the concept of "economic ownership" (leading to the capitalisation in the accounts of the lessee) prevails.

The concept of "economic ownership" is more realistic in terms of activity and is as such closer to statistical homogeneity. It will however be difficult to apply this concept in Member States applying the concept of "legal ownership".

IAS 21: Effects on changes in foreign exchange rates

According to IAS 21, both positive and negative translation (conversion) differences in exchange rates relating to monetary items are to be included in the profit and loss account. The AD do not specifically address the problem. Whilst agreement in Europe has always existed on the fact that negative differences should be charged to the profit and loss account as soon as they arise, the inclusion of positive differences in income has long been debated.

Actually, these positive differences are not easily realisable even though the liquidity of the market is somewhat higher than previously and shouldn't be included according to Article 31 (1)(c) of the Fourth Council Directive which states that unrealised profits cannot be recorded.

Nevertheless, it has to be kept in mind that such a procedure would advantage companies being located in countries having a high monetary stability or tending to this stability and in a European integration process would compensate the difficulty of selling abroad with a strong currency.

IAS 23: Borrowing costs

According to Article 11 of IAS 23, borrowing costs are to be capitalised, when they refer to the acquisition, construction, or production of an asset that necessarily takes a substantial period to be made ready for its intended use or sale. On the other hand, according to Article 35 (4) of the Fourth Council Directive, borrowing costs may be capitalised when they refer (exclusively) to the "production" of an asset, and to the extent that they refer to the period of production.

The actual existing limit laid upon in the Regulation, if it is strictly understood, do penalise intermediation activities both in industry and in services. The use of IAS would as a consequence ease the business life of the intermediation sector. For statistics, it would ease as well the completion of turnover data broken down according to categories such as services, industry, intermediation, agriculture etc.

IAS 25: Accounting for investments

Certain paragraphs of IAS 25 could be interpreted in such a way that it required valuation at the lower cost, at market value and the application of the "portfolio approach" (which considers the assets of a company as external investments submitted to the overall market law). This of course would be in contrast with the AD, and in particular with Article 31 (1)(e) of the Fourth Council Directive, which requires the separate valuation of the items of assets and liabilities. In addition, a valuation made under the so-called portfolio approach could be contrary to the prudence principle, by de facto permitting the inclusion in income of positive unrealised profits (see IAS 21) which would not be included if the portfolio approach were not applied.

This difference makes the harmonisation difficult. IAS are concerned more with giving an accurate image of accounts at one point of time than with the prudential guidelines of AD. In this case, it seems impossible to apply the portfolio approach in the EU. The portfolio approach would make statistics closer to the real business of a company, but would not secure its position according to auditing standards. This reminds us of the first goal of AD: security of debtors and not a "statistical instrument".

In a nutshell, differences between IAS and AD are scarce, but nevertheless of importance. IAS are strongly influenced by American standards and by the accuracy of the information; they are less dependant from auditing views than AD.
Implementation of IAS would globally improve the quality of statistical information for services.

III. Future international developments in (cost) accounting and problems of comparability of service statistics.

Cost accounting was not taken into consideration by the Fourth Council Directive because due to the difficulties of integrating this system into a standardised accounting frame. Indeed, cost accounting differs from the information extracted from published accounts in that it is adapted to the specificity's of each firm. The main focus of cost accounting is to allocate administrative and general costs over some identified activities which directly generate some cash in-flows. In this process, "keys" (so called standards) such as manpower, turnover, number of clients, are used in order to assess the accurate contribution of each activity to the whole process. As a consequence, despite the efficiency of such an appraisal instrument, the issued data are apparently incompatible.

Nevertheless, this argument should be limited in its last extent. What is put into question herewith is that the data are not comparable and as such not of any use for the needs of service statistics. If on the other hand we take the (realistic) assumption that standards established by each company are created in the spirit of the highest accuracy, even though standards differ among enterprises then they could be of extremely high quality and therefore suitable for comparisons of the situations of different enterprises acting in the same area. Moreover, some systems are used to compile standards within companies and these systems are relatively harmonised throughout Europe: there are mainly three:

- Full costing system
- Direct costing system
- Activity based costing model or ABC model

* A full costing system consists of allocating indirect costs to direct costs which are grouped together according to various centre of analysis (functional areas, i.e. administration, production, marketing...).

* A direct costing system seeks to establish a threshold for profitability by only taking fixed costs into account. Variable costs have then to be assessed according to the established threshold.

* ABC model is based on the following two aspects:

- function (management, administration, production, distribution)
- operating unit (establishment, factory, retail centre)

"Standards" are used to disaggregate some functional costs (i.e. for administration) by products or activity ("Theory of homogeneous sections").

The table below shows the three alternatives to breakdown indirect, variable costs and function by direct, fixed costs or activities.

	indirect costs	direct costs	operating unit
variable costs			
fixed costs			
function			

Cost accounting can therefore provide useful elements which could ease the comparability of data between Member States.

However, an impediment is still to be overpassed: some NSO's don't have access to such data due either to overprotective legal systems or unwillingness of enterprises to disclose this type of information to governmental institutions. This therefore restricts harmonisation since some EU Member States do already have access to cost accounting information.

The consequences of a growing gap among Member States in the way information could be collected are enormous in terms of quality standards and of international comparability.

As a matter of fact, data on business costs in a particular industrial sector, in some countries will rely only on the "operating costs" which are disclosed by the enterprises in their annual accounts. Countries having at their disposal a cost accounting information system will have an inside view of the costs between different sections or subdivisions of an enterprise and at the same time allows intra-firm trade to be better assessed. This information would as well ease the calculation of price indices for business services.

The advantages of cost accounting have a counterpart in the difficulty of comparing two different statistical systems. It is not surprising to observe that countries having cost accounting information available are choosing the establishment or the KAUs as preferred statistical units of observation. The KAU being considered as something more homogeneous than an enterprise in terms of activity and being eventually a subdivision of an enterprise will correspond to the frame of cost accounting which attempts to construct homogeneous sections for its information system and being designed for getting information internally to the enterprise.

As a conclusion, this new development in cost accounting could trigger off some difficulties in comparing international information. These problems would concern statistical units, quality standards and comparison possibilities.

Service statistics depends on accounting sources of information for two main reasons:

- Services are rendered by a multiplicity of SMEs and for these only accounting information is available and every development in accounting information which would disclose more of this type of information would be welcome for service statistics.

- Statistics tended always to be dominated by industry and administrative structures have evolved throughout a long period of time. The same applies for national accounts or registers. On the other hand, accounting reflects the present business situation with the preponderance of services.

Accounting should therefore be the main source of information for service statistics. In order to meet this aim, it is necessary to achieve a high degree of international data comparability. Problems as we have seen are still existing in this domain, but are becoming less and less marked.