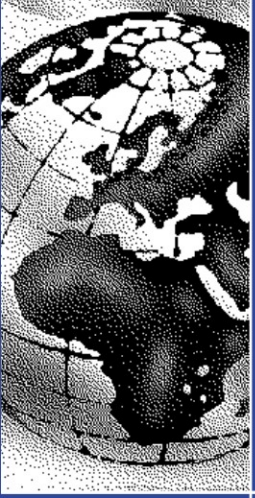


Richard Wittsiepe

IFRS for Small and Medium-Sized Enterprises

Structuring the Transition Process

GABLER EDITION WISSENSCHAFT

Richard Wittsiepe

IFRS for Small and Medium-Sized Enterprises

GABLER EDITION WISSENSCHAFT

Richard Wittsiepe

IFRS for Small and Medium-Sized Enterprises

Structuring the Transition Process

GABLER EDITION WISSENSCHAFT

Bibliographic information published by the Deutsche Nationalbibliothek
The Deutsche Nationalbibliothek lists this publication in the Deutsche Nationalbibliografie; detailed bibliographic data are available in the Internet at http://dnb.d-nb.de.

Habilitationsschrift Universität Warschau, 2007

1st Edition 2008

Editorial Office: Frauke Schindler / Nicole Schweitzer

Gabler Verlag is part of the specialist publishing group Springer Science+Business Media.
www.gabler.de

Cover design: Regine Zimmer, Dipl.-Designerin, Frankfurt/Main
Printed on acid-free paper
Printed in Germany

ISBN 978-3-8349-0940-4

Preface

The idea behind this paper has a rather long history. During the internet boom, the opportunity arose in 1997 of working together with ORACLE experts on major internet projects. In 1998, this turned into a company and there followed many projects and turbulent trade fairs. At the same time, the dissertation on the topic of the web trust audit was finished at the Vienna University of Economics and Business Administration in 2001.

The introduction of quality assurance as a consequence of the Sarbanes Oxley Act, with the concomitant proliferation of checklists and procedures, provided the stimulus for the development of software of our own and as an extension it very soon also became clear that the implementation of the international financial reporting standards (IFRS) for small and medium-sized businesses could be largely automated. The solutions on offer were of little help, for two primary reasons:

1. The business model of the audit is based on a calculation of hours and for exactly this reason auditing teams have been growing and procedures becoming more complex since the mid-eighties, quite in contrast to the opportunities presented by the rapid development of technology during this period.
2. The software on offer is either very rudimentary and limited to a collection of checklists, or it attempts to solve every conceivable problem, which leads to a Leviathan.

That is why the aim here was to develop an alternative, with the fourth EU directive in its original form serving as a basis for the considerations and the focal points of the implementation resulting from a comparison of different countries. In this sense, the issue of just what software need not be capable of doing is particularly important, and many software projects fail owing to an excess of functions. Here specific decisions must be made beforehand, which take their orientation from those areas that are of primary importance. The original idea of including the concept of the software in the text was rejected in favor of the development of the software itself, that is, this text practically represents the first part, discussing the structure and visualization of the IFRS procedures, while their implementation in software forms the second part, and the status of the development can be followed on the internet at www.us-gaap.de.

The goal is to come up with rational procedures and sensible structures in a service process which can be divided up into sub-steps depending on requirements, but without attempting to replace the human factor. This approach does not answer the question of why a small or medium-sized business should implement the IFRS in the first place. This must be governed by economic considerations alone. Idealized reasons, such as the desire for comparability, are not relevant. However, the economic aspects do indeed

include an offer of effective, inexpensive procedures which result in a lowering of the cost threshold for the company as well as for the consultant. This is the main concern of the approach pursued here.

Writing this paper while at the same time keeping up with my free-lance work was only possible thanks to the experience gained in nearly ten years of working on software and the internet, as well as the patience of my wife, Gisela, without whose understanding and support this would not have been possible.

Dr. Richard Wittsiepe

Table of Contents

Index of Tables

List of Abbreviations

AAA	American Accounting Association
AG	Aktiengesellschaft
AICPA	American Institute of Certified Public Accountants
AktG	Aktiengesetz
APB	Accounting Principles Board
ARB	Accounting Research Bulletin
ArSEC	Accounting Series Release (of the SEC)
BDI	Bundesverband der Deutschen Industrie
CPA	Certified Public Accountant
EDP	Electronic Data Processing
ETIF	Emerging Issues Task Force
EU	European Union
FASB	Financial Accounting Standards Board
FIFO	First-in First-out
GAAP	General Accepted Accounting Standards
GATT	General Agreement on Tariffs and Trade
GmbH	Gesellschaft mit beschränkter Haftung
HGB	Handelsgesetzbuch
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IFRS	International Financial Reporting Standards
IOSCO	International Organization of Securities Commissions
IPO	Initial Private Offering
JoA	Journal of Accountancy
KPMG	Klynveld, Peat, Marwick, Goerdeler
LIFO	Last-in First-out
NAFTA	North American Free Trade Agreement
No.	Number
NRV	Net Realisable Value
NYSE	New York Stock Exchange
OECD	Organisation for Economic Cooperation and Development
PCAOB	Public Company Accounting Oversight Board
POB	Public Oversight Board
SA	Société Anonyme
SARL	Societé á Responsibilité Limitée
SAS	Statement of Accounting Standard
SEC	Securities and Exchange Commission
SFAC	Statement of Financial Accounting Concept

SFAS	Statement of Financial Accounting Standards
SMEs	Small and Medium-sized Entities
SOP	Statement of Position
SOX	Sarbanex Oxley Act
UNCTAD	United Nations Council on Trade and Development
US United	States of America
US-GAAP	United States Generally Accepted Accounting Standards

Introduction

The development of international accounting has evolved from a reporting tool for multinational companies in the 1960s to a medium for global competition for financing and investing opportunities today. During this time, international accounting activities have gone through different stages.

From a European perspective, the 4th and 7th EU Directives in the 1980s could be seen as a milestone for the development of a unique European accounting framework. The 4th EU Directive is the common legal basis for all accounting regulations within the European Union.

Since the 1970s, international activities for setting and using international standards have been driven by international organisations. The foundation of the International Accounting Standards Committee in 1973 marked another milestone.

Traditionally, large international companies have been the target of international standards, because the need for comparable financial information was mainly seen for stock listed companies in order to facilitate the decision process for international investors.

A new approach in international accounting is the setting of standards for small and medium-sized companies. The process and the discussion regarding a core set of accounting standards for non-listed companies is not yet finished, but a number of technical problems have to be solved during a transition process from national accounting standards to international accounting standards. These problems are different to those of listed companies, because listed companies must have the personnel and financial capacities to fulfil the reporting requirements of the stock exchange, otherwise a listing is not possible.

The know-how, experience and financial funds for a transition process to international accounting standards in smaller companies requires a streamlined and cost-efficient approach. The task of this work is to develop a cost-efficient transition process for this type of company within the European Union. The limitation to companies within the European Union is necessary because a common basic national accounting framework is required as a starting point and the 4th EU Directive represents this common accounting basis.

The first part of the work is an analysis of the European environment for accounting and

financial reporting. Continental European and Anglo-Saxon types of accounting are combined within the 4th EU Directive and the background of both accounting traditions including differences and similarities to International Financial Reporting Standards (IFRS) are evaluated using the national accounting principles of France and Germany as representatives of the Continental European accounting tradition, the United Kingdom as a member of the Anglo-Saxon tradition and Poland as an example of a new member state of the European Union. Different classification schemes of financial accounting and reporting systems help to identify the main problem areas of a transition process, resulting in a model transition process.

Part 2 is a discussion of the particular accounting problems for small and medium-sized companies in connection with IFRS. IFRS are classified as Level I and II statements depending on the relevance of the accounting procedures for the group of small and medium-sized companies. This separation is necessary because individual IFRS statements or parts of statements only apply to listed companies, which are classified as Level II statements, and transition procedures will only be developed for Level I statements.

To arrive at a cost-effective transition approach, standard audit procedures and concepts of an audit according to the 8th EU Directive are discussed in part 3. The general idea is that statutory audits of financial statements within the European Union are required not only for listed companies but also for medium-sized companies as defined by the 4th EU Directive. These standard audit procedures, already in operation during an audit, form the basis for the detailed transition procedures.

Part 4, the main part, analyses all Level I IFRS statements. A decision structure for each statement will be developed and main problem areas are defined and audit procedures assigned to address the different problem areas. The developed decision structure also aims to define a logical process in order to serve as a scheme for extending existing audit software programmes. Usually, a statutory audit of financial statements is performed using special audit software programmes that follow a predefined audit process similar to a transition process. It is obvious that an integration of the transition procedures in existing audit processes will enable a cost-efficient transition process. This integration approach is a main target of the work presented and the result is a consistent methodology, starting from the 4th EU Directive as a common basis and arriving at a common set of integrated transition procedures in software-assisted audit steps.

Part I

European Accounting and Financial Reporting Environment

1. General Developments within the European Union

Comparing financial reports from different countries reveals a number of differences. Accounting differences are the norm because the development of accounting, which is interwoven with double-entry bookkeeping, is always related to varying political, economic and social contexts. The European Commission launched a programme of accounting harmonisation in the 1960s and with the growing number of countries becoming members of the European Union, the ideas and the regulations of the 4th and 7th EU Directives were enacted in all member states. This development could be seen as the first major wave of accounting harmonisation in Europe and should be divided into two major phases:

1. The first phase concerns the concept and introduction of the EU Directives with a further development and adjustment of national standards in the period from the 1960s up to 1990.
2. The second phase covered the newly independent countries from Eastern Europe and the adoption of the EU accounting regulations in connection with the integration of these countries into the Western European economic system from 1990 until today.

This second phase is of particular interest because these countries were not usually able to develop their own accounting traditions. They had to adopt the EU Directives, formerly influenced by Continental European and Anglo-Saxon accounting traditions, and usually had to introduce new company and commercial codes as well as auditing standards.

A second major wave of international accounting is represented by International Accounting Standards. From its inception in 1973 until its reorganisation into the International Accounting Standards Board in 2001, the concept of IAS or IFRS was changed radically from standards offering a wide range of options and alternative treatments to a standardised set of accounting rules for listed consolidated companies[1].

A conflict arose as to whether or not International Accounting Standards, primarily set up for internationally operating listed companies, should be applied to all enterprises, large

[1] Evans,Th.G., Taylor,M.E., Rolfe,R.J., "International Accounting and Reporting", 3rd ed. Houston 1999.

and small, in all industries of a given economy. Additional problems for small and medium-sized companies and financial statements for a single company arise from the fact that taxation, profit distribution and many other legal requirements are linked to single financial statements instead of consolidated statements. Reporting and accounting regulations for consolidated statements developed unaffected by national laws and requirements. It is not yet clear as to whether International Financial Reporting is useful for small and medium-sized companies, the discussion is ongoing and may lead to a different set of accounting standards in the European Union, one for listed companies and one for all other companies.

Although the final result of this process cannot be predicted yet, the question of a technical approach to change from national GAAP to International Accounting Standards has to be answered anyway. It may be the case that non-listed companies have to prepare financial reports according to IAS as well as according to national GAAP for several reasons, for instance to attract foreign investors or for rating purposes to receive credit from national or foreign banks. In order to develop an approach and a methodology to integrate a financial reporting process based on IAS in a given audit scheme, it is first necessary to analyse accounting traditions and causes of diversity in accounting and financial reporting within the European Union to become aware of the magnitude of problems arising in a transition process.

2. Theory of International Accounting

2.1. Main Reasons for International Accounting

There are several reasons and forces that are driving accounting into an international dimension. These forces should be reviewed and discussed because they influence the present process of accounting standardisation in different ways and represent the key basis for the actual accounting and auditing standards in the European Union.

2.1.1. Environmental Factors

International integration of markets has been a privilege for multinational corporations for a long time, but is today a common business for smaller and medium-sized companies as well as for privately held companies. This development is the result of integrated economies, for which the European Market or NAFTA[2] are good examples.

Political and economic integration forces boundaries and tariffs down and facilitates international trade. As a consequence, local economies have become more vulnerable to international trends and global capital markets offer funds for investments in new markets and new local areas. "Black Monday"[3] in October 1987 at the New York Stock Exchange demonstrated dramatically how interrelated the world's major stock exchanges are. It is now common practice for companies to formally list their shares on stock exchanges outside their home countries. Companies with international operations are comparatively more profitable than domestic corporations, because they are able to use comparatively better production cost and investment opportunities and can more easily shift their resources between different countries. In addition, international companies are able to gain management knowledge and competence on an international basis and thus gain international know-how. The so-called immaterial production factor has become more relevant over time.

On the other hand, foreign trade theory is based on "laws of comparative advantage"[4], which forms the basis for major international agreements, such as the General Agreement on Tariffs and Trade (GATT), but represents an old capitalist theory. Although there are

[2] NAFTA: North American Free Trade Agreement, launched on 1st January 1994.
[3] Galbraith,J.K., "A Journey Through Economic Time", 1994.
[4] O'Sullivan,A., Sheffrin,S.M., "Economics, Principles & Tools", 2003.

many subsidiary concepts, e.g. the notion of purchasing power parity as an explanation for foreign exchange rate behaviour, a general concept for the booming international investment market is still lacking; there is no theory for an international economy driven by world investment rather than world trade.

The growing number and amounts of direct international business investments[5] and the importance of international financial markets require financial company information in order to make and support investment decisions. Financial accounting and reporting, however, is locally oriented and therefore does not meet international information requirements. As a consequence, it must be adjusted substantially. This adjustment process is not only a mere translation of a financial report from one language to another and a currency conversion, it requires an adjustment and restatement to reflect different accounting standards. The general problem of restatements is that they are typically performed on summary data instead of restating all individual transactions, which is usually too costly and time consuming. Because of this, restatements always include some degree of statistical bias and may lead to problems with information content. Users of look-alike information in other countries may assume that the content of information is the same only because of the translation of a financial report, which is seldom the case and this could be misleading.

Earnings and cash flow ratios along with debt/equity ratios are used to identify investment opportunities in single companies or in whole industrial sectors.[6] In addition, rating agencies use this financial data to evaluate the credit standing and the ability of a company to generate future cash flows and thus repay credit amounts or pay cash disbursements to shareholders.

The results and “hit lists” of international rating agencies[7] and additional financial ratios are the main indicators for international investors and since the so-called Basel II agreement[8], play a major role in calculating different interest rates for different credit risk scenarios.

---

5 European Central Bank, “Foreign Direct Investment and International Business Cycle Comovement”, Working Paper Series No. 40, October 2004.
6 Loth,R., “Evaluating a Company's Capital Structure”, in Investopedia, October 2006.
7 Tigue,J.R., “Standard & Poor's Guide to Long Term Investing”, New York 2003.
8 Engelmann,B., Rauhmeier,R., “The Basel II Risk Parameters”, Berlin 2006.

For reasons already discussed, locally oriented accounting data means different things in different countries. If accounting numbers are measured and stated differently, financial ratios calculated on the basis of this data are likewise not comparable from one country to another. For a single company in a given country this development can represent a danger because local financial reports may be misinterpreted by foreign investors. Therefore, each single company has to take care of its own financial reports and must bear in mind the possible sources of misinterpretation.

The need for international accounting standards is obvious, but these standards must meet the needs of international investors and financial markets[9]. National economies follow different legal, social and political schemes which are one reason for differences in accounting standards. Standard setting has to overcome these differences, but the general approach in doing so needs to be observed.

Uniform standardisation may not be possible because of a lack of an effective enforcement mechanism; harmonisation may entail too many compromises. Harmonisation of international accounting was the overriding principle of the earlier IAS statements until the general shift in concept in 2001 in connection with the IOSCO Agreement[10]. The revision of most IAS statements since then should be seen as a shift from alternative accounting treatments to uniform accounting treatments. Both concepts will be considered during the discussion later.

2.1.2. Internationalisation of Accounting and the Role of the Accounting Profession

The American Accounting Association (AAA) has defined accounting as

> *"the process of identifying, measuring, and communicating economic information to permit informed judgements and decisions by users of the information"*[11].

This definition is broad under all aspects. Users could be investors as well as the national

[9] Savich,R.S., "Cherry-Picking Sarbanes-Oxley", in JoA, June 2006, pp. 71ff.
[10] Kern,A., Dhumale,R., Eatwell,J., "Global Governance of Financial Systems: The International Regulation of Systematic Risk", New York 2005.
[11] American Accounting Association, A Statement of Basic Accounting Theory (Evanston, Il: AAA,1966) p. 1

tax service. Because the information needs and the legal environment of investors and the national tax service are different, accounting information may serve different tasks and therefore contains different information. For international purposes, different definitions of international accounting have been presented which reflect different approaches to standard setting and methodology.

In academic research, the concept of Professors Weirich, Avery and Andersen distinguish between three approaches[12]:

World Accounting:

In this universal system, a framework and a set of worldwide generally accepted accounting principles would be established and practices and principles would be applicable to all countries.

International Accounting:

This approach covers all methods and standards of all countries and includes all varieties of principles. This concept allows a set of individual, generally accepted accounting principles for each country which represent a single set of the collection of all principles and standards of all countries with allowed variations resulting from different social, political, legal and economic influences.

Accounting for Foreign Subsidiaries:

This concept refers to accounting practices of a parent company and foreign subsidiaries. Usually, the legal environment of the parent company has to be followed for financial reporting with translation and adjustment of the subsidiary's financial statements.

The 4th and 7th EU Directive are examples of the World Accounting approach, because they contain a set of different accounting principles which are acceptable. Each individual member country can make a selection out of the given EU Directive accounting set.

[12] Weirich,Th,R., Avery,C.G. and Anderson,H.R., "International Accounting: Varying Definitions", International Journal of Accounting, autumn 1971, pp. 80-81.

The International Accounting Standards, released by the International Accounting Standards Committee (IASC), now Board (IASB), have also been an example of the World Accounting Approach, but are today an example of the International Accounting approach.

This shift took place when IASC entered a new phase in 1987, which led directly to its 2001 reorganisation, when then-Secretary General, David Cairns, encouraged by the US-SEC, negotiated an agreement with the International Organisation of Securities Commissions (IOSCO). IOSCO was looking for a common international "passport" with which companies could be accepted for a secondary listing in the jurisdiction of any IOSCO member. The concept was that, whatever the listing rules in a company's primary stock exchange, there would be a common minimum package which all stock exchanges would accept from foreign companies seeking a secondary listing. IOSCO was prepared to use IFRS as the financial reporting basis for this passport, provided that the international standards could be brought up to the level IOSCO stipulated. For the first time, the IASC would have a clear client and a clear role for its standards.

Historically, a major criticism of IFRS was that it essentially endorsed all accounting methods then in wide usage, effectively becoming a "lowest common denominator" set of standards. The trend in national GAAP was to narrow the range of acceptable alternatives, although uniformity was not anticipated in the near term.

The background of the "Accounting for Foreign Subsidiaries" approach is more or less technical. Multinational corporations had to prepare financial reports for decades under different approaches and circumstances. Multinational corporations operate in various fields, e.g. oil exploration, computer, software. Each industry has is own unique economic problems and corresponding accounting problems, which have not been addressed in detail in accounting standards. The auditing profession has developed additional audit approaches to meet the requirements of different industries. Montgomery's Auditing[13] as one example covers additional audit approaches for engineering and construction companies, gas, electric and telecommunication companies, healthcare organisations, high-technology companies, insurance and investment companies, mining and oil and gas producing companies, real estate and others.

[13] O`Reilly,V.M., McDonnell,P.J., Winograd,B.N., Gerson,J.S., Jaenicke,H.R., "Montgomery's Auditing" 12th ed., New York 1998.

The specialisation of accounting and auditing standards on different industries is one of the first indications that international standardisation in the meaning of the IASB might not be possible to accomplish.

A second trend is the internationalisation of the accounting profession. This process was slower than in the field of accounting itself because of different types of legal barriers, especially professional licensing regulations which have been traditionally restrictive. One example of a legal barrier is the licensing requirements in the USA. Each single state has its own licensing requirements. There are states where a domicile is necessary to receive a license, there are others where this is not the case. A license granted by one state is not automatically recognised in other states.

The 8th EU Directive has regulated the licensing process and requirements for auditors within the European Union including mutual recognition of an auditing license in all other member states.

A major reason for the licensing restrictions could be seen in the enforcement of public policy in the event of audit failures. It seems a difficult task to hold a professional accountant responsible if he is licensed in a foreign country and permanently resides there.

The internationalisation of the auditing profession mainly took place via the large international professional practices, the so-called “Big Four” British/American domiciled firms operating under single names throughout the world. These firms are usually organised as international “partnerships of partnerships”. This means that each regional partnership is integrated in an international partnership.

In 1988, eight international audit companies, the “Big Eight”, dominated the worldwide audit market. Since then, a concentration process has led to four large internationally operating companies. Ernst & Whinney and Arthur Young merged into Ernst & Young, Deloitte Haskins & Sells and Touche Ross & Co. merged into Deloitte, Price Waterhouse and Coopers & Lybrand merged into Price Waterhouse Coopers and KPMG was initially a merger in 1988 between Klynveld Main Goerdeler & Co. and Peat Marwick Main. Arthur Andersen was broken up as a consequence of the Enron scandal.[14]

[14] Toffler,B.L., “Final Accounting – The Fall of Arthur Andersen”, New York 2003.

Because the “Big Four” dominate the worldwide audit market, at least in the field of internationally listed larger companies, and because technical auditing procedures, training programmes and technical accounting procedures within these firms are highly similar to one another, the mere fact of market domination has led to similar international auditing standards. The 8th EU Directive is an example of this development. The main features are discussed later, but it is important for the transition process that at least the operational level has a common foundation based on the similar technical auditing procedures developed over the past decades.

These technical procedures are mainly US-based and influenced by the FASB and SEC. Because many internationally operating companies are listed on the New York Stock Exchange (NYSE), these procedures were spread throughout the world and applied by the consolidated subsidiaries. This should be seen as an advantage for a transition process. The audit standards, which are published worldwide, can serve as a basis for standard transition procedures. During the further development of these transition procedures, the standard US audit procedures as published in the Miller Audit Guide[15] will be used as a basis.

2.2. International Classification of Financial Accounting and Reporting

Classification is a basic tool for describing and comparing different systems and helps to understand the difficulties in harmonisation of accounting systems.

There have been different approaches to classifying accounting systems. The research work has been summarised in different books and the main results are described in this chapter. The research results could be categorised according to different schemes:

Christopher Nobes and Robert Parker distinguish between extrinsic and intrinsic classifications, where extrinsic classifications are based on factors influencing accounting and intrinsic systems compare accounting practices.[16] Frederick Choi and Gerhard Mueller distinguish between supposed classification and empirically tested classifications.[17] Apart from the difference in wording, the classification approaches under review are the same.

[15] Georgiades,G., “Miller Audit Procedures 2006”, Chicago 2005.
[16] Nobes,Ch., Parker,R. “Comparative International Accounting”, 9th ed., Essex 2006, pp. 55ff.
[17] Choi,F.D.S., Mueller,G.G. “International Accounting”, 2nd ed. New Jersey 1992, pp. 32.ff.

We will follow the extrinsic/intrinsic classification scheme, but first begin with a review of the fundamental results of the pioneering work of G. Mueller.

2.2.1. Prof. G. Mueller's Classification

The initial work on classification was carried out by Prof. G. G. Mueller.[18] He came to the conclusion that ten different sets of accounting systems can be distinguished. He then related the ten groupings to the different business environments in which they operate.

The ten groups are as follows:

1. United States, Canada, The Netherlands
2. British Commonwealth (excluding Canada)
3. Germany, Japan
4. Continental Europe (excluding Germany, the Netherlands and Scandinavia)
5. Scandinavia
6. Israel, Mexico
7. South America
8. Developing nations of the Middle East and Far East
9. Africa (excluding South Africa)
10. Communist nations

Mueller pointed out that accounting rules existing in a country are a product of the economic, political and other environments which have determined the system. In the next step he distinguished four approaches to accounting development among Western nations with market-oriented economic systems.

These four patterns of accounting development are:

1. The macroeconomic pattern
2. The microeconomic pattern

[18] Mueller,G.G., "Accounting Principles Generally Accepted in the United States versus Those Generally Accepted Elsewhere", International Journal of Accounting, spring 1968, pp. 91-103.

3. The independent discipline approach
4. The uniform accounting approach

Macroeconomic Approach:

Macroeconomically oriented accounting follows the accepted political and economic goals of a society. If, for example, full employment is a postulated macroeconomic goal, minimising business cycles and avoiding swings in business cycles would help to reach this goal. Accounting rules leading to an averaging of reported income for a company over the length of the typical business cycle are in line with these policies. Wider recognition rules and fast write-off regulations help companies to average income. Sweden is one of the countries where the macroeconomic approach has found acceptance.

Microeconomic Approach:

In the microeconomic approach, accounting is viewed as a service function for business and business enterprises and oriented to the same micro considerations. Accounting is a tool area of microeconomics and derives its concepts and applications from economic analysis. The main policy of a single business is to ensure its existence over time. This is best done by holding constant the invested capital in real terms and avoiding tax or dividend payments as a result of inflation. The measurement system based on the microeconomic approach is best represented by replacement costs. Detailed accounting reports issued to shareholders, segment reports, revenue analyses, detailing of wages and production costs, long-term commitments and other financial figures are a consequence of the microeconomic approach, because all detailed reports give rise to possible sources of capital erosion. The Netherlands represent the most comprehensive example of the microeconomic pattern.

Independent Discipline Approach:

If accounting is viewed as a service system for a business and reflects business processes, accounting rules can be derived from the business processes themselves. A conventional definition of business income as a quantity that seems useful in practice is an example of this approach. The notion of income as a

construct is widely accepted. The concept of full and fair disclosure is an important standard of accounting. Accounting as an independent system responds to the practical needs of the business community. The United Kingdom and the United States are comprehensive examples of accounting as an independent discipline.

Uniform Accounting Approach:

Uniform accounting can be achieved under different systems:

a) In the Business Approach, uniformity is oriented towards particular users of accounting data and relies on convention. Sectional uniform charts are an example of this approach, e.g. railroad or utilities companies in the United States or the M-Chart for Swedish metalworking companies.

b) The Economic Approach, which is similar to the macroeconomic pattern, links accounting to public policy. The call for increased output and efficiency during Nazi Germany required a close knowledge and control of all business transactions and a well-developed accounting system was introduced.[19]

c) The Technical Accounting Approach derives uniformity schemes from the basic system of double bookkeeping. It is a general and theoretical approach which focuses on specific business characteristics of processes and transactions and tries to treat the same type of accounts consistently. France is one example of the uniformity pattern.

2.2.2. Additional Extrinsic Classification Schemes

The classification system of G. Mueller was the basis for additional schemes because it proved to be useful in many circumstances, e.g. for various international organisations and multinational professional accounting firms.

The American Accounting Association suggested five zones of influence on accounting systems.[20]

[19] Singer,H.W., "Standardized Accountancy in Germany", Cambridge 1944, p.15.
[20] American Accounting Association, "Report of the American Accounting Association Committee on International Accounting Operations and Education 1975-1976", in Accounting Review, No. 52, 1977, p.65-101.

These are as follows:

1. British
2. French-Spanish-Portuguese
3. German-Dutch
4. USA
5. Communist

Professor S. J. Gray evaluated the influence of cultural factors on accounting by using the work of Professor G. Hofstede[21]. Gray came to the conclusion that cultural differences may explain cross-national differences in accounting systems.[22]

2.2.3. Intrinsic Classifications

A set of different classifications using data from Price Waterhouse surveys in 38 countries[23] was prepared during the 1970s and 1980s. Da Costa, Bourgois and Lawson[24] produced a classification of two groups whereas Frank[25], using the same data came to a more reasonable classification which then was extended by Nair and Frank[26] in 1980. The disadvantages of the classifications based on Price Waterhouse data have been expressed by Nobes.[27]

He found four general problem areas:

1. Lack of precision in the definition of what is to be classified.
2. Lack of a model with which to compare statistical results.

---

[21] Hofstede,G., "Culture's Consequences: International Differences in Work-Related Values", Beverly Hills 1980.

[22] Gray,S.J., "Towards a Theory of Cultural Influence on the Development of Accounting Systems Internationally", in Abbacus, 24 No. 1, 1988.

[23] Price Waterhouse, "Accounting Principles and Reporting Practices: A survey in 38 countries", London 1973.

[24] Da Costa,R.C., Bourgois,J.C., Lawson,W.M., "A classification of international financial accounting practices", in International Journal of Accounting, spring 1978.

[25] Frank,W.G., "An empirical analysis of international accounting principles", in Journal of Accounting Research, 1979.

[26] Nair,R.D., Frank,W.G., "The impact of disclosure and measurement practices on international accounting classifications", in Accounting Review, July 1980.

[27] Nobes,C.W., "An empirical analysis of international accounting principles: a comment", in Journal of Accounting Research. Spring 1981.

3. Lack of a hierarchy that would add more subtlety to the portrayal of the size of differences between countries.
4. Lack of judgement in the choice of important discriminating features.

Additional research followed to eliminate the problem areas. The errors occurred mainly because the data was not collected for the purpose in hand. Nobes[28] collected his own data and defined a classification of countries by the financial reporting practices of their public companies. The countries chosen were those of the developed Western world and the reporting practices concerned measurement and valuation.

The results of the research work presented and the classifications made were before the implementation of the 4th EU Directive on Company Law. They included a hierarchy of accounting systems following different nationally based schemes and accounting traditions.

Doupnik and Salter[29] tested Nobes' classification 10 years later and suggested 10 variables to explain causes of accounting differences.[30]

D´Arcy[31] uses KPMG[32] data and tried to find an Anglo-American cluster but was not able to do so, perhaps due to imperfect data.

The following table 1 gives an overview of some general classifications of the last 40 years. The classifications offer a wide range of explanations for the differences in accounting systems and empirical data did not help to clarify the situation.

Several major aspects in the development of accounting during the last 20 years are missing:

---

[28] Nobes,C.W., "A judgemental international classification of financial reporting practices", in Journal of Business Finance and Accounting, spring 1983.

[29] Doubnik,T.S., Salter,S.B., "An empirical test of a judgemental international classification of financial reporting practices", in Journal of International Business Studies, No. 1,1993.

[30] Doubnik,T.S., Salter,S.B., "External environment, culture and accounting practice: a preliminary test of a general model of international accounting development", in International Journal of Accounting,, Vol. 30 No. 3, 1995.

[31] D´Arcy, "Accounting classification and the international harmonization debate – an empirical investigation", in Accounting, Organizations and Soc, Vol. 26,2001.

[32] Ordelheide,D., and KPMG, "Transnational Accounting", London 1995.

1. The influence of the 4th EU Directive on accounting systems in Western Europe from 1980 to 1990 (period of introducing the EU Directives in most countries).
2. The integration of formerly communist Eastern European countries into the market and Western financial systems and the influence of adopting EU accounting directives on the financial reporting systems of these countries.

In order to develop an approach for a standard transition process, the classifications of accounting systems are not sufficient and more detailed investigation is necessary[33].

Classification in Accounting	
Extrinsic	**Intrinsic**
Culture (Gray 1988)	Price Waterhouse data (Da Costa 1978, Frank 1979, Nair and Frank 1980)
Economic (Mueller 1967,1968)	Own data (Nobes 1983, Doupnik and Salter 1993)
Colonial (Seidler 1967)	KPMG data (D´Arcy 2001)
Regulatory Styles (Nobes 1992)	

Table 1

3. Harmonisation of Accounting Systems in the European Union

3.1. First Phase: Western Europe (1960s – 1990)

Regarding the present situation of financial reporting and accounting in Europe and the problems which may arise in connection with the transition of national accounting systems to IFRS reporting requirements, we first take a look at the harmonisation process in the European Union as a result of the introduction of the 4th EU Directive.

The final version of the 4th EU Directive was released in 1978.[34] The first preliminary draft was published in 1968 as a result of proposals made by the so-called Elmendorff

[33] Samuels,J.M., Brayshaw,R.E., Cramer,J.M., "Financial Statement Analysis in Europe", London 1995.
[34] European Commission, 4th EU Directive officially released on 18.8.1978, suppl.L222.

commission.[35] Two official proposals were published in 1971[36] and in 1974[37] for further discussion and comment before the final version was presented.

To understand the time lag of 10 years between the first preliminary draft and the final version we take a brief look at the main reasons:

> The first official proposal in 1971 was released before Ireland, the United Kingdom and Denmark entered the European Union in 1973 and was largely influenced by German company law, especially the Aktiengesetz of 1965. As a result, valuation rules were conservative, formats were described in detail and additional notes to financial statements were limited to a minimum.

> The second official draft of 1974 showed the influence of Anglo-Dutch accounting. The concept of the true and fair view principle was introduced, the presentation of financial statements offered more flexibility and the possibility of disclosure through notes was extended.

This process continued until the final release in 1978, where the true and fair view principle became the overriding accounting principle in the European Union.

Another aspect of financial reporting of the final version was the reduced influence of tax effects on financial reporting, which has been a characteristic element of German and French accounting, whereas Anglo-Dutch financial reporting prefers separate tax statements. Additional reporting for tax effects was included in the notes section rather than in the balance sheet or profit and loss account.

The 4th EU Directive was supposed to be enacted by July 1980 and to be in force by January 1982, but the implementation dates vary. The following table shows the implementation dates of the 4th EU Directive as law before the year 2000:

> 1981 Denmark and the United Kingdom
>
> 1983 France and the Netherlands

[35] 4th EU Directive, preliminary draft, EU Document 2800/IV/2/68-D, 9.3.1968.
[36] 4th EU Directive, draft 16.11.1971, suppl. C7 28.1.1972.
[37] 4th EU Directive, draft 26.2.1974, EU Bulletin suppl. 6/74

1984 Luxembourg

1985 Belgium and Germany

1986 Ireland and Greece

1989 Spain and Portugal

1990 Austria

1991 Italy

1992 Finland

1995 Sweden

1998 Norway (as a member of the European Economic Area)

It is important to bear in mind that the implementation of the 4th EU Directive did not lead to identical financial reporting standards in all member countries. The 4th EU Directive was a compromise between Anglo-Dutch and Continental European, mainly German-French, accounting tradition. Asset valuation, formats of financial reports and disclosure requirements continued to be different within the European Union, but a high level of harmonisation was reached. The true and fair view principle offered flexibility where specific regulations or disclosure requirements were not able to support adequate financial reports.

3.2. Second Phase – Central and Eastern Europe (since 1990)

The break-up of the Soviet Union and the loss of control over central and Eastern Europe led to a transition from command economies to Western style market economies and thus the introduction of new financial reporting rules.

A large number of countries are effected:

Russia, Ukraine, Belarus, Moldova, Estonia, Latvia, Lithuania, Czech Republic, Poland, Slovakia, Hungary, Romania, Albania, Bulgaria, Serbia, Croatia, Bosnia, Slovenia, Macedonia.

In 2004, eight countries (Estonia, Latvia, Lithuania, Czech Republic, Poland, Slovakia, Hungary and Slovenia) became members of the European Union. As members, they are

committed to enacting legislation implementing the accounting directives and simultaneously requiring their listed companies to comply with IFRS.

Accounting in the pre-communist countries played a different role in comparison to Western Europe. Because of the lack of any equity market and the absence of privately owned enterprises, there was no need for financial reporting to a wide public. In addition, no accounting profession developed during that time and accounting theory was reduced to merely technical accounting or bookkeeping. National accounting charts were often based on the work of Schmalenbach[38] and accounting figures mainly served as a means to control the 5-year plans. Thus, accounting records became more important than financial reports.

In connection with the transition from command to market economy, all countries applying for a full EU membership had to adopt the accounting rules formerly developed in Western Europe after a time-consuming process of more than ten years of discussions and an additional process of enacting the rules in national law. The countries in central and Eastern Europe were not involved in this process but had to adopt all regulations within a short time without having their own tradition in accounting theory and a lack of accounting professionals. Simultaneously, new company laws had to be introduced.
The countries made different choices. In Russia, unconditional adoption of the US GAAP accounting system is not considered to be the best way to reform the national accounting system[39].

The formerly pre-communist countries which joined the European Union in 2004 adapted both the 4th EU Directive and the IFRS reporting requirements for listed companies.

It is important to bear in mind that the concept of the 4th EU Directive is a compromise between traditional Continental European and Anglo-Dutch accounting, allowing a wide range of different reporting styles under the true and fair view principle, whereas IFRS are very closely related to US GAAP. The implications of the different basis of accounting theory of both systems will be analysed in more detail later, but this will influence the transition approach on the operational level. Both systems are different and it is not yet clear as to which reporting system best meets the requirements of non-listed companies. A mixture of both systems could lead to an accounting disarray instead of accounting uniformity.

[38] Schmalenbach,E., “Dynamische Bilanz”, Cologne 1962.
[39] Sokolov,Y.V., Kovalev,V.V., Bychiva,S.M., Smirnova,I.A., “Russian Federation”, in Alexander and Archer, European Accounting Guide, Apsen, New York, pp.1642-84, 2001.

4. The 4th EU Directive/IFRS Framework – Main Differences

4.1. The Role of Conceptual Frameworks in the Development of Accounting Standards

The current IASB "Framework for the Preparation and Presentation of Financial Statements" derives mainly from the FASB US Conceptual Framework, developed in the 1970s and revised in 2001. The general idea of a conceptual framework is an attempt to evolve an internally consistent and comprehensive structure for all aspects of the financial accounting discipline.

The idea of the FASB model was presented in a pyramid of interrelationships by William C. Norby which is shown in the following figure[40]:

The House of GAAP

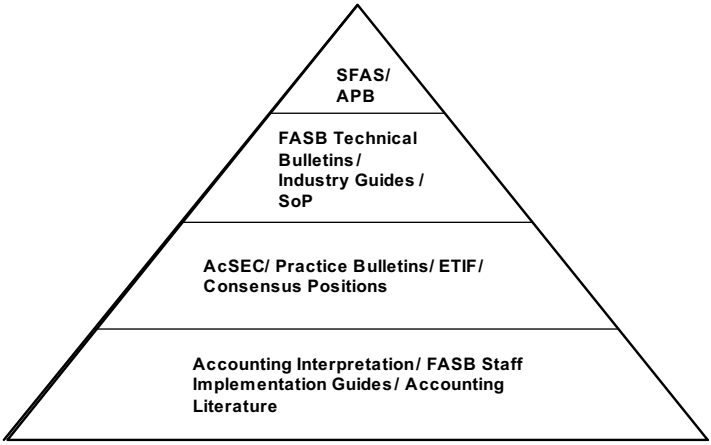


Table 2

The "House of GAAP" illustrates the hierarchy of US GAAP accounting rules:

> FASB Statements of Accounting Standards (SFAS), Accounting Principle Board (APB) opinions and AICPA Accounting Research Bulletins (ARB) are category A rules.

[40] Norby,W.C., "Accounting for Financial Analysis", in Financial Analysts Journal, March-April 1982, p.22.

FASB Technical Bulletins, AIPCA Industry Audit and Accounting Guides and AICPA Statements of Positions (SOP) belong to category B.

AICPA Accounting Standards Executive Committee (AcSEC) Practice Bulletins, FASB Consensus Positions of the FASB Emerging Issues Task Force (ETIF) belong to category C.

AICPA Staff Accounting Interpretations and Implementation Guides and Practices are category D rules.

If category A accounting rules do not contain a treatment for a given accounting issue, CPA are required to refer to category B regulations, then to category C and lastly to category D accounting rules.[41]

The FASB has published 5 additional concept statements (SFAC) to address the basis of US GAAP accounting in more detail.[42]

SFAS 1: Objectives of Financial Reporting by Business Enterprises
SFAS 2: Qualitative Characteristics of Accounting Information
SFAS 3: Elements of Financial Statements of Business Enterprises
SFAS 5: Recognition and Measurement in Financial Statements of Business Enterprises
SFAS 6: Elements of Financial Statements

The institutional framework in the USA for setting accounting standards has evolved through 75 years of experience with formal standard setting. The IASB Framework is similar, but it reflects differences. Its focus is on financial statements rather than the whole process of financial reporting.[43] The FASB approach is appropriate for the needs in the United States and represents the normative approach of US standard setting and is limited largely to the needs of investors. The IASB Framework sets out the concepts that underlie the preparation and presentation of financial statements for external users. The users of financial statements include present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public.

The qualitative characteristics of financial statements in both systems are the same: understandability, relevance, reliability and comparability. Reliability comprises

[41] AICPA Code of Professional Conduct, Rule 203.
[42] Epstein,B.J., Nach,R., Bragg, S.M., "GAAP 2006",New York 2006, pp. 27ff.
[43] FASB, "The IASC-US Comparison Project", Norwalk 1996, p. 94.

representational faithfulness, substance over form, completeness, neutrality and prudence. It suggests that these are subject to a cost/benefit constraint, and that in practice there will often be a trade-off between characteristics. The details will be discussed later in connection with individual IAS standards.

4.2. IFRS Framework and the True and Fair View

4.2.1. Objectives of Financial Reporting and the True and Fair View

The IFRS Framework states that "the objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions."
The information needs of investors are deemed to be of paramount concern, but if financial statements meet their needs, other users' needs would generally also be satisfied.
The Framework holds that users need to evaluate the ability of the enterprise to generate cash and the timing and certainty of its generation. The financial position is affected by the economic resources controlled by the entity, its financial structure, its liquidity and solvency, and its capacity to adapt to changes in the environment in which it operates. The Framework does not specifically include a "true and fair" requirement, but says that application of the specified qualitative characteristics should result in statements that are presented fairly or are true and fair. (IAS 1, Presentation of Financial Statement, does refer to the true and fair requirement)

According to Art. 2 No. 3 of the 4th EU Directive, the annual accounts shall give a true and fair view of the company's assets, liabilities, financial position and profit or loss.
Where the application of the provisions of this Directive would not be sufficient to give a true and fair view, additional information must be given. The true and fair view principle as the overriding principle of the 4th EU Directive has its origins in British accounting and there are a number of analyses of the history and the meaning of the principle[44].
Walton[45] categorises the meanings into three basic ideas:

a) a legal residual clause;
b) an independent concept;
c) generally accepted accounting principles.

[44] Chastney,J.G., "True and Fair View", Research Committee of the ICAEW, London 1975.
[45] Walton,P.J., "The True and Fair View: A Shifting Concept", Occasional Research Paper No. 7, ACCA 1991.

Regarding financial statements, the majority of analyses suggest that the true and fair view is not an independent quality but is defined by current accounting principles.[46] Concerning harmonisation within the European Union, under this definition, each member state had its own true and fair view before the 4th EU Directive and after enacting the 4th EU Directive in national law so far as different accounting practices still existed.

The question has arisen as to whether there is a European true and fair view. An analysis by Alexander[47] came to the conclusion that countries interpret the true and fair view in the context of national culture, national accounting tradition and national GAAP. True and fair view and GAAP are living and dynamic concepts and they are affected by the cultures within which they are used. Homogeneous attitudes to such concepts imply homogeneous cultural contexts. As long as different accounting practices are possible under the 4th EU Directive, different interpretations of the true and fair view principle exist.

It is a widespread view that under the IFRS accounting rules no different accounting practices are possible, but the question arises as to whether this is really the case and if IFRS and true and fair view are different concepts. IFRS are closely linked to US GAAP, but there is no similar hierarchy of accounting regulations in the IFRS concept. IFRS statements should be seen as category A level accounting rules compared to the House of US GAAP concept.

The true and fair view principle as the overriding principle of the 4th EU Directive fills the gap, if written accounting rules and additional accounting practices do not result in comprehensive financial statements. This simply means that, if in a certain case the accounting laws and additional GAAP do not contain a specific accounting regulation, the case will be solved using accounting practices under local national GAAP. And this solution may differ between countries due to different accounting traditions and culture. The resulting financial statement must show a true and fair view under these circumstances.

IFRS do not contain accounting rules for each possible accounting problem, so “regulation gaps” also exist under IFRS. This may especially be the case where non-listed or privately owned companies apply IFRS. IAS 8, which was revised in 2005, has established a hierarchy of accounting guidance to be followed by those companies reporting in conformity with IFRS. This selection of accounting principles is comparable to the “hierarchy of US GAAP” established under US auditing standards. It provides a logical ordering of authoritativeness for those instances when competing and possibly conflicting

[46] Walton,P.J., “Introduction: the true and fair view in British accounting”, in European Accounting Review 1993, pp. 48-58.

[47] Alexander,D., “A European True and Fair View”, in European Accounting Review 1993, pp. 59-80.

guidance exists. To fill regulation gaps, reliance is placed on reasoning by analogy from the existing standards and from materials found in various non-authoritative sources.
According to IAS 8, when an IFRS standard, or an interpretation of a standard, applies to an item in the financial statements, the accounting policy or policies applied to that item are to be determined by considering the following in descending order of authoritativeness:

1. The standard itself (including any appendices that form a part of it);
2. Any relevant interpretations;
2. Appendices that do not form a part of the standard; and
3. Implementation guidance issued in respect of the standard.

When there is not any standard or interpretation that specifically applies to an item in the financial statements or class of transaction, management must use its judgement in developing and applying an accounting policy. This should result in information that is both:

1. Relevant to the decision-making needs of users; and
2. Reliable in the sense that the resulting financial statements—
    a. Will represent faithfully the results and financial position of the entity;
    b. Will reflect the economic substance of transactions and other events, and not merely their legal form;
    c. Are neutral (i.e. free from bias);
    d. Are prudent; and
    e. Are complete in all material respects.

In making this judgement, management must give consideration to the following sources, in descending order:

1. The requirements and guidance in standards and in interpretations dealing with similar and related issues, and appendices and implementation guidance issued in respect of those standards;
2. The definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses set out in the Framework; and
3. Pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards;

4. Other accounting literature and accepted industry practices, to the extent that these are consistent with the promulgated standards and interpretations cited above under 1. and 2.

This selection of accounting regulations may lead to different solutions in different countries when accounting literature and accepted industry practices differ because of different accounting traditions and cultural influences. As long as these national accounting solutions are not in conflict with general concepts of IFRS and lead to relevant financial information for the decision-making needs of users, they are in line with IAS 8.

IFRS focus on listed companies, which are corporations.[48] But besides this special group of listed corporations, which offer their shares to the public and investment groups, there is a much larger group of non-listed companies in different legal forms. Non-listed corporations have a similar legal framework to listed companies, so the IFRS accounting rules will satisfy most accounting and reporting problems. For privately held companies, the legal environment is different. In some countries the status is largely influenced by tax legislation and often includes complicated regulations and definitions regarding the rights and obligations between the different owner groups.

Although financial reports are similar, there are a lot of differences in detail, e.g. equity position or additional material assets economically used by the company but held in private ownership. For these cases, it seems obvious that IFRS does not contain accounting rules for each possible scenario in each possible country and that accounting rules must be derived from general rules according to the concept of IAS 8 discussed in this section.

The implications will be analysed in more detail later regarding different situations in some countries within the EU which represent the different classes of accounting traditions in Europe already described. The main disadvantage of IFRS in comparison to US GAAP is that IFRS are similar to most of the category A or B US GAAP regulations, but have a different underlying foundation. Category C or D US GAAP rules differ to national European accounting traditions to a greater or lesser degree.

[48] Pacter,P., “International Financial Reporting Standards”, in: F.D.S.Choi (ed.), International Finance and Accounting Handbook, 3rd ed. New Jersey 2003, p. 16.1f.

4.2.2. Components of Financial Statements

The components of financial statements represent the individual parts of a complete set of financial statements and usually entail a structure or format of presentation. According to IAS 1, Presentation of Financial Statements, a complete set of financial statements comprises the following components:

1. A balance sheet
2. An income statement
3. Another statement showing either
   a. All changes in equity, or
   b. Changes in equity other than those arising from capital transactions with owners and distributions to owners
4. A cash flow statement
5. Notes comprising a summary of significant accounting policies and other explanatory notes.

Art. 2 No. 1 of the 4th EU Directive states that the annual accounts shall comprise:

1. The balance sheet
2. The profit and loss account
3. The notes on the accounts.

These documents shall constitute a composite whole.

Comparing both regulations, the 4th EU Directive does not request a cash flow statement or a statement of changes in equity. The IFRS statement of cash flows has its origins in FASB SFAS No. 95, which established standards for providing a statement of cash flows in general-purpose financial statements. SFAS superseded APB Opinion No. 19, “Reporting changes in financial position”, and it requires that specified information about non-cash investing and financing transactions and other events must be provided separately. SFAS 95 became effective for annual financial statements ending after July 15, 1988. FASB issued a “Discussion Memorandum” in December 1980, “Reporting Funds Flows, Liquidity, and Financial Flexibility”, which was discussed during the following years.
During the time of discussion of the 4th EU Directive in the 1970s, cash flow reporting was not common or presented in a more rudimentary format like the change in financial position method.

Since the introduction of SFAS 95, the cash flow statement has evolved to a standard part in financial reporting. Cash flow figures are the basis for many calculation schemes for company valuations and similar purposes. Although the 4th EU Directive does not entail a statement of cash flows, it is possible to calculate different cash flow figures from the profit and loss statement and the additional notes and balance sheet information and thus arrive at a statement of cash flow according to the indirect method. It is obvious that some technical skills are necessary for a user of financial statements to prepare a statement of cash flows and that mistakes and misinterpretations are easily possible. The inclusion of a cash flow statement in the set of a financial statement could be seen as a progress in financial reporting.
This additional statement must be prepared in a transition process from accounting regulations, based on the 4th EU Directive to IFRS Reporting.

The statement of changes in equity is an additional part of IFRS financial statements. The equity section of the 4th EU Directive includes similar information, but not in a separate format. The balance sheet format of Art. 9 of the 4th EU Directive itself shows a detailed equity section which separates line items which offer similar information. In comparison to IFRS, the main distinction in reporting movements in equity stems from possible effects on equity as a result of revaluations.
In the 4th EU Directive, revaluations were limited to certain items and the effect of revaluations are shown in a separate revaluation reserve within the equity section of the balance sheet and additional notes information.

Besides the possibility for revaluating assets, a general movement towards fair value accounting has evolved over recent years. This should be seen in connection with the increasing importance of immaterial assets as part of the balance sheet. In addition, the most important immaterial assets of large EDP and Internet companies are self-made and have never been traded. In many cases, market prices do not exist. Fair value accounting methods address this accounting problem and show the effects of revaluations on the net worth of a company. The statement of changes in equity shows the different sources of revaluation amounts. This information is useful for analysts to evaluate the appropriateness of revalued figures and their influence on the financial performance of a company.

In cases where fair value accounting and revaluation methods are not used or are not material, the transition from the balance sheet presentation of the 4th EU Directive to the information contained in the statement of changes in equity is merely a technical problem.

4.2.3. Recognition and Measurement

Recognition and measurement criteria are the main parts of any accounting system. Recognition criteria describe the single elements of accounting. Economic transactions or elements that do not meet the recognition criteria are not accountable and not included in the balance sheet or profit and loss account and related schedules. It may be possible that the reporting of certain elements that do not meet the recognition criteria is shifted to the notes section.

Measurement defines the methods at inception date of an asset or liability and the subsequent measurement concepts. Comparing different accounting systems always requires an analysis of recognition and measurement criteria. The IFRS Framework and the IFRS statements intend to present a full set of accounting statements which offer limited methods of acceptable accounting treatments. After the IOSCO agreement, many alternative treatments which were permitted under the standards were removed and the IASC launched its comparability and improvement project to develop a "core set of standards" as demanded by IOSCO.

The 4th EU Directive as a compromise between Anglo-Dutch and Continental European accounting offers a wider range of alternative accounting treatments which are enacted in the national law of each member state. The 4th EU Directive does not address individual companies. A comparison between IFRS and the 4th EU Directive is a comparison between different levels of standard-setting procedures. It is necessary to compare IFRS statements with the different individually enacted accounting laws within the European Union to verify the main problem areas during a transition process, which will be a transition from national, 4th EU-Directive-based financial reporting to IFRS.

The comparison of both financial reporting areas will be done in two steps: firstly, the main concepts of IFRS and the 4th EU Directive are discussed and secondly, the different approaches in national accounting law within the European Union are compared with the IFRS approach, using representative accounting laws with different cultural and social backgrounds.

The national accounting laws of the United Kingdom, Germany, France and Poland will be part of the comparison and analysed in more detail.

4.3. General Recognition and Measurement Concepts of the IFRS Framework

4.3.1. Definition of Elements of Financial Statements

The IFRS Framework defines the elements of balance sheets similarly to US GAAP. Assets are defined as “Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.”

The following three characteristics must be present for an item to qualify as an asset:

1. The asset must provide probable future economic benefits that enable it to provide future net cash inflows.
2. The entity is able to receive the benefit and restrict other entities’ access to that benefit.
3. The event that provides the entity with the right to the benefit has occurred.

In addition, the asset must be capable of being measured reliably. The Framework says that reliable measurement means that the number must be free from material error and bias and can be depended upon by users to have representational faithfulness. In the “Basis for Conclusions” of IFRS 2, the IASB notes that the use of estimates is permitted, and that there may be a trade-off between the characteristics of being free from material error and having representational faithfulness.

Assets have features that help identify them in that they are exchangeable, legally enforceable, and have future economic benefits (called service potential). It is that potential that eventually brings in cash to the entity and that underlies the concept of an asset.

Besides this broad definition of an asset, IAS 38 “Intangible Assets” offers additional guidance and description. Identifiable intangible assets have much in common with tangible long-lived assets (usually part of property, plant, and equipment), and the accounting for them is accordingly very similar. Recognition depends on whether the broad Framework definition of an asset is satisfied.

The key criteria for determining whether intangible assets are to be recognised are:

1. Whether the intangible asset can be separately identified from other aspects of the business enterprise;

2. Whether the use of the intangible asset is controlled by the enterprise as a result of its past actions and events;
3. Whether future economic benefits can be expected to flow to the enterprise; and
4. Whether the cost of the asset can be measured reliably.

IAS 38 outlines that an intangible meets the identifiability requirement if:

1. It is separable (i.e. is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability); or
2. It arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

IAS 38 includes a comprehensive listing of possible separate classes of intangibles. These are:

1. Brand names;
2. Mastheads and publishing titles;
3. Computer software;
4. Licenses and franchises;
5. Copyrights, patents and other industrial property rights, service and operating rights;
6. Recipes, formulae, models, designs and prototypes; and
7. Intangible assets under development

The provisions of IAS 38 require that an enterprise should be in a position to control the use of any intangible asset that is to be reflected on the entity's balance sheet. Control implies the power to both obtain future economic benefits from the asset as well as restrict others' access to those benefits.

Generally, an asset is recognised only if it is probable that future economic benefits specifically associated therewith will flow to the reporting entity, and the cost of the asset can be measured reliably.

Liabilities are defined as "Probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events."

The following three characteristics must be present for an item to qualify as a liability:

1. A liability requires that the entity settle a present obligation by the probable future transfer of an asset on demand when a specified event occurs or at a particular date.
2. The obligation cannot be avoided.
3. The event that obligates the entity has occurred.

Liabilities are similarly recognised, subject to the constraint that they can be measured reliably. Liabilities usually result from transactions that enable entities to obtain resources. Other liabilities may arise from nonreciprocal transfers, such as the declaration of dividends to the owners of the entity or the pledging of assets to charitable organisations.

The definitions of the main IFRS financial statement items “asset” and “liability” are defined in the Framework with additional guidance in IAS 38 for assets and IAS 37 for liabilities, which partly offsets the missing additional concept statements in comparison to US GAAP.

4.3.2. General Measurement Concepts

Under IFRS, assets and liabilities are recorded in financial statements at fair value at inception, which for assets and liabilities arising from arm’s-length transactions will be equal to negotiated prices. The term “arm's-length” refers to willing, unrelated parties on a free market and is a basic approach in Anglo-Saxon accounting.

Subsequent measurement is usually done under the historical cost principle, although in many cases subsequent changes in values are also recognised. All assets are now subject to impairment testing.

Currently, IFRS does not provide specific guidance to the measurement of fair value. Fair value is the objective for most measurements at initial recognition and for fresh-start measurements in subsequent periods. At initial recognition, the cash paid or received (historical cost or proceeds) is usually assumed to be a fair value, in the absence of evidence to the contrary. For fresh-start measurements, a price that is observed in the marketplace for an essentially similar asset or liability equals fair value.

If purchase prices and market prices are available, there is no need to use alternative measurement techniques to approximate fair value. However, if alternative measurement

techniques must be used for initial recognition and for fresh-start measurements, those techniques should attempt to capture the elements that when taken together would comprise a market price if one existed. This simply means that IFRS try to simulate market conditions using mathematical methods that are described but not precisely defined.

In this case, estimates of future cash flows as the basis for accounting measurements either at initial recognition or when assets are subsequently remeasured at fair value (fresh-start measurements) are used. Present value is used to calculate fair value, especially when the amount of future cash flows, their timing, or both are uncertain. However, it does not address recognition questions, such as which transactions and events should be valued using present value measures or when fresh-start measurements are appropriate.

4.3.3. Recognition and Measurement Concepts of the 4th EU Directive

The 4th EU Directive does not include a definition of an asset or a liability, but the general measurement rule that fixed assets must be valued at purchase price or production cost means that a fixed asset must be marketable or exchangeable because otherwise there will be no purchase price or production cost available and the question that an asset may not be capable of being measured reliably does not arise. Fixed assets include both tangible and intangible assets and therefore only acquired intangible assets are accountable. According to this concept, the scope of assets recognised under the 4th EU Directive is more limited than in IFRS. Fair value accounting or the use of present value techniques are unknown and not useful because purchase price or production costs are the only possible criteria.

The purchase price or production cost of fixed assets with limited useful economic lives must be reduced by value adjustments calculated to write off the value of such assets systematically over their useful economic lives. Provisions for liabilities and charges may not exceed in amount the sums which are necessary. Revaluation methods are possible for certain assets in limited circumstances. Liabilities are valued at their repayment amount; no further guidance is offered within the 4th EU Directive but it is obvious that a legal obligation for payment is necessary to meet the criteria for a liability.

The lack of definitions for elements of financial statements does not mean that no definitions exist. According to the general concept of the 4th EU Directive, the definition of elements and the details of alternative measurements are part of the national accounting

laws, so there is no need for general definitions within the 4th EU Directive. Recognition and measurement are both part of each national accounting system.

4.4. Summary and Conclusion

Assets and liabilities are more broadly defined in IFRS than in the 4th EU Directive, but IFRS do not contain a detailed method for fair value accounting in cases where a reliable market value is not available. Although the 4th EU Directive does not contain detailed definitions, the mere fact that recognition of an asset or a liability is only possible when a purchase price or a legal obligation for payment exists represents a limitation of possible assets or liabilities. The elements are closely linked to market transactions. Where no market transactions exist, no asset or liability occurs. IFRS widens this approach by accepting market-like measurement methods to verify an asset or a liability.

The main similarities and differences are summarised in the following table:

Topics	IFRS	4th EU Directive
Assets	Broad definition in Framework with further guidance in IAS 38, cash-flow-oriented approach	No definition, but limited recognition because of measurement criteria, marketable approach
Liabilities	Broad definition connected to cash-oriented approach (cash outflows)	Legal obligation of payment requirement
Capital	Defined as residual value between assets and liabilities	No definition, but detailed in balance sheet format
Purchase price	Fair value in case of purchase	Standard valuation method
Production cost	Fair value in case of production	Standard valuation method
Fair value	Standard valuation method, but no detailed computation in cases where purchase price and production costs are not available	No method
Depreciation	Standard valuation method for subsequent measurement on historical cost	Standard valuation method for subsequent measurement on historical cost
Revaluation	Alternative valuation method for subsequent measurement, impairment test required	Only limited to certain events

Table 3

The wider range of possible assets and liabilities in IFRS financial statements leads to further problems regarding the treatment of revaluation amounts in the equity section and the influence on the profit and loss account, both being a question of subsequent measurement.

A transition of local GAAP financial statements to IFRS financial statements will have to recognise additional assets and liabilities according to the IFRS definitions of elements of financial statements as the first step. A second major task is to find measurement methods for those assets and liabilities with no market price or production costs. The fair value concept and present value techniques have to be applied in these cases. The problems will be analysed in more detail using the accounting laws and regulations of the major countries of the European Union and the different concepts of enacting the 4th EU Directive in national law. This will be the task of the next chapter.

5. Financial Accounting and Reporting in the European Union

5.1. Introduction

The European Union has been very active in the field of financial reporting during the last 30 years.[49] The 4th and 7th EU Directive aimed to achieve harmonisation and reduce differences between the financial statements of companies located in different member states.

The main reasons for these activities relate to:

1. Common market;
2. Protection of shareholders;
3. Competition.

The European Union is based on the principles of a free common market within which there is a free flow of goods, services, labour and factors of production. One important factor of production is capital and to achieve the most efficient use of capital a company should be able to raise its capital in any member state. Financial statements are a medium for presenting investment opportunities. However, if the accounting rules are very different, this will be a constraint on the efficient operation of capital markets.

Besides the aspects of capital markets, similar financial reporting rules provide a common environment for business throughout Europe. A company based in one member state

[49] Flower,J., "Introduction-The EU's role in financial reporting", in: J.Flower,Ch.Lefebvre (eds.) Comparative Studies in Accounting Regulation in Europe, Leuven, p. 21f.

should not experience major difficulties in carrying out business in another member state. Different financial accounting and reporting requirements can add considerably to the costs of operating in another member state.

The limited liability of companies renders shareholders and investments through credits vulnerable in the event of financial failure or bankruptcy. Shareholders' and investors' claims are limited to the remaining assets of the company. For this reason, most countries have enacted laws to protect the interests of shareholders. Usually, companies have to render accounts and financial statements to their shareholders annually. Foreign shareholders and investors are more vulnerable than domestic shareholders.

With the foundation of the European Union in 1957, it was expected that the number of foreign shareholders would increase and the following article was written into the Treaty of Rome:

> "Article 54 ...1.....the Council shall draw up a general programme for the abolition of existing restrictions on freedom of establishment within the Community... ..3 The Council and Commission shall carry out the duties devolving on them under the preceding provisions, in particular:... (g) by coordinating to the necessary extent the safeguards which, for the protection of the interests of members and others, are required by member states of companies...with a view to making sure safeguards are equivalent throughout the Community"

The article is the sole legal basis for action in the field of accounting in the European Union. Harmonisation of company accounts is one part of shareholder protection. The European Union is also entitled to protect other groups, for example creditors and workers.

In order for a common market to operate efficiently, competition is one major factor. Regarding financial statements, the requirement to publish accounts is one of the most important obligations. In general, companies are reluctant to publish accounts and reveal financial and business information because of a general fear of aiding competitors. For this reason it would be a competitive advantage if a member state were permitted not to publish accounts or publish uninformative accounts. Such unequal regulations would create an unfair advantage over companies in other member states.
The harmonisation process within the European Union is driven by three main reasons:

1. The economic reason to ensure efficient operation of the common market;
2. The legal reason to fulfil treaty obligations to protect shareholders;
3. The competition reason to prevent member states from unfairly favouring their own companies.

In comparison to IFRS, the reasons for harmonisation within the European Union are much wider. Whereas IFRS mainly address the capital market and especially the accounting and financial reporting requirements of listed companies with the aim of common worldwide standards for reporting on stock exchanges through the IOSCO agreement, EU accounting regulations aim to protect competition, the common market, shareholders and other groups.

IFRS and the 4th EU Directive have parts in common and similar, but not identical, aims. It is not clear if IFRS can automatically and simultaneously fulfil the wider EU harmonisation aims. Currently, IFRS reporting requirements are limited to financial reporting for listed companies within the European Union. This mainly affects consolidated accounts and not the accounts and financial reports of single individual companies with different legal forms. The financial accounts of single companies usually have additional functions, for example they may serve as a basis for tax computation or define legal rights for different owner groups.

The enactment of the 4th EU Directive within the European Union and the differences and similarities of accounting regulations will be discussed reviewing the accounting regulations of four representative countries: France and Germany as members of the so-called traditional Continental European accounting group, the United Kingdom as the main example of common-law-based accounting with an Anglo-Saxon background which has influenced the EU Directive by introducing the true and fair view principle, and Poland as an example of a formerly communist country with a limited accounting and financial reporting tradition that has recently joined the European Union and had introduced a large number of different company and accounting laws and regulations.

The accounting and reporting regulations of these countries will be compared in major categories in order to reveal the main problem areas for the transition of financial reports of individual companies to IFRS accounting standards.

5.2. Financial Accounting and Reporting in France

5.2.1. Background of French Accounting

France has a long accounting and financial reporting tradition and the Code Napoleon especially has influenced many other countries in Europe[50]. The first requirement for accounting dates from Colbert's directive issued in 1673, which is also known as the Savary Code.[51] The 1673 directive is the first major attempt at codification which would impose the constraints upon the habits and customs of merchants.[52] The code required accounts to be kept and provided for the pages of the accounting books to be numbered and initialled by the mayor or magistrate. A trader who went bankrupt and whose pages were not numbered and initialled would be declared a 'fraudulent bankrupt'. The numbering of the central ledger is still a requirement today. The directive was silent as to how the books and accounts should be maintained and it is interesting to note that the silence of French law on accounting principles and valuation methods lasted nearly three centuries until the 1947 Plan Comptable Général.

The Commercial Code of 1807, which was prepared following a series of bankruptcies which occurred in 1805 and 1806, replaced the 1673 directive. It was part of an interventionist and centralist attitude on the part of the state which was reinforced during the Revolution and then by Napoleon. It was based on the 1673 directive and introduced the Société Anonyme (SA) into French law. The obligation to maintain accounting records from the 1673 directive was kept, but was modified in order to make the accounting records a means of providing evidence. It is worth noting that this modification of the 1807 Napoleon Code still exists almost unchanged. According to the 1983 Commercial Code, "the accounts, regularly written up, can be accepted as legal evidence between traders about the facts of commercial transactions."

The 1807 Code made reference for the first time to a balance sheet and schedule of profit and loss account. The balance sheet was not the result of a logical accounting system but rather a collection of independently established facts.

---

[50] Lévy-Bruhl,H., "Histoire juridique des sociétés de commmerce en France aux 17ème et 18ème siècles", Paris 1938.

[51] Savary,J., "Le parfait négociant ou Insruction générale pour ce qui regarde le commerce de toute sorte de Marchandise, tant de France, que de Pay Etrangers", 1st ed. Livre 1, Paris, Reprint 1993, Düsseldorf.

[52] Mikol,A., "The history of financial reporting in France", in: P.Walton (ed.), "European Financial Reporting", San Diego 1995, pp. 91ff.

The 1807 Code in connection with the Code Napoleon had a great influence on Continental European law because it was enacted in all occupied European countries and kept as a basis for national legislation after the Napoleonic Era.

The development in large parts of the 20th century was influenced by German regulations. The Act of 1925 created the Societé à Responsibilité Limitée (SARL) based on the model of the German Gesellschaft mit beschränkter Haftung (GmbH), which had come into Alsace and Lorraine under German occupation. This legal form is very popular for small and medium-sized companies.

In 1942, the first French Plan Comptable including a chart of accounts and principles was introduced. Its concept was the control of the economy through standardised accounting which was a general concept of Nazi Germany. Central direction of the economy by the state had been a French tradition since 1673. After the war, several Plan Comptable were enacted. The 1982 Plan Comptable already included requirements of the 4th EU Directive which was enacted in 1983. The Accounting Act of 1983 installed accounting principles and valuation rules which were new for French accounting law and made accounting more autonomous from tax law. Accounting principles were set out in the Commercial Code itself. Although the French Plan Comptable contains an implicit framework, a conceptual framework as a basis for accounting is far from French accounting culture and tradition.

5.2.2. Influence of Taxation on Accounting in France

The Tax Acts of 1914 and 1917 laid down the basis of the tax system which is still in force today and changed the system which dated from the 1789 Revolution. Although the Tax Acts of 1914 and 1917 created a link between taxation and the need to keep accounts, the tax was not calculated from the profit shown in the profit and loss account, mainly because of unreliable accounting regulations at that time.

The Tax Act of 1965 made reference for the first time to the Plan Compatble and specified the accounting documents to be attached to the annual tax return and introduced the valuation rules of the Plan Compatble for tax calculation, thus marking the beginning of a close link between tax computation and accounting. Fiscal authorities only accept accounting results as a good measure of the taxable capacity of the company. Accounting standardisation was a way to help taxation in the role of an instrument at the service of the economic policy of the government. Fiscal law dominated accounting in several ways, for example as far as depreciation and provisions are concerned, the fiscal advantages are

linked to formal recording in the accounting books. For instance, the recording of special depreciation can only reduce taxable profit if it is written into the financial statements. The argument behind this treatment is that the state, providing a fiscal advantage to the firm, wants to avoid distribution of the financial advantage to shareholders, who have to accept a lower profit and lower potential dividend.

After enacting the 4th EU Directive in 1983, isolation of the fiscal impact on some accounts was necessary. The additional amount of depreciation should be recorded in a special account which appears in the shareholders' equity section. In the profit and loss account, the additional amount is shown in the extraordinary expenses and not in the operating results, but net income is still influenced by additional tax depreciation.[53]

Even after 1983, accounting and financial reporting is influenced by tax law. Following the issuance of APB Opinion No. 8 and IAS 19 on pension liabilities, it was discussed whether or not a provision should be created. Since a special Act in 1985, provisions for pensions are not tax deductible and represent a permanent difference. Another major influence of tax regulations on accounting are the rules for tax losses carried forward. For tax purposes, a loss carryforward is deductible with future tax profits for five years. This means that if cumulated profits for a period of five years after a tax loss do not offset the amount of the original tax loss, the unused tax loss is lost. This regulation influences financial reporting in two ways. Firstly, the recognition of a tax asset as a result of a tax loss according to IAS 12 has to observe the five-year timeframe and especially in cases of longer periods for new companies or new products and technical developments to become profitable this might be a disadvantage. Secondly, the possible revaluation method according to the 4th EU Directive and according to IAS are favoured in cases where a definite tax loss might occur. Because the difference of a revaluation is taxable this method offers an opportunity to generate additional profit to offset a tax loss which otherwise could not be used against ordinary income.

5.2.3. Main Accounting Principles in Comparison to IFRS

The following overview shows a summary of similarities and differences between the main French and IFRS accounting principles for major balance sheet positions relevant mainly for financial reports of small and medium-sized companies.[54]

[53] Frydlender,A., Pham,D., "Relationship between accounting and taxation in France", in: European Accounting Review 1996, p. 845ff.

[54] Giot,H., "Règles comptables francaises et référentiels IASC et FASB: différences et convergences", in:

Subject	France	IFRS
Intangible assets	Generally capitalised at purchase price. Depreciation no longer than five years. No revaluation permitted.	Capitalised if recognition criteria met, internally generated also possible. Depreciation over useful life or at fair value in case of indefinite useful life with impairment test. Revaluation possible.
Research and development costs	General research costs expensed as incurred. Costs for a special order may be capitalised or expensed.	General research costs expensed as incurred. Development costs shall be recognised if criteria are met.
Property, plant and equipment	Capitalised at historical costs if legal owner, no leases capitalised. Depreciation over useful live, revaluation possible.	Capitalisation of leases possible. Historical cost or revalued amounts. Frequent valuations of entire classes of assets necessary when revaluation method used. Depreciation over useful life.
Financial assets - investments	Capitalised at historical costs. The carrying values of investments are reviewed at each balance sheet date. Only value reduction is possible in case of valuation fluctuations. No special rules for derivatives or other financial instruments.	Long-term investments at cost or revalued amounts. Revaluations recorded in income statement or equity. Current asset investments at lower of cost or market. Special rules for derivatives and other financial instruments.
Inventories	Capitalised at purchase price or costs of conversion. FIFO, weighted average method possible. No value adjustment because of net realisable value.	Carry at lower of cost and net realisable value. Long-term contract revenues according to percentage of completion method.
Foreign currency translation	No regulation regarding translation of accounts receivable denominated in a foreign currency.	The effects of changes in foreign exchange rates are subject to IAS 21.
Capital and reserves	Detailed regulations for capital and reserves including reserves for revaluation, government grants and other reserves.	No explicit definition of capital and reserves.

Revue francaise de comptabilité 1997, Oct., pp. 45ff.

Subject	France	IFRS
Provisions	Two main categories: Risks and expenses. Pension costs usually not provided. No method to calculate pension costs.	General provisions related to present obligations from past events. Risks for possible losses only disclosed. Special provisions for restructuring and employee benefits and pension costs.

Table 4

The overview reveals a wide range of differences between French accounting regulations and IFRS for all major balance sheet sections which is not surprising regarding the background of French accounting history.[55] In connection with the close relation between tax accounting and financial accounting in France, it becomes obvious that a transition of a local French GAAP-based financial report to an IFRS financial report requires a basic approach for all balance sheet sections.

At first sight, one could imagine that the transition problems for a small company would be less complicated than for an internationally operating French company because a single financial report does not usually entail so many details. But this is not the case. The single financial report might be more basic in comparison to consolidated reports of listed companies, but French tax authorities do not care for consolidated reports, which allows different accounting treatments in consolidated accounts. As a general result, there are more differences than similarities between French accounting and IFRS.[56]

5.3. Financial Accounting and Reporting in Germany

5.3.1. Background of German Accounting

Accounting tradition in Germany was closely related to France. The rules of determining profits were mainly influenced by legal reforms, e.g. the common Prussian law of 1794, and the state attempted to regulate the behaviour of individual merchants through using the force of law by developing generally accepted accounting principles.

The Savary code of 1673 was immediately translated into German and influenced accounting in Germany in the following centuries.[57] Balance sheets were only used from

[55] Hartmut,H., “Europäisches Bilanzrecht in Frankreich”, in: Internationales Steuerrecht 1997, pp.697ff.
[56] Horau,Ch., “International accounting harmonization: American hegemony or mutual recognition with benchmarks?”, in: European Accounting Review 1995, pp. 217ff.
[57] Schneider,D., “The history of financial reporting in Germany”, in: P.Walton (ed.) European Financial Reporting, San Diego 1995, pp. 123ff.

the beginning of the 18th century in disputes over assets among partners and, due to the absence of a market for companies, different means were found for resolving conflicts concerning assets.

Accounting was also unpopular among banks in the 19th century and it took a long time until the Aktiengesetz of 1884 codified more detailed regulations.[58] Roman law was the origin of the profit notion. According to Roman law, a profit is restricted to regular, ordinary inflows of goods and cash, and gains on disposals of assets which are part of the asset base do not count as income. Even ordinary income does not qualify as profit as long as the substance has not been maintained in its original volume. This is the origin of the concept of capital maintenance in accounting and reporting profit. In addition, in Roman law the firm, called "Societas", is seen as a household and business association. From this understanding, which was valid until the 19th century, profit calculation is only done on the termination of the firm. Because of this Roman law tradition, commercial law outside Prussia regarded the measurement of periodical profit in trading companies only as a documentation of wealth allocation among partners.[59]

In the legal commentaries to the Aktiengesetz of 1884, almost all of the principles of profit determination were established which are still valid today, for instance the capitalisation of intangible fixed assets only in cases where they are separable by selling, or the anticipation of losses on pending transactions.

Accounting went on to be a business of lawyers until Betriebswirtschaft (business economics) evolved as an independent science from 1912. Schmalenbach first made a distinction between a business-economic and a legal perspective of the balance sheet by introducing the concept of the "Dynamic Balance Sheet"[60]. Profits were regarded as distributable only once earlier losses were covered. If a balance sheet is regarded as a means to calculate profit, this is different to a static view of a balance sheet, which compares a status between an opening and closing balance, enforcing strong comparability requirements. According to Schmalenbach, because absolute comparability and accuracy is not possible, it is less significant that profits are absolutely correct. Elements of the balance sheet are seen as timing differences between different accounting periods and do not represent the actual accurate amount. Thus, understatement is allowed

[58] Wagner,A., "Beiträge zur Lehre von den Banken", Leipzig 1857.
[59] Wilmowski,B., "Kommentar zum Preussischen Einkommensteuergesetz vom 24. Juni 1891", Breslau 1891.
[60] Schmalenbach,E., "Dynamische Bilanz", Cologne 1962.

at least insofar as it represents an escape from the impossibility of determining the correct value.

This view was later extended to the thesis that a risk is to be treated differently from an opportunity. In this context, dynamic accounting was used by practitioners to attempt to hide profits and conceal later losses by reversing hidden reserves. This accounting treatment then became part of generally accepted German accounting principles and found its way into the commercial law of the Handelsgesetzbuch.[61] Creditor protection became a fundamental concern of German accounting and conservative balance sheet valuations are a central function. Reserves are seen as protection against unforeseen risks and possible future losses. The calculation of a prudent distributable profit is a result of this concept.

The implementation of the 4th EU Directive in German commercial law took place in 1985. Many tax law definition were adopted. The German government first refused to accept the revaluation rule for companies and accepted it only when the inclusion of tax-motivated extraordinary write-offs were permitted. According to German commercial law, revaluation does not have to be followed in case of an additional tax burden as a result of a revaluation. In contrast to France, losses can be carried forward indefinitely for tax calculation and therefore no tax-motivated revaluation is necessary in Germany. Despite the reform of the Stock Corporation Law in 1965 and the transformation of the 4th EU Directive and introduction of the true and fair view principle into German accounting law, the tradition of prudent accounting in line with the dynamic balance theory according to Schmalenbach is still a basis for accounting in Germany, especially for small and medium-sized and non-listed companies.

5.3.2. Influence of Taxation on Accounting in Germany

Germany traditionally has a close link between tax law and commercial law profit distribution.[62] Before the First World War, income under tax law, which was initially based on the Roman law theory of income, was extended to the profit determination for commercial law. The intention was to offer an alleviation for merchants who would not need to draw up an independent income statement for tax purposes. In this way, the commercial generally accepted accounting principles are understood in tax jurisdiction and

[61] Leffson,U., “Die grundsätze ordnungsmässiger Buchführung”, Düsseldorf 1964.
[62] Schneider,D., “Die Anfänge der Steuerbilanz und die Entstehung des Massgeblichkeitsprinzips”, in: N.Herzig (ed.) Betriebswirtschaftliche Steuerlehre und Steuerberatung, Wiesbaden 1991, pp. 175-190.

the principle of Massgeblichkeit (determining influence) of GAAP for tax purposes was created.

This approach led to a unified balance sheet in the sense of law as far as income or profit determination is considered. The principle of determining influence means that only when a tax law rule explicitly diverges from commercial law rules are differences between the commercial and tax balance permitted. Commercial GAAP became authoritative for tax reporting. Tax court decisions influence commercial law accounting through this close link. The commercial valuation rules are generally also valid for tax purposes. Tax allowances or additional write-offs are only recognised if the commercial accounts use the same approach.

Partnerships especially usually draw up one annual report for commercial and tax purposes. The German unified balance sheet approach led to a conflict with Anglo-Saxon accounting principles during the course of the 4th EU Directive implementation. This conflict was solved by allowing additional tax-motivated depreciation or allowances in the commercial balance sheet and additional reporting requirements in the Notes section of a financial report according to the 4th EU Directive.

5.3.3. Main Accounting Principles in Comparison to IFRS

The following overview summarises the subjects already discussed for French accounting principles in order to give a first impression of similarities and differences.[63] As a result of the discussion of German accounting tradition it is obvious that a large number of differences exist between German accounting and IFRS due to the approach being basically different.

Subject	Germany	IFRS
Intangible assets	Generally capitalised at purchase price. Systematic depreciation over expected life. No revaluation permitted.	Capitalised if recognition criteria met, internally generated also possible. Depreciation over useful life or at fair value in case of indefinite useful life with impairment test. Revaluation possible.
Research and development costs	General research costs expensed as incurred. Costs for a special order may be capitalised or expensed in inventory.	General research costs expensed as incurred. Development costs shall be recognised if criteria are met.
Property, plant and equipment	Capitalised at historical costs, including leases if criteria are met. Depreciation over useful live, no revaluation possible.	Capitalisation of leases possible. Historical cost or revalued amounts. Frequent valuations of entire classes of assets necessary when revaluation method used. Depreciation over useful life.
Financial assets - investments	Capitalised at historical costs. Only extraordinary depreciation possible if certain criteria are met. No special rules for derivatives or other financial instruments.	Long-term investments at cost or revalued amounts. Revaluations recorded in income statement or equity. Current asset investments at lower of cost or market. Special rules for derivatives and other financial instruments.

[63] Nobes,Ch., Parker,R., “Comparative International Accounting”, 9th ed. Essex 2006, p. 305f.

Subject	Germany	IFRS
Inventories	Capitalised at purchase price or costs of conversion. FIFO, weighted average method possible. Required value adjustment to lower cost or market or net realisable value.	Carry at lower of cost and net realisable value. Long-term contract revenues according to percentage of completion method.
Foreign currency translation	Special regulation regarding translation of foreign currencies.	The effects of changes in foreign exchange rates subject to IAS 21.
Capital and reserves	Detailed regulations for capital and reserves.	No explicit definition of capital and reserves.
Provisions	Prudence principle allows a wide range of provisions. Possible risks are the main factor for detailed calculation. Pension costs are provided according to a tax method.	General provisions related to present obligations from past events. Risks for possible losses only disclosed. Special provisions for restructuring and employee benefits and pension costs.

Table 5

France and Germany are usually viewed as members of the so-called Continental European accounting group. Although both countries share a common Roman law history and tax regulations had a large influence on accounting in both countries, the accounting regulations show a large number of differences in detail. Pension costs are one example of general interest. In France, pension costs are generally not tax deductible and no detailed calculation method exists whereas in Germany the calculation is based on tax regulations and recognised for tax and commercial profit determination.[64] The reason behind this difference is that in France, pension obligations of companies do not play a great role in retirement insurance and even if detailed calculation methods did exist, balance sheets of French companies would only show limited pension liabilities because of the absence of pension schemes. In Germany, company pension schemes have a long tradition and are one part of retirement plans.

In the end, social differences in both countries are the main reason for the different accounting rules.

[64] Gélard,G., “Comparative financial statements – United Kingdom, Germany, France”, KPMG ed. 1999.

5.4. Financial Accounting and Reporting in the United Kingdom

5.4.1. Background of British Accounting

The accounting tradition of the United Kingdom falls into two main periods, divided by the year 1970. Before 1970, corporate financial statements were relatively unregulated.[65] Agriculture was the dominant economic activity in Britain until the nineteenth century and much of international commercial activity was controlled by Italians. Accounting literature did not emerge until the beginning of the nineteenth century. The East India Company as the most notable early commercial company moved to a system of annual accounting to work out the amount of dividends that could be paid to its members.

The first companies who adopted double-account methods for their financial reports were the canal companies and the railway companies in the nineteenth century. They required a large amount of capital and this was only possible on the basis that investors had a limited liability for the debts of the companies. In order to gain limited liability, railway companies were obliged to incorporate through an Act of Parliament. The Companies Clauses Consolidation Act of 1845 set a standard to all new statutory companies and required that a bookkeeper be appointed. An exact balance had to be made up to give a true statement of the capital stock, credits and property, and a distinct view of profit and loss. The Act omitted rules as to the form and content of financial statements and how items are to be determined. General terms such as 'exact', 'true' and 'distinct' were used. Although railway accounts were regulated later in 1868 in more detail because of misleading reporting, this lack of regulation and a lack of theoretical framework remained a dominant factor in British accounting.

Accounts continued to be seen as a private matter between shareholders and directors and this remained the case for the rest of the nineteenth century. As a result, a series of scandals occurred. The Companies Act of 1907 and 1908 recognised partially the right of investors to information about the financial position of companies in which they invested. A distinction was made between privately held companies that had 50 members or less and public companies, which were required to file their balance sheet with the Registrar of Companies. However, even for public companies, the Act provided only a minimal degree of regulation. It was still possible for public companies to file a balance sheet that was different from that presented to shareholders in the general meeting. Financial statements became increasingly uninformative and the figures that were disclosed were likely to have been heavily manipulated.

[65] Napier,Ch., “The history of financial reporting in the United Kingdom”, in: P.Walton (ed.) “European Financial Reporting”, San Diego, 1995, pp. 259ff.

The stagnation in accounting regulation led to highly misleading statements and scandals and the financial collapse of large companies, for instance the collapse of Britain's largest shipping company in the 1920s. The London School of Economics was the only exception to the lack of a developed academic body of accounting knowledge during the 1940s. The Companies Act of 1947/48 introduced extensive reporting requirements and additional notes to companies' accounts, but did not require standard formats. The overall requirement of a 'true and fair view' was introduced and replaced the 'true and correct' wording which was seen to permit accounts which were formally accurate but highly misleading.[66]

In 1975, the Accounting Standard Committee was formed and it began to issue Statements of Standard Accounting Practice, but accounting standards turned out to be essentially unenforceable in practice, particularly if a sizable number of companies decided not to comply.

The Companies Act 1981 incorporated the 4th EU Directive into British law and for the first time formats of company balances and profit and loss accounts were prescribed as well as accounting principles and valuation rules with which company accounts had to comply. Because of its late entry into the European Union, the British government was not able to change most of the detailed accounting regulations of the Directive but managed to introduced the 'true and fair view' principle as the overriding principle. But it was unclear if this offered an opportunity for companies to deviate from the strict legal requirements of the Companies Act in order to reflect the 'substance' of transactions. The 4th EU Directive introduced Continental European concepts of accounting in the tradition of Roman law to British companies.

Partnerships and sole traders still do not have a general obligation to keep accounts. They may retain their accounts in any particular form or present specified periodic statements. Partners may in principle agree on any method of measuring profit that they wish. This has not changed with the introduction of the 4th EU Directive. A large number of small and medium-sized companies of unincorporated businesses are not subject to legal regulations.

[66] Walton,P.J., "Introduction: the true and fair view in British accounting", in European Accounting Review 1993, pp. 49-58.

5.4.2. Influence of Taxation on Accounting in the United Kingdom

It is not surprising that the United Kingdom is notable for the relative independence of its calculations of accounting profits and taxable profits.[67] Because of the wide variety of accounting practices and the lack of authoritative financial reports, tax authorities were forced to develop their own rules to measure taxable profits.[68] As a consequence, accounting is not influenced by tax rules and the measurements used in financial accounting are generally not binding for tax purposes. Expenses do not have to be reported in financial accounting in order to be deductible for fiscal purposes.

The definition of taxable profit is mainly based on case law and not according to codified tax law. One basic approach of British taxation is the principle that losses as well as profits should not be anticipated. The principle of prudence, which represents a major accounting principle in Germany and France, is not accepted under British tax law. In addition, British literature stated that it is 'generally not desirable' to have financial reporting decisions influenced by their potential tax impact. Tax-induced valuation of fixed and current assets is unknown and Art. 35 (1) d) and Art. 39(1) e) of the 4th EU Directive have not been implemented.[69]

But the relationship between tax and profit measurement in Britain remains a complex one. Profits for income tax are determined according to 'the ordinary principles of commercial accountancy'. Although many businesses have reflected tax regulations in preparing their annual financial statements, for instance calculating depreciation on a basis consistent with tax deductions, they are under no obligation to do so. Businesses could present a profit and loss account to its owners and others showing a profit very different to that presented and calculated for tax purposes.

[67] Porcano,Th.M., Tran,A.V., “Relationship of Tax and Financial Accounting Rules in Anglo-Saxon Countries”, in: The International Journal of Accounting, Vol. 33, No. 4, pp. 433-454, 1998.
[68] Lamb,M., “The relationship between accounting and taxation: The United Kingdom”, in: European Accounting Review 1996, pp. 937-948.
[69] Eberhartinger,E., “The Impact of Tax Rules on Financial Reporting in Germany, France and the UK”, in: The International Journal of Accounting, Vol. 34, No. 1, pp. 93-119,1999.

5.4.3. Main Accounting Principles in Comparison to IFRS

It is not surprising that differences between British accounting principles and IFRS are much smaller in comparison to French and German accounting principles. But this first comparison may be misleading, because a large number of small and medium-sized companies do not have to follow the British accounting principles. They are free to adopt any principles that are useful in determining the profit for their members. This could be seen as a major difference between British and Continental European accounting tradition.[70]

Subject	British	IFRS
Intangible assets	Broadly comparable to IFRS, indefinite life possible in certain rare circumstances.	Capitalised if recognition criteria met, internally generated also possible. Depreciation over useful life or at fair value in case of indefinite useful life with impairment test. Revaluation possible.
Research and development costs	Comparable to IFRS but option to capitalise and amortise development costs if criteria are met.	General research costs expensed as incurred. Development costs shall be recognised if criteria are met.
Property, plant and equipment	Comparable to IFRS, but no standard on frequency of valuation.	Capitalisation of leases possible. Historical cost or revalued amounts. Frequent valuations of entire classes of assets necessary when revaluation method used. Depreciation over useful life.
Financial assets - investments	Fixed asset investments at cost, market value or other basis, such as net asset value. Current asset investments at lower cost and net realisable value or at current cost.	Long-term investments at cost or revalued amounts. Revaluations recorded in income statement or equity. Current asset investments at lower of cost or market. Special rules for derivatives and other financial instruments.

[70] PricewaterhouseCoopers ed., "IAS,US GAAP and UK GAAP – Similarities and Differences", London 1998.

Subject	British	IFRS
Inventories	Comparable to IFRS.	Carry at lower of cost and net realisable value. Long-term contract revenues according to percentage of completion method.
Foreign currency translation	Closing rate for balance sheets; either average or closing rate of income statement. Difference taken to equity; not included in gains on disposal.	The effects of changes in foreign exchange rates are subject to IAS 21.
Capital and reserves	Detailed regulations for capital and reserves.	No explicit definition of capital and reserves.
Provisions	Comparable to IFRS.	General provisions related to present obligations from past events. Risks for possible losses only disclosed. Special provisions for restructuring and employee benefits and pension costs.

Table 6

5.5. Financial Accounting and Reporting in Poland

5.5.1. Background of Polish Accounting

The history of Poland's regulatory framework for accounting is influenced by its political history in the twentieth century. During this period until today, Poland adopted accounting regulations within the Continental European tradition, was forced to apply communist-type accounting and then changed to the accounting rules of the European Union in the early 1990s in order to prepare for joining the European Community. Poland is the largest of the transition economies to become a member of the European Union and is, according to the OECD, an example of a successful transition process.[71] Due to political turbulence, Poland had no chance to develop its own accounting history or an auditing profession and in particular was not able to build up a university-level accounting education.[72] All this had to be introduced within a short timeframe from 1990 until today. The process is still continuing.

[71] OECD “Economic Survey”, Paris, 2000, p. 23 and A. Aslund, “Building Capitalism. The Transformation of the Former Soviet Bloc”, Cambridge 2002.

[72] Grant,C., “Changes in university-level accounting education in Poland”, in European Accounting Review, 1992, pp. 407-412.

After re-establishing the Second Republic after the First World War in 1918, a lack of private risk capital was a problem for economic development and due to political risks was reinforced by the lack of foreign investments. The Commercial Code of 1934 consolidated relevant regulations on accounting and auditing and was influenced by the German code.[73] Under the Commercial Code of 1934, the joint-stock company was introduced, similar to the German Aktiengesellschaft, which marked the starting point for privatisation. There was a large state interest in the promotion of industry and the safeguarding of private investments in stock companies by relatively advanced and progressive accounting requirements.[74]

In 1928, it was enacted that stock companies had to publish audited balance sheets and profit and loss accounts within 14 days after their ratification by the annual general meeting. In England, the presentation of a profit and loss account to the members was introduced in 1929; filing was required in 1948. In Germany, the auditing of financial statements became law in 1932. During the German occupation, the rules of the uniform German General Plan of Accounts were in force which also introduced ideas of Schmalenbach and the German Betriebswirtschaftslehre. But there was no chance to apply these ideas under the Nazi regime.

From 1944 until 1989, the abolition of private investors and capital markets, the absence of a commercial banking system and the state budget becoming the primary investor meant that accounting was reduced to a mere bookkeeping function to control the overall Central Plan. The recording of transactions became a passive function and reporting was exclusively for the internal use of central authorities. Under the socialist theory, there was no need for accounting innovation, assessing the commercial performance of enterprises by evaluating accounting data was not relevant[75].

With the collapse of the Soviet Bloc in 1989, all of this changed dramatically. The change from accounting appropriate for a market economy had to be done in the absence of a strong accountancy profession. The Commercial Code of 1934 was reviewed and Poland made use of the experience of Western European nations. The French and German experience and approach to the incorporation of the EU Directives have been studied very carefully. A number of laws were enacted between 1991 and 1994, the following overview

[73] Nobes,Ch., Parker,R., "Comparative International Accounting", 9th ed. Harlow 2006, p. 235.
[74] Krzywda,D., Bailey,D., Schroeder,M., "A theory of European accounting development applied to accounting change in contemporary Poland", in European Accounting Review, 1995, pp. 625-657.
[75] Jaruda,A., Szychta,A., "The origin and evolution of charts of accounts in Poland", in European Accounting Review, London 1997, pp. 509ff.

shows the main governmental acts regulating accounting[76]:

- Act of 19th October 1991 on the Examination and Disclosure of Financial Reports, and Auditors and their Self-Government
- Act of 15th February 1992 on the Taxation of Legal Entities
- Act of 13th July 1990 on Privatisation of State Enterprises
- Act of 14th June 1991 on Companies with Foreign Shareholders
- Act of 29th September 1994 on the Accounting Act

The Accounting Act of 1994 will be analysed in more detail later because it represents the basis of accounting in Poland and incorporates regulations of the 4th EU Directive as well as regulations in the tradition of Continental European and Anglo-Saxon accounting.

5.5.2. Influence of Taxation on Accounting in Poland

The initial Decree of the Ministry of Finance on Accounting, which came into force on 1st January 1991, created a strong relationship between tax and accounting. It allowed the Ministry of Finance to determine rules for bookkeeping and accounting. Recording of economic events became the basis for tax assessment and influenced many principles of financial accounting.
In the following period, the quality of financial statements was sometimes misleading and other regulations from the Ministry of Finance adjusted the profit figure in different directions. The Income Tax Act of 1992 introduced the requirement of an additional separate tax profit report. Differences between accounting profit and tax profit were due to deviations from the accrual principle, tax deductions and allowances.

The Accounting Act of 1994 was the first general statute of this kind. Regarding the relationship with the tax system, the 1994 Act introduced the presentation of a profit before tax instead of a profit after tax and also imposed a comparison between profit before tax and taxable profit. The prudence principle was given an important role which is similar to German accounting regulations and forms a basis for the close German relationship between tax and financial reporting.
Deferred taxation is another important feature and different depreciation rates of fixed assets for financial reporting and tax reporting are a main source of deferred taxes.
The possibility of revaluation of fixed assets is different to other European countries. It is not covered in the Accounting Act itself but possible under special Decree of the Ministry of

[76] Jaruga,A., "Changing rules of accounting in Poland", in European Accounting Review, 1993, pp. 115-126.

Finance. The last Decree allowing revaluation for tax purposes was set out in 1995. in general, although the 1994 Accounting Act is a move away from tax domination, it was not followed by changes in other statutes which results in contradictory regulations.[77]

Unstable and unclear tax law leads to very complicated rules from a technical point of view. Temporary tax differences in one year may become permanent in the next year. The regulations regarding deferred taxes were later adjusted to IFRS and a link to IFRS regulations was introduced in Art. 10 No. 3 of the Accounting Law which refers to IFRS regulations in case of missing national standards. This shift to IFRS since 2002 does not solve general accounting problems regarding the influence of tax assessment.

5.5.3. Main Accounting Principles in Western Europe

According to A. Jaruga, the Polish accounting tradition has more in common with the codified approach to accounting than with the common law one.[78] The Accounting Law of 1994 and the changes are worth analysing in more detail to get an impression of the problems facing small and medium-sized companies in a tran to IFRS on the basis of the Polish Accounting Law.

The following overview compares general accounting principles of the Accounting Law with corresponding regulations in the German Commercial Code and IFRS regulations.

Principle	German HGB	Polish Acc. Law	IFRS
Qualifying date: The balance sheet is presented annually	§ 242 I,II	Art. 12	IAS 1.49
Financial Statement must be clear and well set out	§§ 243 II, § 247 I	Art. 4 I	IAS 1.29 under the concept of materiality
Offsetting	§ 246 II	Art. 7 III	IAS I.32ff. but offsetting possible if permitted by a standard
Consistent valuation	§ 252 I No. 6	Art. 5 I	IAS 8 Changes in accounting policies possible

[77] Jaruga,A., Walinska,E., Baniewicz,A., “The relationship between accounting and taxation in Poland”, in European Accounting Review 1996, pp. 883-897.
[78] Jaruga,A., “Changing rules of accounting in Poland”, European Accounting Review 1993, p. 119.

Principle	German HGB	Polish Acc. Law	IFRS
Going concern	§ 252 I No. 2	Art. 5 II	IAS 1.23
Valuation on an item by item basis	§ 252 I No.2	Art. 7 III	In general, but in cash-generating units or hedge accounting aggregation possible
Prudence	§ 252 I No 4	Art. 7 I	Framework 37
Completeness	§ 246 I	Art. 6 I, Art. 8 I	Framework 38

Table 7

All major German accounting principles could be found in the Accounting Law. In addition, the formal regulations of Art. 9-25 of the Accounting Law are similar to regulations of the German Commercial Code and German Tax Law regulations.

Art. 10 III refers to International Accounting Standards in cases where the Accounting Law and additional national standards do not contain a special regulation. This may lead to problems because the general valuation methods of IFRS are based mainly on US GAAP accounting whereas the Accounting Law is mainly based on the 4th EU Directive.

Generally, the overriding true and fair view principle of the 4th EU Directive has to be applied in cases where accounting law or accounting principles do not contain a regulation or result in misleading financial statements. In these cases, the lack of a regulation is compensated for by deriving an accounting regulation which is in line with the general accounting rules of the 4th EU Directive. This means, for instance, that valuation methods which are not allowed under the 4th EU Directive could not be selected.

With reference to International Accounting Standards, it may be the case that valuation methods could be applied which are not possible under the 4th EU Directive. Art. 10 III does not contain any limits, for instance a regulation which allows alternative accounting treatments only if they do not conflict with general regulations of the Accounting Law itself.

The possible mixture of the Continental-European-based Accounting Law with US-GAAP-based IFRS regulations could lead to misleading statements because users of financial statements may not be aware that a financial statement presented may contain a mixture of valuation methods.
In addition, there are general accounting differences from IFRS which have been

summarised by Nobes/Parkes as follows:[79]

Areas on which there are IFRS but no Polish rules:

- Discounting of provisions, which is not normally the practice.
- Accounting for employee benefits other than defined contribution plans.
- Provisions in the context of a business combination.
- Rules requiring disclosure of the fair value of financial assets and liabilities, segmental reporting, except for some details on sales.

Polish practices that differ from IFRS rules:

- Impairment losses are based on permanent diminution and by reference to net selling price. Formation and start-up costs can be capitalised.
- Goodwill is calculated by reference to book value.
- Goodwill/negative goodwill on consolidation is amortised over a life that must not exceed five years (may be extended to 20 years for positive goodwill)
- Revaluation occurs from time to time in accordance with Ministry of Finance decrees, but are not kept up to date.
- Investments denominated in foreign currencies are translated at the lower of closing and historical rates, so that gains are deferred.
- Deferred tax accounting can be based on timing differences rather than on temporary differences.
- Deferred tax assets need not be recognised.
- An issuer's financial instruments are classified following their legal form, and need not be classified on the basis of whether they are liabilities in substance, and compound instruments are not split on this basis.
- Extraordinary items are defined more broadly.

The reference to International Accounting Standards is one of the main differences between Polish accounting law and the discussed French, German and British regulations. The European Union has made a clear distinction between the application of IFRS, which is limited to listed companies, and the application of national accounting regulations based on the 4th EU Directive, avoiding any mixture of different accounting concepts.

[79] Nobes,CH., Parker,R., “Comparative International Accounting”, Harlow 2006, p. 238f.

5.6. Summary

Accounting harmonisation within the European Union can be seen to a large extent as harmonising accounting regulation and its relationship with cultural differences of the member states.[80] The 4th and 7th EU Directives have had a dramatic impact in financial reporting throughout the EU. Although the 4th EU Directive offered many options, it did succeed in standardising the approach for presenting income statements, it provided coherent balance sheet formats by standard classification and provided a minimum level of additional information in the notes to the accounts, including modifications of the economic result brought about by tax regulations.

There are different cultural traditions within Europe concerning the role of accounting and the way regulation should be composed. There is a long tradition in Europe of adapting regulations from other countries. Examples are the Savary Code of 1673, the Code Napoleon of 1806, the German Commercial Code, general ideas of the German Betriebswirtschaftslehre and the concept of true and fair view. The 4th EU Directive was able to combine these traditions, but the price which had to be paid was a relatively large number of options.

The introduction of IFRS for all listed companies within the European Union from 2005 onwards can be seen as a second major step of the European Commission to develop a single European financial market. According to the estimation of the EU, about 7,000 companies are affected by this regulation. As a consequence of this decision, the discussion about future harmonisation arises. Should the EU Directives and national GAAP be developed further or should IFRS be adopted for unlisted companies as well and how far should this adoption go? The experience of the United States shows that many U.S. companies that are not SEC registrants follow US GAAP to the full and it may be the case that unlisted European companies will also use IFRS when possible.
But the concept in the U.S. is different, because following US GAAP to the full does not mean following all SEC rules. The SEC requires additional reporting for listed companies which are in line with US GAAP but are not necessary for unlisted companies using US GAAP to the full[81].

As a first step, the European Commission permitted the use of IFRS standards by unlisted

[80] Walton,P.J., "European Harmonization", in F.Choi, International Finance and Accounting Handbook, 3rd ed. New Jersey 2003, pp. 17.1ff.
[81] United States Securities and Exchange Commission, "Survey of Financial Statement Reconciliations by Foreign Registrants", Washington D.C., 1993.

companies as an option for member states. In Germany, unlisted companies that prepare consolidated accounts have the choice of adopting IFRS instead of national GAAP. But consolidated accounts are a different area. Tax assessments in France and Germany do not influence consolidated accounts. The single financial statement forms the basis of tax calculation and the close relationship between tax and financial accounting is limited to this single financial statement. With the introduction of IFRS for consolidated accounts for listed companies and as an option for unlisted companies, two different sets of accounting regulations exist within the European Union. The main problems of a transition from national accounting principles to IFRS are not in the area of consolidated accounts, but in the field of single financial reports of individual companies with different legal forms, where the financial report or financial accounting is tax-based or serves as a mere calculation of profit distribution for the partners.

The following overview, adapted from La Porta, Lopez-de-Salines, Shleifer and Vishny[82] gives an impression of the different Code and Common Law countries. Poland, which was not included in the original classification, was added to the Code Law German group.

Code Law – French Origin

Africa: Egypt

Americas: Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay, Venezuela

Asia: Indonesia, Jordan, Philippines, Turkey

Europe: Belgium, France, Greece, Italy, Luxembourg, The Netherlands, Portugal, Spain

Code Law – German Origin

Asia: Japan, South Korea, Taiwan

Europe: Austria, Czech Republic, Germany, Hungary, Poland, Slovak Republic, Switzerland

Code Law – Scandinavian Origin

Europe: Denmark, Finland, Iceland, Norway, Sweden

[82] La Porta,R., Lopez-de-Salines, Shleifer,A., Vishny, R.W., “Law and Finance”, in Journal of Political Economy 106, No. 6, 1998, pp. 1142-1143.

Common Law

Africa: Kenya, Nigeria, South Africa, Zimbabwe

Americas: Canada, United States

Asia: Hong Kong, India, Israel, Malaysia, Pakistan, Singapore, Sri Lanka, Thailand

Australia: Australia, New Zealand

Europe: Ireland, United Kingdom

Part II

Small and Medium-Sized Companies – Analysing the Transition Process

1. The Project of the IASB for Small and Medium-Sized Entities

The IASB issued a discussion paper in 2004 containing primary views on accounting standards for small and medium-sized entities.[83] The intention of the IASB is to develop accounting standards which are suitable for entities that do not have public accountability and publish general-purpose financial statements for external users. This group of entities are referred to as Small and Medium-Sized Entities (SMEs). This definition may be misleading because public accountability of an entity is defined by referring to a filing of financial statements with the securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market. SMEs are not defined in financial figures, for instance sales, number of employees or total balance sheet amounts. So it may be the case that large, globally operating, privately held companies with thousands of employees are treated as SMEs as well as very small private companies with only local business activities, low sales figures and only a few employees.

This contradicts the approach of the 4th EU Directive, where reporting requirements are related to different classes of companies. Small companies are defined in Art. 11 and 12 and medium-sized companies in Art. 27 of the 4th EU Directive and it is left to the member states to permit deviations from accounting rules.

The IASB approach is surprising because the International Accounting Standards themselves contain different reporting requirements for listed or unlisted companies, for instance IAS 14 'Segment Reporting', which applies only to enterprises whose equity or debt securities are publicly traded, including enterprises in the process of issuing debt securities in a public securities market, but not to other economically significant entities.[84]

IASB clarified its position by stating that standards for SMEs will focus on financial reporting by those non-publicly accountable entities that have external users of their financial statements.[85] Privately owned companies which mainly use their financial statements to calculate profit distribution among their partners are not the focus of

[83] IASB, "Preliminary View on Accounting Standards for Small and Medium-Sized Entities", Discussion Paper, London 2004.
[84] See IAS 14.1.
[85] IASB, SME Discussion Paper, p.2.

standards for SMEs[86]. According to the IASB, these types of financial statements are not general-purpose financial statements.[87] In addition, financing institutions like banks usually have access to further financial and other information of their clients which may extend far beyond the horizon of the financial statements which, for instance in Germany and France, contain tax-driven accounting figures, whereas in England accounting for privately held companies is relatively unregulated.

The staff draft includes illustrative financial statements and these statements are consolidated financial statements, which usually means a large company in the definition of the 4th EU Directive, and would require a consolidation according to the 7th EU Directive.

The discussion papers and the presented preliminary staff draft has led to confusion regarding the usefulness of standards for SMEs. According to the IASB, it would make more sense in Europe to have a set of accounting standards for SMEs based on IFRS rather than 28 different sets[88]. According to the German "Bundesverband der Deutschen Industrie" (BDI), the head organisation of German industry, IFRS for SMEs are of little use.[89]

Besides this ongoing discussion, the technical problem of transition from local GAAP to IFRS remains unsolved. The financial markets are generally progressive in inventing new financing instruments for unlisted companies. It is possible to access the market without any listing of equity instruments. One example is the Deutsche Bank Schuldschein[90], which is mainly designed for financing requirements for medium-sized companies. The instrument offers long-term financing, is refinanced in the market but does not require any formal listing. A rating of the financial statements has to be done but there is no requirement for financial statements using IFRS.

It is probable that further instruments will follow, especially in the situation where the capital markets are looking for investment opportunities and the non-listed companies in Europe offer such opportunities. In this situation it might be helpful to be able to present financial statements in accordance with IFRS as a means of communicating the financial and economic strength of a company to attract possible investors or facilitate rating procedures.

---

86 For SEC listed SME see: Green,J.W., "Section 404 for Small Caps", in JoA March 2006, pp. 67ff.
87 IASB, Staff Draft: "International Financial Reporting Standard for Small and Medium-Sized Entities", London 2006.
88 IASB, SME Discussion Paper, p.8.
89 Bräunig,K., "IFRS für den Mittelstand?", in Die Wirtschaftsprüfung, No. 3 2007, pp.114ff.
90 Deutsche Bank AG, "db-Schuldschein:Finanzierung für den Mittelstand", Frankfurt.

Besides any legal requirements there might be economical requirements to prepare IFRS financial statements. In the context already discussed this would mean preparing two sets of financial statements: one set according to local GAAP for tax assessment or calculation of distributable profits, one set for investor-related purposes. This is not new within the reporting requirements of the European Union and especially in the countries with Roman-law-based accounting tradition, because in these countries a separation is made between accounting and reporting for financial statements of a single company and consolidated financial statements of a group. The group accounts are free from tax influences and, for instance in Germany, consolidated accounts may be set up according to IFRS instead of lokal Handelsgesetz (local commercial law) and GAAP rules, so one set of consolidated financial reports is possible for all group accounts regardless of any stock exchange listing. This relief from an additional financial report for the group accounts still requires each individual company to set up its individual financial report according to local GAAP, so there is a double reporting requirement for all member companies of a consolidated group.

In this context, cost effectiveness is a major task of any approach which might allow the preparation and follow-up of two sets of financial statements with two different legal and historical backgrounds for the group of small and medium-sized companies.

2. Hierarchy of IFRS Statements

Generally, all IFRS statements have to be implemented and are relevant in order to comply with the core set of IFRS financial statements. But not all IFRS statements are equally important for the group of small and medium-sized companies. The IASB project for SMEs and the first preliminary draft indicates that different parts of the IFRS standards are more important than others. The relevance of IFRS statements for small and medium-sized companies could be ranked into different levels, depending on the information required. For instance, a cash flow statement or a separation between long-term and short-term balance sheet sections could be seen as a simple mathematical or technical accounting procedure. The regrouping of balance sheet sections from local GAAP balance sheet formats to IFRS prescribed formats is a basic mechanical or technical approach which could be solved by using, for example, accounting software, which is able to perform this process.

The degree of difficulty in defining new elements of financial statements formerly not accountable under local GAAP and applying new measurement criteria is much higher. Accounting software always requires information to be input and is then able to group this

information under different predescribed formats like IFRS or local GAAP, but software does not make decisions in finding new financial elements or new measurement methods.

IFRS statements containing information requirements which need a decision process to receive correct accounting information will be named Level I statements. These Level I statements will be the focus of further investigations and the necessary decision process will be structured to be implemented in standard audit procedure routines. In addition, IFRS statements containing routine recognition and measurement accounting regulations which are typical for each type of business regardless of its size or legal form are included in Level I type statements. Examples are recognition and measurement procedures for fixed assets, inventories and provisions. Technical, mathematical or mere information sampling requirements for small and medium-sized companies will be named Level II statements.

All other statements will not be reviewed. It is possible that one IFRS statement contains both Level I and Level II requirements and additional information not relevant for the group of small and medium-sized companies. In this case, the part of the statement belonging to Level I will be analysed. The presentation of discontinued operations, which is generally a Level II statement, is one example of this type of IAS statement.

Recognition and measurement criteria and accounting decision processes of Level I statements form the basis of each individual financial statement. If this initial part of a transition process is not well organised and fact-finding procedures are not installed according to IFRS, integrated into routine bookkeeping functions and agreed to local GAAP accounts on a regular monthly or quarterly basis, the probability of accounting failures and errors will increase to a high level and costs of keeping different sets of accounting data will rise.

2.1. Level I IAS Statements

The following IFRS statements are treated as Level I statements:

IAS 2 – Inventories

This standard applies to all assets held for sale, in the process of production or in the form of materials or supplies to be consumed in the production process. These categories are typical for each type of producing or trading company. IAS 2 covers general measurement procedures and defines categories of costs which may be included in the valuation of inventories.

IAS 11 – Construction Contracts

Construction contracts are part of the inventories section in the balance sheet and IAS 2 and 11 should be viewed as a component of inventory recognition and measurement. IAS 11 also applies to service contracts as well as to long-term contracts.

IAS 12 – Income Taxes

The concept of current and deferred taxes is a main feature of IFRS and Anglo-Saxon accounting which is different from Continental European Roman Law based accounting and usually involves the recognition of deferred tax assets and liabilities and the introduction of new methods of tax measurement.

IAS 16 – Property, Plant and Equipment

Nearly all companies are affected by this statement. Usually, historical cost accounting principles are used for measurement purposes in IAS 16 and traditional accounting systems, but IAS 16 also offers a revaluation model as an alternative treatment in connection with impairment tests, which is also possible under the 4th EU Directive but was rarely enacted within Europe. The possibilities of revaluation in France, The Netherlands or Poland differ in detail and are based on several distinct assumptions which could not be compared to the revaluation method under IAS 16.

IAS 17 – Leases

Agreements to lease equipment are a type of investment in fixed assets and the structure and terms of the lease agreement decide if the asset and the liability shall be recognised in the financial statements. The definitions of IAS 17 require accounting decisions which differ to a greate or lesser degree to existing procedures within the European Union.

IAS 18 – Revenues

The problems of revenue recognition according to IFRS are more complicated in comparison to 4th EU Directive regulations. The 4th EU Directive is based on historical cost accounting and usually a transaction or sale is required to generate revenues. The role of fair value accounting may lead to revenues as a result of revaluation procedures requiring no transaction with a third party according to the

IFRS concept. Extended possibilities of revenue recognition are possible and may influence the presentation of a company's financial position.

IAS 36 - Impairment of Assets

In the event of revaluation, an impairment test is required if certain circumstances indicate an impairment of assets, that means a lower value. In the event of missing market values, fair value accounting has to be applied, allowing a range of possible figures depending on the detailed method. IFRS do not offer a certain method and do not include a statement of how to calculate fair values in a certain situation and therefore, no general procedures exist. But it is necessary to analyse different approaches of fair value measurements during a transition process to evaluate the possible effects which may be important for the balance sheet and performance figures of an entity.

IAS 37 – Provisions, Contingent Liabilities and Contingent Assets

The problems arising from IAS 37 relate to the different role of the prudence principle in IFRS in comparison to the 4th EU Directive. The prudence principle is more dominant in traditional European accounting which offers more types of provisions and because risk evaluation drives the calculation of provisions more than business chances, the amounts of individual provisions according to 4th EU Directive are generally higher than according to IFRS.

IAS 38 – Intangible Assets

In the balance sheet format of the 4th EU Directive intangibles are a part of fixed assets. Because recognition of an intangible asset always requires an acquisition transaction and depreciation rates are relatively high, intangibles are of minor importance. This is quite different in IFRS. The possibility to recognise intangible assets also includes internally generated intangibles. Accounting theory regarding intangible assets has evolved during the last two decades and the results are reflected in IAS 38. When the 4th EU Directive was enacted during the 1980s, intangible assets did not have the same importance as today. The introduction of IAS 38 will usually require each company to apply new accounting and valuation methods.

IAS 40 – Investment Property

Investment property is part of the fixed asset balance sheet section according to the

4th EU Directive. The format does not distinguish between fixed assets used in the production process or held for investment purposes. IAS 40 requires different recognition and measurement criteria in the case of property held as an investment. Generally, all fixed assets must be analysed to identify a proper classification which affords a new decision model.

2.2. Level II IAS Statements

IFRS 1 – First-Time Adoption of International Financial Reporting

This statement contains procedures and regulations for the first IFRS financial statements of a company, for instance the presentation of transition figures and processes in the opening balance sheet. The first-time adoption of IFRS requires special procedures which are different to ongoing accounting procedures.

IFRS 2 – Share-Based Payment

The payment of services using shares is a practice mainly used by large listed companies and not a common form of payment for small and medium-sized companies.

IFRS 5 – Non-Current Assets Held for Sale and Discontinued Operations

Discontinued operations are presented separately. IFRS covers a special situation not in the ordinary course of the business. IFRS 5 affects long-lived assets and will be discussed in connection with property, plant and equipment. Although it is not a Level I statement, classification procedures should be introduced during the transition process.

IFRS 7 – Financial Instruments: Disclosures

Small and medium-sized companies do not usually operate with financial instruments.

IAS 1 – Presentation of Financial Statements

The presentation according to IAS 1 is a question of correct classification in the balance sheet and profit and loss schemes and mainly a technical process.

IAS 7 – Cash Flow Statements

The classification and presentation of cash flow statements require the balance sheet and profit and loss figures already prepared under IFRS rules.

IAS 8 – Accounting Policies, Changes in Accounting Estimates and Errors

IAS 8 covers three different parts. Accounting policies define the reporting requirements for the basic accounting principles applied and contains regulations regarding consistency and changes in accounting policies. Estimates describe the measurement procedures in the event of uncertainties, the effect of changes in estimates and disclosure requirements. Errors include reporting requirements and adjustment procedures in the event of accounting errors. Generally, IAS 8 mainly describes technical procedures and reporting requirements in special situations.

IAS 19 – Employee Benefits

Employee benefits according to IAS 19 are treated differently to Continental European practices. IAS focus on the Anglo-Saxon and especially on the US GAAP approach. Although the treatment is quite different and the mathematical calculation complicated, companies offering employee benefits do not usually calculate the balance sheet or profit and loss figures themselves; they use the services of special agencies and special mathematical software which can usually supply local GAAP figures as well as IFRS figures.

IAS 20 – Accounting for Government Grants and Disclosure of Government Assistance

Special accounting treatment, technical bookkeeping and reporting requirements.

IAS 21 – The Effect of Changes of Foreign Exchange Rates

Currency translation is a technical process for calculating differences.

IAS 23 – Borrowing Costs

Technical accounting treatment of borrowing costs, which are usually expensed but alternative treatment is possible.

Additional IFRS statements apply only to listed companies, special industries or consolidated statements and will not be regarded further.

These statements include:

IFRS 3 – Business Combinations

IFRS 6 – Exploration for and Evaluation of Mineral Resources

IAS 14 – Segment Reporting

IAS 24 – Related Party Disclosures

IAS 26 – Accounting and Reporting by Retirement Benefit Plans
IAS 27 – Consolidated and Separate Financial Statements
IAS 28 – Investments in Associates
IAS 29 – Financial Reporting in Hyperinflationary Economies
IAS 31 – Interests in Joint Ventures
IAS 32 – Financial Instruments: Presentation
IAS 33 – Earnings per Share
IAS 34 – Interim Financial Reporting
IAS 39 – Financial Instruments: Recognition and Measurement
IAS 41 – Agriculture

Part III

The Audit Process – Theory and Practice Developments

1. The Auditing Profession and Structure of the Audit Process

1.1. Developments within the European Union

Although the IFRS approach for SMEs avoids any definition of what a small or medium-sized company might be in terms of sales or balance sheet figures and the first draft for IFRS statements for SMEs only states that it is not designed for companies with less than 50 employees, a more precise definition of this group of companies exists within the European Union since the introduction of the 4th EU Directive. The 4th EU Directive also introduced a segregation of reporting requirements in relation to the size and type of companies.

According to the 4th EU Directive, the definition of a medium-sized company is as follows:

- Total balance sheet more than €4,015,000;
- Sales more than €8,030,000;
- More than 50 employees during the year.

A company must meet 2 of the 3 criteria for at least two consecutive years to be treated as a medium-sized company. Companies not meeting the criteria are small companies.
The line between medium-sized and large companies is defined by the following criteria:

- Total balance sheet more than €16,016,000;
- Sales more than €32,120,000;
- More than 250 employees during the year.

All companies who meet the criteria of a medium-sized company are subject to a statutory full audit of their financial statements including a publication of the audited financial statements and the audit opinion[91].

The requirements are independent of any stock exchange listing. The present obligation to prepare financial statements according to IFRS only affects listed companies. Therefore, the legal obligation to undergo an audit concerns far more companies within the European Union. Because this obligation is part of the 4th EU Directive, a large number of medium-sized companies in Europe are subject to a financial statement audit which also means that this group of companies is accustomed to audit procedures which usually also include regular inquiries and examinations of new accounting standards.

The regulation concerning an audit of financial statements is subject to the 8th EU Directive which was amended in April 2006 by the Council of the European Union and confirmed by the European Parliament in May 2006. The amendment of the 8th EU Directive, which was initially approved in 1984 in connection with the 4th and 7th EU Directive, was necessary to update the 8th EU Directive and introduce additional EU rules on the auditing of company accounts, aimed at reinforcing the reliability of company financial statements by establishing minimum requirements for statutory auditing of annual accounts and consolidated accounts. The new 8th EU Directive reflects international developments in connection with the Sarbanes-Oxley Act, which specifies the duties of statutory auditors, their independence and ethics, introducing requirements for external quality assurance, in particular with a view to ensuring a better public oversight over the auditing profession and improving cooperation between oversight bodies.

The new measures are intended to help improve quality audits within the EU and hence underpin confidence in the functioning of EU capital markets. They will also provide a basis for cooperation with oversight bodies of third countries to take account of globally interconnected capital markets[92].

The 8th EU Directive's main provisions are as follows:

1. Since 1984, audit firms have grown in size and importance and the auditing of listed companies is dominated mainly by large international audit firms. The directive defines statutory auditor and audit firms separately in order to provide

[91] Auditing Practices Board: “The audit of small businesses”, London 1996.
[92] Lopez Combarros,J.L., “Accounting and financial audit harmonization in the European Union”, in European Accounting Review, London 2000, pp. 643ff.

more clarity in the scope of legislation. A considerable number of the new provisions deal specifically with audit firms.

2. Public interest entities: the Directive requires the audit firms that carry out statutory audits of public-interest entities to provide a detailed public report that gives an insight into the audit firm and the network to which it belongs. The report must include the date of the last quality assurance review, policies on continuing education requirements and a break-down of fees charged by the audit firm. Public interest entities may be listed or unlisted companies. The Directive contains a definition which relates to transferable securities traded on a regulated market, credit institutions and insurance companies, but member states are free to designate other entities as public-interest entities.
3. In order to strengthen the monitoring of the financial reporting process and the statutory audit and to prevent any possible undue influence of the executive management on the financial reporting of the audited entity, an independent audit committee is required for each public-interest company.
4. Registration of each statutory auditor and audit firm is necessary in an electronic public register with updated information. For audit firms, the register must show the size of the audit firm by indicating the number of all statutory auditors employed by or associated as partners or otherwise with the audit firm. The register must contain information on the owners and members of the management of the audit firm, and must comprise information on the membership of a network.
5. Independence is a main objective of the 8th Directive. The general principle is that a statutory auditor or an audit firm must be independent from the audited entity and in no way be involved in decision-taking of the audited entity.
6. The Directive introduces a requirement for all statutory auditors and audit firms to be subject to a system of quality assurance, organised in a manner that remains independent from the reviewed statutory auditors and audit firms and subject to public oversight. Furthermore, statutory audits must be carried out in accordance with international standards on auditing.
7. Investigations and sanctions are part of an effective systems of investigation and sanctions, which may be civil, administrative or criminal. The member states must provide for appropriate disclosure to the public.
8. A Public Oversight Board is introduced ensuring that oversight has sufficient public integrity and independence.
9. Appointment, dismissal and communication procedures for appointment of the

statutory auditor or audit firm to ensure that the statutory auditor or audit firm is independent from those that prepare the financial statements of the audited entity. The Directive introduces a principle whereby the statutory auditor or audit firm can only be dismissed if there is a significant reason why the statutory auditor cannot finalise the audit. The reasons for dismissal and resignation must be disclosed to the responsible oversight authorities.

10. Member states must designate competent authorities responsible for approval, registration, quality assurance, inspection and discipline for the purposes stipulated by the Directive and must cooperate with each other. They must be organised such as to prevent conflicts of interest. An obligation of professional secrecy applies to all persons who work or have worked for competent authorities.
11. Auditors and/or audit firms from third countries that issue audit reports in relation to securities traded in the EU must be registered in the EU and be subject to member state systems of oversight, quality assurance and investigations and sanctions. Only auditors or audit firms that meet quality criteria equivalent to the directive can be registered. The Directive allows for exemption from registration, oversight, quality assurance and investigations and sanctions only if audit firms from third countries are subject to equivalent systems of registration and oversight.
12. The Directive introduces changes to current EU legislation by requiring audited companies to disclose total fees paid to the statutory auditor or audit firm, broken down by fees for audit services, other assurance services, tax services and other non-audit services.

According to the 8th EU Directive, the audit environment is regulated on a common basis within the European Union and the Directive is comparable to the Sarbanes-Oxley Act and US regulations, although there are different approaches in detail. The Directive does not prescribe the audit process itself, it does not contain a standard audit process or distinguish between listed or unlisted companies in type of required procedures. This is part of the professional judgement of any statutory auditor[93].

Audit theory in the last two decades has evolved a number of audit strategies and methods to test controls and systems during an audit and standard procedures exist for different types of audits, industries and risk environments. These standard procedures will be used

[93] Fédération des Experts Comptables Europeéns, “Statutory Audit in Europe”, Brussels 1998.

to set up and integrate the local GAAP/IAS transition and follow-up process for IFRS statements for small and medium-sized companies. In order to develop a strategy, a standard audit procedure for the type of companies has to be defined.

2. Standard Audit Process – Theory and Concepts

2.1. Management Assertions, Audit Objectives and Auditing Procedures

The financial statements could be viewed as an assembly of assertions by management. For group financial statements, SAS No. 80 (Section 326) outlines the following broad categories:

- Existence and occurrence
- Completeness
- Rights and obligations
- Valuation or allocation
- Presentation and disclosures

Assertions about existence and occurrence relate to physical items such as inventory, plant and equipment or cash, as well as non-physical items such as accounts receivable and accounts payable. Occurrence is concerned with whether all transactions, such as purchases and sales, represent economic events that actually occurred[94].

Completeness states that all financial statement items are in fact included in the financial statements and that all transactions and economic events that occurred during a specific period have been recorded[95].

Rights and obligations relate to whether assets are the rights and liabilities the obligations of an entity at a given date.

Valuation and allocation pertain to whether financial statement items are valued in conformity with generally accepted accounting principles.

Presentation and disclosure relate to the proper classification, description and disclosure of all financial statement items.

---

[94] Flint,D., "The Philosophy and Principles of Auditing", Macmillan Education, 1988, pp.104ff.

[95] Whittington,R., Zulinski,M., Ledwith,J.W., "Completeness – The Elusive Assertion", in JoA August 1983, pp. 89ff.

SAS No. 31 includes two additional assertions which are of general interest:

- Accuracy
- Cut-off

Accuracy relates to the mathematical correctness of recorded transactions included in financial statements and cut-off relates to the recording of transactions in the proper reporting period.

These seven broad categories of management assertions could be used to formulate audit objectives and develop audit procedures for a useful transition process.

The following table gives an example of this process using the Level I IFRS statements:

Management Assertion	Example of Audit Objectives	Example of Audit Procedures
Existence or occurrence	Construction contract recorded in inventory physically exists according to IAS 11	Review client confirmation of recorded work in progress
Completeness	All lease contracts are classified according to IAS 17	Review all lease contracts
Accuracy	Provisions are calculated according to IAS 37	Review calculation method
Cut-off	IAS 18 'Revenue Recognition' has been followed	Review all revenues resulting from revaluation of assets or liabilities
Rights and obligations	All recorded intangibles are controlled by the entity according to IAS 38	Review all contracts
Valuation or allocation	Deferred tax assets are valued according to IAS 12	Review calculation of tax assets and applied tax rate
Presentation and disclosure	Property is classified separately according to IAS 40	Review list of all recorded property classifications

Table 8

In audit theory, audit procedures are directly linked to management assertions about the financial statements. Audit procedures are the operational basis to ensure that the financial statements as a whole are in accordance with generally accepted accounting standards.[96]

The design of a transition process from local GAAP to IFRS can make use of the relationship between audit procedures and management assertions. The IAS statements themselves could be seen as audit objectives and represent the starting point for the whole process. Audit procedures applied relate to the detailed regulations included in the IAS statements. Under this concept, each IAS statement will be viewed as a decision tree and each branch is related to detailed audit procedures. A systematic decision process will automatically lead to the detailed procedures and the application of these procedures will ensure financial statements in accordance with IFRS.

The main difference between the audit approach and the transition approach is that the transition is not an audit of financial statements but a set up of IFRS statements themselves. This would impair the principle of independence in an audit engagement and is generally not legal under the 8th EU Directive regarding an audit of financial statements. Because independence is not required under a transition engagement, which is not an audit engagement, management assertions are not replaced but relocated and represent the end of the transition process instead of the beginning.

The concept of developing a decision tree forms a basis for possible further development, e.g. the construction of software programmes. Software developers may use the decision tree structure as a model pattern.

2.2. Audit Evidence and Audit Tests

Audit tests in the sense of audit procedures must be designed to be able to verify whether management assertions are correct or incorrect[97]. They are a means to gain evidence about the quality of the information contained in financial statements and form the basis for an audit opinion[98]. Auditors use various methods or procedures, for example inquiry, observation, inspection and counting of assets, confirmation, examination of documents

[96] Trombetta,M., "International regulation of audit quality: full harmonization or mutual recognition", in European Accounting Review, London 2003 pp. 3ff.
[97] Hadnot,B.L., "Audit Evidence – What Kind and How Much?", in CPA Journal, October 1979, pp. 23ff.
[98] Moeckel,C.L., Plumlee,R.D., "Auditors Confidence in Recognition of Audit Evidence", in Accounting Review October 1989, pp. 653ff.

and records, reperformance and analytical procedures to reach a conclusion[99]. In any case, competent and sufficient evidential accounting material is necessary to be able to make a decision. Various detailed tests and methods have been developed in auditing accounts under different situations.[100] Usually more than one source or method is available. These methods and audit tests could be applied in the transition approach.

Because the concept of IFRS is most comparable to US GAAP, standard audit procedures of the AICPA seem to be the most appropriate way in order to set up accounts according to IFRS statements. These detailed procedures are usually applied by the large international audit companies, which are regularly based in the USA or legally bound to audit procedures according to US standards because of SEC regulations. The procedures themselves are well known in the accounting and auditing profession. The Miller Audit Guide 2006[101] summarises all relevant audit procedures and will be used as a general model in developing transition procedures. This ensures that the procedures selected are in line with applied international standards and this approach offers an opportunity to integrate the transition process into well-known working procedures within the accounting department of a company as well as in the service procedures of auditing companies.

The main problems may arise in situations where IFRS themselves do not contain sufficient regulations and therefore a regulation gap occurs. In this situation, a decision has to be made about the accounting principle or mathematical method applied. Procedures are not able to fill regulation gaps, nor can they make a decision, but it is possible to list the variety of solutions and different approaches.

The fair value accounting concept and the lack of detailed regulations as to which calculation method should be applied is one example of a regulation gap. Evidence is not possible in these circumstances and a method which is reasonable under the given situation has to be adopted. This means that the connection between a set of audit procedures to a given IAS statement may be very close in situations where a clear accounting regulation exists, and therefore procedures and the decision process lead to a predetermined accounting solution and, on the other hand, may be more general in cases of a regulation gap. The accounting solutions applied in the situation of a regulation gap may differ from country to country depending on the accounting traditions as long as the

[99] Marchant,G., “Analogical Reasoning and Hypothesis Generation in Auditing”, in Accounting Review, July 1989, pp. 500ff.
[100] Lindow,P.E., Race,J.D., “Beyond Traditional Audit Techniques”, in JoA July 2002, pp. 28ff.
[101] Georgiades,G., “Miller Audit Procedures 2006”,Chicago 2005.

method applied does not conflict with the general concept of IFRS.
The transition approach does not automatically lead to similar financial statements within the European Union insofar as regulation gaps are compensated for using national accounting treatments which may be different according to national traditions. The transition process itself cannot offset any deficiencies of IFRS statements or general concepts.

2.3. Evaluation of Audit Risk

The term audit risk describes the risk that the auditor will issue an inappropriate opinion. It comprises of two major components: the risk that the financial statements will contain misstatements that are material and the risk that the auditor will not detect the misstatements through the performance of a detailed audit procedure[102].

In audit theory, many attempts have been made to develop a mathematical approach to assess risk, but in general there is no need for mathematical risk models because risk evaluation is a matter of professional judgement.[103] If a risk is seen as high, audit testing is done in more detail; if a risk is evaluated as being medium or low, detailed testing is reduced or limited to analytical procedures. Therefore, the design of audit procedures is directly related to risk evaluation.

Regarding the transition process, the general concept of audit risk evaluation is also useful in defining the type of procedures which will address certain risk situations and risk environments. Risk evaluation also helps to describe the volume of procedures. In addition, risk evaluation during an audit can be used in similar risk environments of a transition process. For example, if plant and equipment is valued at historical cost and depreciated over the useful life and if this method is also applied according to IAS 16 'Property, Plant and Equipment', the risk evaluation and procedures during an audit may also be applied for the transition process. Additional procedures may be necessary to separate investment properties according to IAS 40, if any.

In audit theory, different types of risks have been developed: inherent risk, control risk, detection risk, sampling and non-sampling risk.[104] Apart from inherent risk, all other risks

[102] Pomeranz, F., “The successful audit”, Homewood 1992.
[103] Yardley,J., “Explaining the Conditional Nature of the Audit Risk Model”, in Journal of Accounting, Vol. 7 1989, pp. 107ff.
[104] Hellier,C., Lyon,R., Monroe,G.S., Ng,J., Woodliffe,D.R., “UK Auditors’ Perceptions of Inherent Risk”, in British Accounting Review, March 1996, pp. 45ff.

relate to audit methods and sampling procedures which are not useful for a transition process because sampling methods will generally not be used. Sampling is an approach to gain evidence by application of statistical methods to verify the correctness of the underlying data, but in a transition process general accounting methods have to be developed in the event of a regulation gap and this evaluation and decision process for a specific method is not a question of sampling.

Inherent risk is quite a different type of risk. Inherent risk relates to characteristics of an account balance or transaction, which may also be influenced by the entity's business environment.[105] Changes in general business conditions, new governmental regulations and declining industries are effects which are out of management control. These effects may lead to valuation adjustments for existing assets or they may create new recording requirements, for instance incurrence of liabilities. The idea of inherent risks is also useful for IFRS. For example, if the European Commission decides to deregulate the market for airlines and introduces licensing procedures, this may lead to new accounting items in the form of intangible assets which are accountable according to IFRS, but not according to local GAAP. Another example are environmental obligations which may lead to increased responsibilities for companies.

Because IFRS widens the opportunities to account for additional assets, especially intangible assets, and introduces fair value accounting methods connected to market developments, the inherent risk of IFRS itself is higher in comparison to historical-cost-based accounting systems and especially the provisions of the 4th EU Directive.

Components and methods of group accounting according to the 7th EU Directive, for instance the analysis of a purchase price and recognition of additional assets, are transmitted to a single-entity financial statement. In general, specific IFRS methods, for example fair value accounting, or specific statements, for example IAS 38 'Intangible Assets', could be viewed as bearing a higher inherent risk than other statements or methods. Consequently, a general risk evaluation is necessary in determining the type of procedures during a transition process. If a generally higher inherent risk is stated, the type of procedures will be more detailed.

[105] AICPA Control Risk Audit Guide Task Force, “Audit Guide: Consideration of the Internal Control Structure in a Financial Statement Audit”, AICPA, New York 1990.

2.4. Materiality

Materiality is a matter of practical necessity and avoids complicating audit procedures by reducing efforts and procedures for immaterial items. Materiality judgements help to streamline the audit process and avoid uneconomical accounting and auditing procedures[106]. The question of cost effectiveness is also relevant for the transition process to IFRS for SMEs. A highly complicated and time-consuming process will reduce the willingness of companies to shift to IFRS and therefore the materiality concept is also suitable for the transition process.

Materiality is defined in SEC regulation S-X (Rule 1-02) as follows:

> "The term material, when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters about which an average prudent investor ought reasonably to be informed."

Materiality judgement in an audit usually takes place during planning of the audit. It requires a preliminary judgement about materiality levels which relate to significant captions in the balance sheet, income statements and statements of cash flow and the financial statements taken as a whole. The auditor's attention is focused on the more significant financial statement items.[107]

In a transition process, the materiality concept is also applicable. For example, if IAS 38 'Intangible assets' has an overall higher inherent risk, the application of standard procedures to identify and record immaterial items in the balance sheet according to IFRS for the first time may be reduced to a moderate level with basic mathematical methods in cases where this balance sheet caption is not material for the financial statements as a whole. If a trading company with a total balance sheet sum of $1,000,000,000 has "know-how" which is accountable and will result in a balance sheet item of about $500,000 for intangible assets, it makes no sense to develop mathematical approaches and test methods which allow the revaluation of the "know-how" anytime with exact results that may lead to valuation fluctuations in the range from $400,000 to $600,000 during the reporting period.

[106] Leslie,D.A., "Materiality, the Concept and its Application to Auditing", Canadian Institute of Chartered Accountants, Toronto 1985.
[107] Pany,K., Wheeler, S., "A Comparison of Various Materiality Rules of Thumb", in The CPA Journal, June 1989, pp. 62ff.

The question of effectiveness may indicate that the additional cost of follow-up work and calculation procedures is not relevant regarding materiality of the balance sheet caption and a basic approach is used keeping the balance sheet amount unchanged during the year.

This may be quite different in other situations, for example a software company where more than 50% of the total balance sheet is represented by intangible items.

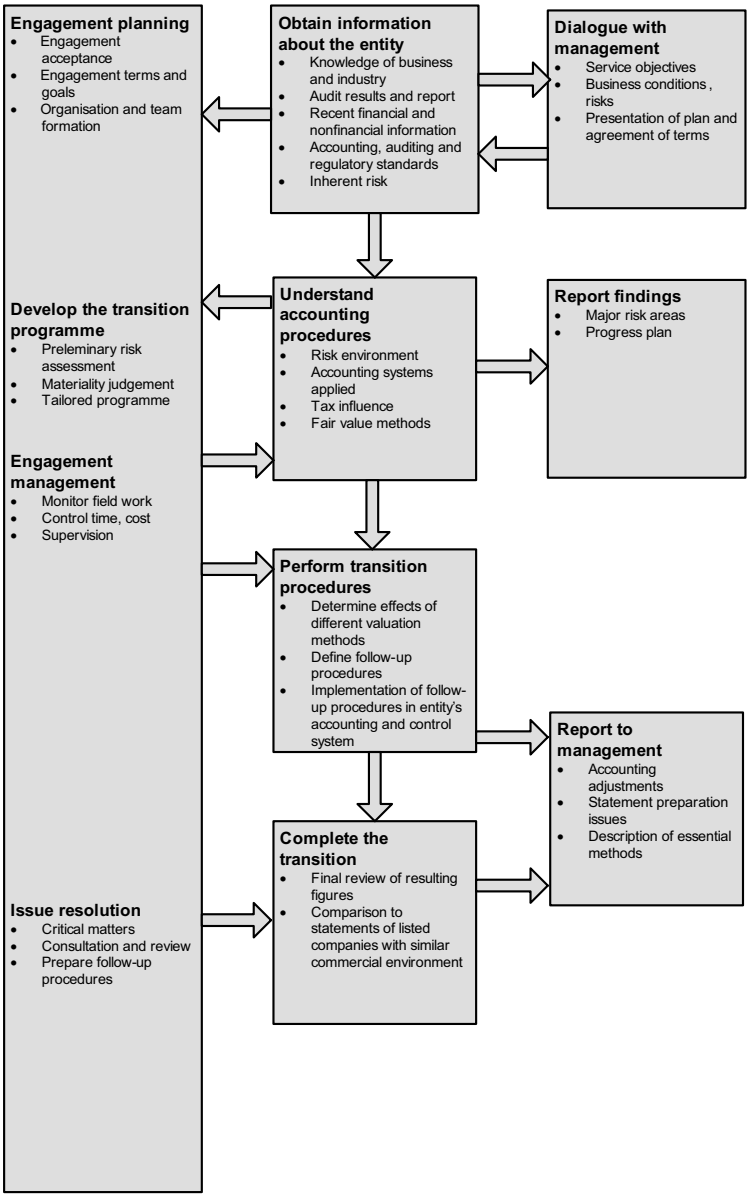
As we have previously discussed, IFRS statements contain types of regulation gaps which have to be filled by accounting methods. IAS 8 describes the procedure of finding accounting methods which should be in line with IFRS which is a relatively low hurdle. Regarding fair value accounting, IFRS do not contain detailed methods and therefore a wide range of alternative methods may be applied. The type of method applied defines the resulting value and the following adjustments and the methods may be more basic or not in terms of necessary underlying information for the mathematical calculation.

The materiality concept offers the opportunity to decide if more or less complicated methods are useful. Because the fair value concept is a general concept of IFRS, any transition process has to address the problems of IAS 36 'Impairment of Assets' regardless of the fact that several methods are allowed. The general idea is to offer a range of calculation methods in relation to materiality and suggest a specific cash flow calculation procedure depending on materiality judgement. As a consequence, the accounting decision process of Level I IAS statements will be accompanied by fair value methods where applicable, affording a materiality judgement.

The following table No. 9 summarises the activities of the transition process including organisation and planning decisions which are comparable to an audit process.[108]

[108] Dutta,S.K., Graham,L.E., “Considering Multiple Materialities for Account Combinations in Audit Planning and Evaluation: A Cost Efficient Approach”, in Journal of Accounting, Auditing and Finance Vol. 13 No. 2 Spring 1989, pp. 151ff.

Summary of Transition Process



Part IV

Standard Audit Procedures and Structure of IFRS Level I Statements

1. Introduction - Detailed Relevant IAS Statements Ist Level – Decision Structure

Management assurances are the basis for developing audit objectives and audit test methods. In order to make an audit operational, a break up of general audit objectives into detailed audit objectives for specific accounts is necessary. Specific accounts and typical workflow procedures are classified into different audit sections, audit objectives related to the audit sections are defined and tests for accounts and procedures are assigned. Audit sections divide and regroup balance sheet and profit and loss account captions into economically linked audit sections. Over time, audit theory and practice has evolved standard audit sections with standardised audit objectives and procedures.[109] The classifications are sometimes different in their detail, for example intangibles may be part of the property, plant and equipment audit section or the prepayments audit section, but this is mainly a shift in headings, the audit objectives and audit test are practically the same.

To classify the IFRS Level I statements according to standard audit sections, the Miller Audit Procedures 2006 classification will be used. They include the latest audit pronouncements through SAS-101 (Auditing Fair Value Measurements and Disclosures) and cover the latest standards of the Public Company Accounting Oversight Board (PCAOB). Although PCAOB is mainly concerned with listed companies, standards and procedures should be applied when reasonable, ensuring a high-quality transition process.

The main audit sections are as follows:

- Cash and Cash Equivalents
- Investments in Securities, Derivative Instruments and Hedging Activities
- Accounts Receivable and Sales
- Inventory and Cost of Sales
- Property, Plant and Equipment
- Prepaid Expenses, Deferred Charges, Intangibles and Other Assets
- Accounts Payable and Purchases

[109] Quadackers,L.M., “Audit Risk and Audit Programmes: Archival Evidence from Four Dutch Audit Firms”, in The European Accounting Review 1996, pp. 217ff.

- Payroll and Other Liabilities
- Income Taxes
- Debt Obligations
- Equity
- Revenue and Expenses

The following table shows a preliminary assignment of IFRS Level I statements to the different audit sections:

Audit Sections	IFRS Statements
Inventory and Cost of Sales	IAS 2 Inventories; IAS 11 Construction Contracts
Property, Plant and Equipment	IAS 16, Property, Plant and Equipment; IAS 17 Leases; IAS 40 Investment Property; IAS 36 Impairment of Assets (IFRS 5: Discontinued Operations, Non-Current Assets held for Sale)
Prepaid Expenses, Deferred Charges, Intangibles and Other Assets	IAS 38 Intangibles
Payroll and Other Liabilities	IAS 37 Provisions, Contingent Liabilities and Contingent Assets
Income Taxes	IAS 12 Income Taxes
Revenue and Expenses	IAS 18 Revenue

Table 10

Audit sections and IFRS statements are not consistent under all aspects and may overlap in some details, but the main content of IFRS statements agrees with that of the audit sections.

A detailed analysis of IFRS statements should be done according to the structure of standard audit sections to verify standard audit procedures which meet accounting requirements and adjustments of a transition process. In this sense, IFRS statements will be structured like a decision model in the form of an audit workflow and as a result it will be possible to assign procedures to all relevant steps of an audit workflow decision process. This alignment of the IFRS transition process to audit sections is part of the integrated workflow process. For practical reasons and as a question of cost effectiveness, it is useful to elaborate the similarities in both processes.

Although IASB has developed an international due process for projects which includes a number of steps and addresses different users (regulatory and legal authorities, accountants and organisations) for setting up a new IFRS standard or discussing changes to existing standards, no general scheme exists which describes the structure of an IFRS statement.

The typical elements of an IFRS standard are as follows:

- Objective: Short description of the subject.
- Scope: Detailed distinguishing of transactions that are covered by the standard or not.
- Definitions: Explanation of all major accounting terms used in the statement.
- Recognition and first-time measurement: Description of recognition criteria and valuation methods for initial recording.
- Measurement after recognition: Description of valuation methods for following accounting periods.
- Notes: List of additional disclosure requirements.
- Transitional provisions: Procedures for implementation.
- Effective date: First year of application.

The elements are sometimes spread over the statement itself, including in the appendix or in the basis for conclusion, which makes it difficult to find out the accounting treatment for a given transaction.
Taking IFRS as a whole, the missing structure in detail leads to a confusing picture in aggregate. From the standpoint of an operational process, it is not quite clear how such a process should begin and what the relevant procedures are.

The approach for comparing IFRS accounting requirements with the content of audit sections aims to get a structure which allows the application of standardised procedures and materiality considerations in connection with audit test methods and determine the detailed steps as part of a logical workflow.

2. Inventories and Cost of Sales Section

2.1. General

Manufacturers, retailers, wholesalers and service-based companies often maintain large amounts of inventory, which represents a significant balance sheet caption. Existence, ownership, pricing and valuation are the main objectives during an audit. The term 'Inventory' refers to items held for sale, in process of production, or to be converted or consumed in the production of goods or services.

Inventory is divided into different sections:

- Merchandise, which are goods acquired for resale and require little or no additional cost preparing them for resale.
- Raw materials, which are consumed in the process of production.
- Work in process, representing products in intermediate stages of production.
- Finished goods are the final product at the end of a production process.

Finished goods and work in process normally have material, labour, and overhead components. The range of cost components which may be included could be different, depending if full or partly cost accounting is required. The underlying cost accounting systems and the allocation of costs to different cost centres influence the valuation. Cost of sales is the corresponding profit and loss caption and includes all costs directly associated with purchasing and producing goods sold and may include losses from writing inventories down to market value.

The separation of cost components which should be included in the balance sheet or in the profit and loss account is a main problem area of any accounting system, because it influences the profit or loss in one way or another. Write-down procedures and type of fair value or net realisable value calculation methods influence the recorded profit and performance of a company.

2.2. IFRS and 4th EU Directive Regulations

Art. 9 of the 4th EU Directive separates inventories into the following captions:

D. Current assets

I. Stocks

1. Raw materials and consumables.
2. Work in progress.
3. Finished goods and goods for resale.
4. Payments on account.

According to Art. 39, current assets must be valued at purchase price or production cost. Value adjustments to a lower market value or another lower value attributable at the balance sheet date shall be made, and exceptional value adjustments are possible if the valuation of these items is not to be modified in the near future. Lower values may not be continued if the reason for which the value adjustments were made have ceased to apply. The definition of purchase price and production cost relates to Art. 35, which defines the terms for fixed assets. This means that the 4th EU Directive contains a uniform definition.

According to Art. 35, purchase price is defined as the price paid and the expenses incidental thereto. Production cost is defined as a calculation by adding to the purchasing price of the raw materials and consumables the costs directly attributable to the product in question. A reasonable portion of the costs which are only indirectly attributable to the product in question may be added into the production costs to the extent that they relate to the period of production. The Directive permits the purchase price or production cost of stocks of goods of the same category and all fungible items including investments to be calculated either on the basis of weighted average prices or by the "first in, first out" (FIFO) method, the "last in, first out" (LIFO) method, or some similar method. According to the Directive, member states are allowed to apply the inclusion of interest on capital borrowed according to Art. 35 (4) in the production costs to the extent that it relates to the period of production.

Inventories are defined by IAS 2 as items that are:

- held for sale in the ordinary course of business;
- in the process of production for such sale;
- or in the form of materials or supplies to be consumed in the production process or in the rendering of services.

But the scope of IAS 2 is different: work in progress under construction contracts including directly related service contracts are subject to IAS 11 'Construction Contracts' and the standard does not apply to financial instruments, biological assets and commodities of broker trades.

Compared to the 4th EU Directive, the scope of IAS 2 and 11 may be classified as follows:

4th EU Directive	IAS
Raw materials and consumables	IAS 2: Materials or supplies to be consumed in the production process or in the rendering of services
Work in progress	IAS 2: Assets in the process of production for sale; IAS 11 work in progress arising under construction contracts including directly related service contracts
Finished goods and goods for resale	IAS 2: Assets held for sale in the ordinary course of business

Table 11

Although the wording is different, the main difference in the scope of the regulations can be seen in the 'Work in progress' section. IAS 11 reflects the international developments of accounting for construction contracts since the 1980s. The principal concern of accounting for long-term construction contracts involves the revenue recognition. Because of the long-term nature of such contracts, deferring revenue recognition until completion would often result in large fluctuations of profits and sales figures. The “percentage of completion method” was developed to avoid this distortion by reporting revenues proportionally to the degree to which the projects are being completed. Under an earlier version of IAS 11, both the percentage of completion method and the completed-contract method were recognised as being acceptable alternative methods of accounting for long-term construction activities.

Many national GAAP recognise both methods as being appropriate, although they may not be viewed as equally acceptable under given circumstances. The United States, Canada and Japan allow both GAAP methods. The national accounting standards of the United Kingdom recognise only the percentage-of-completion method, whereas Germany for a long time supported the completed-contract method. Because the prudence principle dominates German accounting and financial statements are subject to taxation, there is a tendency to avoid profits resulting from work in progress under construction contracts and therefore avoiding taxes on profits although there is no legal possibility to collect payments.

2.3. Structure of IAS 2: Inventories

IAS 2 (8) contains a more precise description of different types of inventories. Five subgroups can be identified:

1. Goods purchased and held for resale (merchandise)
2. Finished goods
3. Work in progress
4. Materials and supplies
5. Services

For the initial measurement of inventories, four different methods are presented and compared to 4th EU Directive in the following table:

4th EU Directive	IAS 2
Purchase price	Costs of purchase + other costs
Production cost	Costs of conversion + other costs Cost of inventories of a service provider

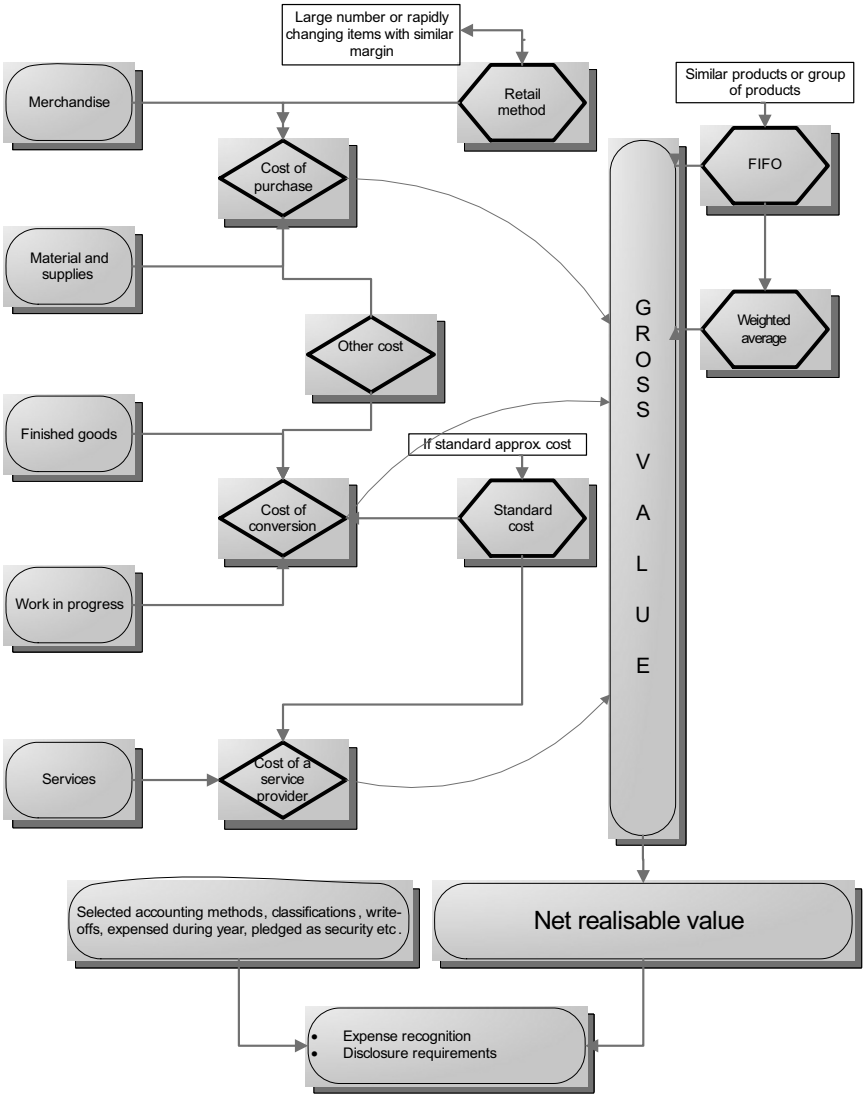
Table 12

Costs of purchase relate to merchandise and materials and supplies; costs of conversion to finished goods and work in progress; costs of inventories of a service provider relate to services. Other costs are applicable to all sections except services.

The valuation methods are generally acceptable for all subgroups of inventories where applicable. IAS 2 (21/22) offers simplification in certain circumstances. Standard cost methods may be used if the results approximate costs; the retail method is allowed in the event of large numbers of rapidly changing items with similar margins.

Specific identification of costs is necessary if goods or services are not interchangeable. The FIFO or weighted average method is possible for similar products or group of products. Net realisable value adjustments are necessary for all subgroups if applicable.
The decision structure of IAS 2 is shown in the following table No. 13:

IAS 2 - Inventories



The decision structure of IAS 2 is straightforward. Depending on the type of inventories, cost of purchase and cost of conversion, both including additional other costs, are

available to general valuation methods. Simplifications such as the retail method, standard cost method, FIFO and weighted average, are allowed. Cost of service provider requires a special rule. All amounts are subject to net realisable value evaluation. Additional disclosure requirements are listed in IAS 2.

2.4. Applying Standard Audit Procedures

2.4.1. Cost of Purchase

Testing cost of purchase is done using an 'Inventory Price Test' for purchased goods. During this test, a sample of vendor invoices for a number of individual inventory items are listed to verify price per quantity and additional costs which are then compared to the company's inventory valuation lists.

To comply with IAS 2.11, the following checklist should be included in the price test to obtain information as to whether the valuation is in line with IAS 2.

Inventory Price Test – Purchase Price IAS 2.11

For merchandise, materials and supplies and purchased finished goods, test the cost of purchase as follows (Inventory Price Test)

a. Vouch the cost to the most recent vendor's invoice and other external evidence; if the quantities on hand exceed the invoice total, vouch the excesses back to previous purchases until the quantity on hand has been built up.

b. Determine that purchase price, import duties and other taxes (other than those subsequently recoverable by the entity from the taxing authorities) are consistently accounted for.

c. Determine that transport, handling and other costs directly attributable to the purchase are included.

d. Determine that trade discounts, rebates and other similar items are deducted in determining the cost of purchase.

e. Exchange differences arising directly on the recent acquisition of inventories invoiced in a foreign currency are not permitted to be included in the cost of purchase (IAS 2, IN10)

2.4.2. Cost of Conversion

The cost of conversion method include costs directly related to the units of production. Usually, a cost accounting system exists which is tested during an audit by selecting a sample of transactions of inventory items and agreeing the cost components with underlying documentation and performing analytical procedures.

According to IAS 2.11-14, the following test programme should be applied.

Cost of Conversion - Sample Test IAS 2.11-14

1. For testing a sample of transactions representing additions to or requisitions from inventory, select from the following documents:

   a. Raw materials requisitions

   b. Labour charge reports

   c. Production records

   d. Finished goods requisitions

   e. Receiving reports

   f. Shipping documents

   g. Other

2. For the sample of items selected in Step 1 above, perform the following:

   a. Trace the documents selected through cost and inventory records.

   b. Test the accumulation of the cost records by agreeing material costs to suppliers' invoices, labour to time studies, production reports and labour tickets and overheads to appropriate supporting documentation.

3. Review the analysis of overheads charged to inventories, as follows:

a. Review the costs included in the overhead base for propriety and reasonableness and analyse fixed and variable production overheads.

a.1 Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production (depreciation, maintenance of factory buildings and equipment, cost of factory management and administration)

a.2 Variable production overheads are those indirect costs of production that vary directly with the volume of production (indirect materials, indirect labour)

b.Determine if allocation of fixed overhead costs is based on the normal capacity of production which is the production expected to be achieved on average over a number of periods.

c. Review the analysis of variance between overhead costs incurred and overhead costs applied to production and inventory. Investigate the causes of the variance to determine if a portion should be allocated to inventories or if the overhead contents are excessive.

d. In the event of joint products, the allocation of costs between the products should be on a rational and consistent basis (relative sales value, in case of immaterial by-products use net realisable value and deduct this value from the cost of the main product).

2.4.3. Other Costs

IAS 2.15-18 lists different types of additional costs which may be included or not and refers to IAS 23 for borrowing costs. From the standpoint of an audit, the different parts of other costs should be included in a checklist in order to ensure that all aspects are reviewed.

Other Costs IAS 2.15-18

1. Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition.

   Included: Non-production overheads or the costs of designing products for specific customers may be included

   Excluded: Abnormal amounts of wasted materials, labour or other production costs

   Excluded: Storage costs, unless those costs are necessary in the production process before a further production stage

   Excluded: Administrative overheads that do not contribute to bringing inventories to their present location and condition

   Excluded: Selling

   IAS 23: Borrowing costs included under limited circumstances

   Financing agreements: The purchase of inventories on deferred settlement terms including a financing element. The financing element for normal credit terms is recognised as an expense over the period of financing.

2.4.4. Standard Cost Method

Depending on the structure of the cost accounting system, overheads may be charged through several intermediate accounts before ending up in inventory. Many different kinds of cost centres are accumulated into overheads[110].

This complex structure is also used for company planning schemes and comparing actual and planned results. For reasons of comparability and planning requirements, individual

[110] Brock,H.R., "Cost Accounting: Principles and Applications", 5th ed. 1989.

items in the cost accounting system are stated with a fixed price, which is usually determined on market prices or effective labour costs of the last period.

These fixed prices represent standard costs for calculation purposes and are recorded in inventory valuation through the different stages of a cost accounting system. This may lead to an over-absorbed overhead inclusion in inventory which must be removed to prevent stating them in excess of actual costs. Volume or price variances are calculated to determine the reasons for any deviation. For standard cost methods, the sample test to verify cost of conversion includes steps which also cover standard cost methods. The review of overhead charges and the agreeing of documents to the cost records would also cover standard cost systems. Additional steps are necessary to verify if a standard cost method is suitable for IAS reporting purposes.

The following checklist applies in addition to the checklists for testing costs of conversion.

Cost of Conversion– Standard Cost Method

For the standard cost method, the following additional steps should be performed:

Inventory price test: Trace results to applied standard costs.

Reconciliation of total amount of overheads charged to inventory with total incurred costs of corresponding profit and loss accounts.

Calculation of volume and price variances.

Determine procedures in case of over- or under-absorbed overheads

2.4.5. Simplification Methods – Retail, FIFO and Weighted Average

IAS 2 allows certain simplifications regarding calculation of inventories. The retail method applies mainly to retail companies; FIFO and weighted average are mathematical calculations of inventory values[111]. FIFO matches the most recent costs of purchase against current revenues; weighted average derives the valuation as unit price and volume of each purchase. Retailing is the selling of goods to the ultimate consumer, usually in small quantities. Retailers may be classified according to whether they are store-based or direct response. Store-based retailers include department stores, supermarkets, warehouses, home centres, outlets etc. Direct response include catalogue merchants, television or Internet shopping services without face-to-face contact with their customers.

The retail method is an averaging method used with reasonably homogeneous inventory groupings[112]. For each grouping, a relationship is established between goods available for sale at cost and at retail. From this difference, a cost multiplier is derived which is used to convert the period-end inventory from retail to cost. Consistency in gross profit margins and proper treatment of mark-ups and mark-downs are necessary to get inventory stated at lower cost or market.

The allowed simplification under IAS 2 should be tested according to the inherent calculation scheme of the different methods and the general applicability of the method should be reviewed. The basic steps are listed below:

Retail Method

For the retail method, determine if products are traded regularly in large quantities.

Test accuracy of product groupings.

Recalculate cost multiplier.

Review development of gross profit margins.

Review mark-ups and mark-downs.

[111] Bohan,M.P., Rubin,S., “LIFO/FIFO: How Would It Work?”, in JoA September 1986, pp. 106ff.
[112] Wheldon,H.J., Brown,J.L., Owler,L.W.J., “Wheldon's Cost Accounting and Costing Methods”, 1978.

FIFO

Test accuracy of mathematical calculations.

The FIFO method should result in inventories valued at the most recent purchase price. Use the inventory price test to verify the valuation.

Weighted Average

Test accuracy of mathematical calculations.

Use the inventory price test to verify the valuation at year end.

2.5. Cost of Inventories of a Service Provider

The methods to measure inventories of a service provider are similar to cost accounting systems, with the difference that these costs primarily consist of labour and other costs of personnel directly engaged in providing the service. Labour and other costs relating to administrative or sales personnel are not included in inventory.

Usually, a job order cost system should exist[113]. A main difference between work in process of a service provider to work in process of a manufacturing company is that no profit margin should be included in work in process of a service provider. This is very important because in the case of long-term construction contracts, a part profit may be included in inventory when specific requirements are met. A service is seen differently under IAS. Only if the service is completed is profit recorded.
The main procedures are listed below.

[113] Carter,W.K., "Job Order Cost Accounting Practice Case: Printwrite Inc.", 1998.

Service Provider - Job Order Cost System IAS 2.19

Obtain the job order ledger and, on a test basis, perform the following:

a. Trace amounts to supporting documentation such as voucher registers for payroll distribution reports for labour, and analysis of overheads for overheads applied.

b. Select job orders for jobs completed and in process, and perform the following:

(1) Trace materials used to supporting documents such as requisitions, purchase orders, receiving reports and processed invoices. Examine the authorisation of the job order.

(2) Determine that no sales or administrative labour costs are included.

(3) Determine that no profit margins are calculated.

(4) Test labour costs by reference to payroll reports, time studies, production reports, and labour tickets. This may be coordinated with the tests of controls for payrolls.

2.6. Net Realisable Value

Inventory valuation according to IAS requires that inventories are reported at the lower of historical costs, using an acceptable method, or net realisable value. In the case of merchandise or raw material and supplies, a lower purchase or market price is an indication of over-valuation. Inventory price tests would indicate a reduction in recent invoice amounts. Because inventories are held for sale, slow-moving items, oversized stock and reduced market prices are an indication of net realisable value problems. In general, net realisable value computations according to IAS do not require additional or specialised inquiries in comparison to an audit. The following checklist summarises the general procedures which are adjusted to the IAS terminology.

Net Realisable Value IAS 2.28-33

Perform the following procedures to determine lower net realisable value:

a. For purchased inventory items, compare, on a test basis, the unit price used in the final inventory listing summary to current price lists, recent sales invoices or recent vendor invoices. Refer to inventory price test. Material and other supplies held for use in production are not written down below cost if the finished product into which they will be incorporated are expected to be sold at or above cost.

b. For work in progress and finished goods manufactured by the company, compare, on a test basis, inventory carrying amounts and recent selling prices or sales invoices; ascertain the stage of completion and estimated cost to complete for work in process items; and ascertain that such carrying amounts are not in excess of NRV.

c. Compare inventory turnover ratio and gross profit percentage of the current period to prior periods. If quantity is held to satisfy fixed sales or service contracts, excess quantity is valued on general selling prices.

d. Compare quantities on hand with quantities needed for fixed sales. If fixed sales contracts are in excess of inventory on hand, determine if provision under IAS 37 is necessary.

e. If reasons for NRV write-downs no longer exist, the write-down is reversed.

2.7. Disclosure Requirements

IAS 2 defines a number of different disclosure requirements which are listed below. Because information for the 'Notes' section of financial statements is often collected separately after completing the balance sheet and profit and loss account, the information requirements are summarised in a separate checklist instead of being incorporated in the individual detailed programmes.

Notes:

1. The accounting policies and the cost formula used in inventory valuation.
2. Total carrying amount and the breakdown of the carrying amount by appropriate classifications (merchandise, production supplies, work in progress, and finished goods).
3. Carrying amount of inventories at fair value less cost to sell.
4. Carrying amount of inventories pledged as securities.
5. The amount of any reversal of any write-down that is recognised as a reduction in the amount of inventories recognised as expense in the period in accordance with paragraph 34.
6. The amount of inventories recognised as an expense during the period.
7. The amount of inventories recognised as an expense during the period.
8. The circumstances or events that led to the reversal of a write-down of inventories in accordance with paragraph 34.

3. IAS 11 – Construction Contracts

3.1. Introduction

Construction contracts are part of inventory valuation. The accounting and reporting is subject to a single IAS statement. Because of the nature of the activity undertaken in construction contracts, the time between the beginning of a construction process until the final delivery to the customer affects more than one accounting period.[114] The main issue is the allocation of contract revenue and contract costs. The accounting rules have a major influence on the financial statements of a construction company. The statement affects large industries, for example building construction companies, including single-family dwellings, apartment houses, industrial plants, office buildings, heavy construction companies who build dams, bridges, tunnels, electric power plants and construction companies with special knowledge including plumbing, heating and air conditioning, electrical work etc.

[114] Hickok,R.S., “New Guidance for Construction Contractors: A Credit Plus”, in JoA March 1982 pp. 46ff.

Providers of engineering and architectural services will usually show construction contracts in their balance sheet. If construction contracts are part of inventory, resulting financial statement positions are material because of the size of the construction projects themselves.[115]

IAS 11 can be seen as a special statement for revenue recognition for construction companies and construction contracts.

3.2. 4th EU Directive and IAS 11 Decision Structure

The 4th EU Directive does not address the special accounting problems of construction contracts. The general rules are applicable, which means a valuation at production cost according to Art. 39, on the basis of the definition of production costs of Art. 35. There is no separation between valuation for fixed and current assets within the 4th EU Directive. As a consequence, accounting and valuation for construction contracts has developed differently within the European Union and is, for instance in Germany, driven by tax regulations through the definition of cost components, which have to be recognised for tax purposes in the valuation for current assets.
The decision structure for IAS 11 is as follows:

[115] Bhamornsiri,S., “Losses from Construction Contracts”, in JoA April 1982 pp.26ff.

IAS 11 – Construction Contracts

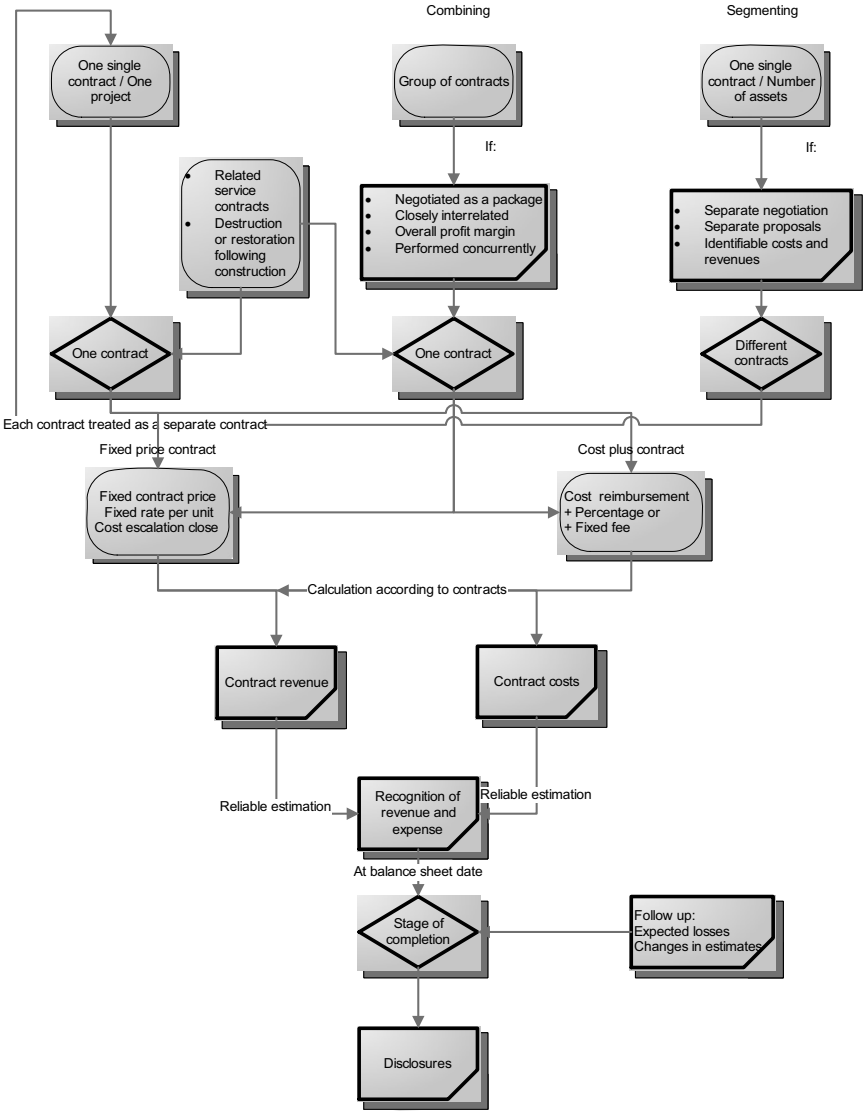


Table 14

As already discussed, IAS 11 recognises the percentage-of-completion method[116] as the only valid method of accounting for construction contracts. Because national GAAP may also allow the completed contract method, a shift is necessary in cases where companies have applied the completed contract method according to national GAAP.
The structure of IAS 11 reveals different stages, which have to be followed in a logical order. The first stage concerns the separation of the individual balance sheet items, which then will be subject of the valuation procedures. A construction contract may be a single contract or a combination of different contracts, or a single contract may be divided into different balance sheet items.

After determining the subject, the next stage classifies each contract into two different types:

1. Fixed-price contract or
2. Cost-plus contract.

In both cases, contract revenue and contract costs are calculated for each contract and revenues and expenses are estimated at each balance sheet date. Revenues and costs are accounted according to the stage of completion. At each following balance sheet date, all amounts should be recalculated. Changes in estimations or additions and changes of contracts may also change the balanced amounts.

3.3. Applying Standard Audit Procedures

In testing construction contracts, the procedures and results of testing cost accounting systems already outlined in the procedures for testing inventories according to IAS 2 should also be applied. A general statement about the quality and system of cost accounting systems is necessary to verify the calculation of construction contracts.

The following procedures summarise additional steps that follow the different stages of IAS 11:

- defining the subject,
- classification of contract,
- revenue and cost calculation,
- recognition according to completion,
- follow-up procedures and disclosures.

[116] Hawthorne,W.H., Herring,H.C., “A Quantitative Approach to the Illustration of the Percentage-Of-Completion Method”, in The Accounting Review, July 1975 pp. 615-616.

IAS 11 Construction Contracts

Stage 1: Contract analysis

a) The contract covers a number of assets if all of the following conditions are met:

- separate proposals have been submitted for each asset;
- each asset has been subjected to separate negotiations;
- customer and contractor have been able to reject or accept each asset;
- costs and revenues of each asset can be identified.

b) A group of contracts shall be treated as a single construction if:

- the group of contracts is negotiated as a single package;
- the contracts are so closely interrelated that they are part of a single contract with an overall profit margin;
- the contracts are performed concurrently or in a continuous sequence.

If a contract provides an option for the construction of an additional asset the construction of the additional asset shall be treated as a separate construction if:

- the asset differs significantly in design, technology or function from the asset covered by the original contract;
- the price of the asset is negotiated without regard to the original contract price.

Stage 2: Type of contract

a) A fixed type contract contains the following characteristics:

- a fixed contract price;
- a fixed rate per unit of output;
- possible cost escalation clauses

b) A cost plus contract contains the following characteristics:

- reimbursement clause for allowable or defined costs;
- additional percentage of these costs or
- additional fixed fee

Stage 3:Contract Revenue

a) Contract revenue:

- initial amount agreed in the contract plus variations, claims and incentives to the extent that they will result in revenue and can be measured reliably.
- uncertainties should be included in the estimation of variations which depend on the outcome of future events

a) Contract costs:

- contract costs comprise costs that are attributable to contract activity and can be allocated to the contract, and
- are specifically chargeable to the customer under the terms of the contract
- direct costs include:

1. Costs of materials consumed in the specific construction contract
2. Wages and other labour costs for site labour and site supervisors
3. Depreciation charges of plant and equipment used in the contract
4. Lease rentals of plant and equipment hired specifically for the contract
5. Costs incurred in shifting plant, equipment and materials to and from the construction site
6. Cost of design and technical assistance directly identifiable with a specific contract
7. Estimated costs of any work undertaken under a warranty or guarantee
8. Claims from third parties

Stage 4: Recognition

The following should be satisfied to estimate the outcome of a construction contract reliably in each case:

1. If it is a fixed-price contract

a. Recognition criteria set by the IASB's Framework; that is
   (1) Total contract revenue can be measured reliably.
   (2) It is probable that economic benefits flow to the entity.

b. Both the cost to complete the contract and the stage of completion can be measured reliably.

c. Contract costs attributable to the contract can be identified properly and measured reliably so that comparison of actual contract costs with estimates can be performed.

2. If it is a cost-plus contract

a. It is probable that the economic benefits will flow to the entity.

b. The contract costs attributable to the contract, whether or not reimbursable, can be identified and measured reliably.

Contract Cannot Be Estimated Reliably

1. Revenue should be recognised only to the extent of the contract costs incurred that are likely to be recoverable.
2. Contract costs should be recognised as an expense in the period in which they are incurred.

Any expected losses should, however, be recognised immediately.

Contract Costs Not Recoverable Due to Uncertainties

Recoverability of contract costs may be considered doubtful in the case of contracts that have any of the following characteristics:

1. The contract is not fully enforceable.
2. Completion of the contract is dependent on the outcome of pending litigation or legislation.
3. The contract relates to properties that are likely to be expropriated or condemned.
4. The contract is with a customer who is unable to perform its obligations, perhaps because of financial difficulties.
5. The contractor is unable to complete the contract or otherwise meet its obligation under the terms of the contract, such as when, for example, the contractor has been experiencing recurring losses and is unable to get financial support from creditors and bankers and may be ready to declare bankruptcy.

In all such cases, contract costs should be expensed immediately.

It is not permitted to restore costs already expensed in prior periods.

Determining the Stage of Completion

One of the following methods may be chosen:

1. The proportion of contract costs incurred to estimated total contract cost
2. Survey of work performed method
3. Completion of a physical proportion of contract work (also called units of work performed) method.

When the stage of completion is determined by reference to the contract costs incurred to date, certain costs are to be excluded from contract costs.

1. Contract costs that relate to future activity (e.g. construction materials supplied to the site but not yet consumed during construction)
2. Payments made in advance to subcontractors prior to performance of the work by the subcontractor

Provision for Expected Contract Losses

When the current estimate of total contract costs exceeds the current estimate of total contract revenue, a provision for the entire loss on the entire contract should be made in the period in which they become evident. The loss provision should be computed on the basis of the total estimated costs to complete the contract, which would include the contract costs incurred to date plus estimated costs. The provision should be shown separately as a current liability on the balance sheet.

Disclosure Requirements under IAS 11

Disclosures relating to all contracts:

a) Aggregate amount of contract revenue recognised in the period

b) Methods used in determination of contract revenue recognised in the period

Disclosures relating to contracts in progress:

a) Methods used in determination of stage of completion (of contracts in progress)

b) Aggregate amount of costs incurred and recognised profits (net of recognised losses) to date

c) Amounts of advances received (at balance sheet date)

d) Amount of retentions (at balance sheet date)

4. Property, Plant and Equipment

4.1. Introduction

The term “property, plant and equipment” refers to non-current tangible assets which are used in the process of generating revenues. The term “fixed assets” is also used to describe assets used for production purposes. Fixed assets also include long-lived intangible assets, for example patents, trademarks and software, but these are long-term, generally identifiable assets that do not have physical substance, or whose value is not fully indicated by their physical existence.

There are four aspects to be addressed in accounting for fixed assets.

1. The amount at which the assets should be recorded initially on acquisition (initial recognition, capital leases);
2. How value changes subsequent to acquisition should be reflected in the accounts, including questions of both value increases and possible decreases

due to impairments (subsequent expenditures, revaluation adjustments, impairment test methods);

3. The rate at which the amount the assets are recorded should be allocated as an expense to future periods (depreciation methods); and
4. The recording of the ultimate disposal of the assets (disposition of assets).

Intangible assets are subject to IAS 38 “Intangible Assets” and are treated separately, although the general accounting problems are the same.

Different IAS standards are relevant in the recognition and measurement of property, plant and equipment. IAS 16 “Property, Plant and Equipment”, as revised in 2003, contains the general accounting regulations. Long-lived assets may be subject to a lease contract and those held under a capital lease are included in property, plant and equipment. IAS 17, “Leases”, as most recently revised in 2003, distinguishes between operating and finance leases. The term “finance lease” is known as capital lease under the corresponding US GAAP, because such leased property is treated as owned, and accordingly, capitalised on the balance sheet. Consequently, IAS 17, which is closely related to IAS 16, has to be reviewed in the case of lease contracts.

4.2. Revaluation of Property, Plant, and Equipment

IAS 16 provides for two acceptable alternative approaches to accounting for long-lived tangible assets. The first of these is the historical cost method, under which acquisition or construction costs are used for initial recognition, subject to depreciation over the expected economic life and to possible write-down in the event of a permanent impairment in value.
The second is the revaluation method, which relates to both the balance sheet and the measure of periodic performance provided by the income statement. Fair value is the basis for the revaluation method, but IAS include no detailed guidance as to how it is applied[117].

Impairment of tangible long-lived assets according to IAS 36 is also closely related to the revaluation method and the fair value determination. Impairment recognition and measurement is part of the statutory obligations in many European countries to compare the carrying value of assets with their market value. In cases where no market value exists, the fair value approach should be applied to reflect impairment in financial reporting.

[117] Herrmann,D., Saudagaran,S.M., Thomas,W.B., “The Quality of Fair Value Measures for Property, Plant and Equipment”,2005.

Two further IAS statements influence accounting for property, plant and equipment.

1. IFRS 5, “Non-Current Assets Held for Sale and Discontinued Operations” has introduced new and substantially revised guidance for accounting for long-lived tangible assets that have been identified for disposal.
2. IAS 40 “Investment Property” addresses the accounting for land and buildings held to earn rent or for capital appreciation rather than for use in production or supply of goods and services.

Both statements need to be reviewed during a transition process for recognition according to IAS.

4.3. General 4th EU Directive Accounting Rules

According to Art. 9, the 4th EU Directive separates tangible fixed assets into the following categories:

1. Land and buildings.
2. Plant and machinery.
3. Other fixtures and fittings, tools and equipment.
4. Payments on account and tangible assets in the course of construction.

According to Art. 15, fixed assets shall comprise those assets which are intended for use on a continuing basis for the purposes of the undertaking's activities and according to Art.16, rights to immovables and other similar rights as defined by national law must be shown under "Land and buildings". Rights to immovables may also entail leasing contracts. The general valuation rule of Art. 34 is that fixed assets must be valued at purchase price or production cost. Art. 33 offers the opportunity for member states to declare to the Commission that they reserve the power, by way of derogation from Article 32 and pending subsequent coordination, to permit or require in respect of all companies or any classes of companies revaluation of tangible fixed assets and financial fixed assets.

In addition, according to Art. 35 (1) (bb), value adjustments must be made, in respect of fixed assets, whether their useful economic lives are limited or not, so that they are valued at the lower figure to be attributed to them at the balance sheet date if it is expected that the reduction in their value will be permanent.

Although the accounting regulations for property, plant and equipment of the 4th EU Directive are more limited in comparison to IAS statements, the general concepts of revaluation adjustments and impairment in the case of lower market values are part of the regulations. The 4th EU Directive is silent regarding detailed methods and leaves further details to the national GAAP of the member states. This has led to different regulations within the European Union. For example, revaluation for fixed assets is possible under French GAAP, but mainly tax driven, not allowed under German GAAP, allowed under British GAAP with many exceptions and generally possible under Polish GAAP, but only in rare circumstances.

Concerning the transition process, the property, plant and equipment section should be viewed as the most complex area, because different regulations exist in most countries and the set of IAS statements affecting property, plant and equipment recognition and measurement includes a number of strict regulations unknown to most companies. Because nearly all companies operate property, plant and equipment in the process of production, the transition problems are of general importance and have to be solved.

The complexity of the decision structure is a result of the different IAS statements which have to be observed. In order to facilitate this process, the decision structure will be developed in a logical order.

1. IAS 16 “Property, Plant and Equipment” should be seen as a general statement,
2. IAS 17 “Leases” will be reviewed only insofar as it contains regulations leading to a reclassification of a lease contract as property, plant and equipment.
3. IAS 40 “Investment Property” contains special regulations concerning land and building for investment instead of production purposes.
4. IFRS 5 “Non-Current Assets Held for Sale and Discontinued Operations” is only applicable in specified situations, but accounting treatments should be introduced in the transition process as early as possible.
5. Revaluation and impairment methods are of more general interest but will only be analysed in connection with specific measurement problems of tangible fixed assets.

4.4. IAS 16 – Property, Plant and Equipment – Decision Structure

IAS 16 was revised in 2004 as part of IASB's "Improvement Project". The main objective of the revision was to reduce alternative accounting treatments and provide additional guidance and clarification. The clarifications and changes concerned the scope of the standard, the recognition of subsequent costs, asset dismantlement, removal and restoration costs, asset exchange transactions, revaluation model, unit of measure for depreciation, depreciation amount, period and date and derecognition. The whole decision structure is more complicated than the statements already discussed, but property, plant and equipment is usually one of the main balance sheet sections of each company and the transition of the balance sheet items will usually be one of the most important procedures.

The problems are sometimes not obvious at first sight. For example, IAS 16 defines property, plant and equipment as tangible items that:

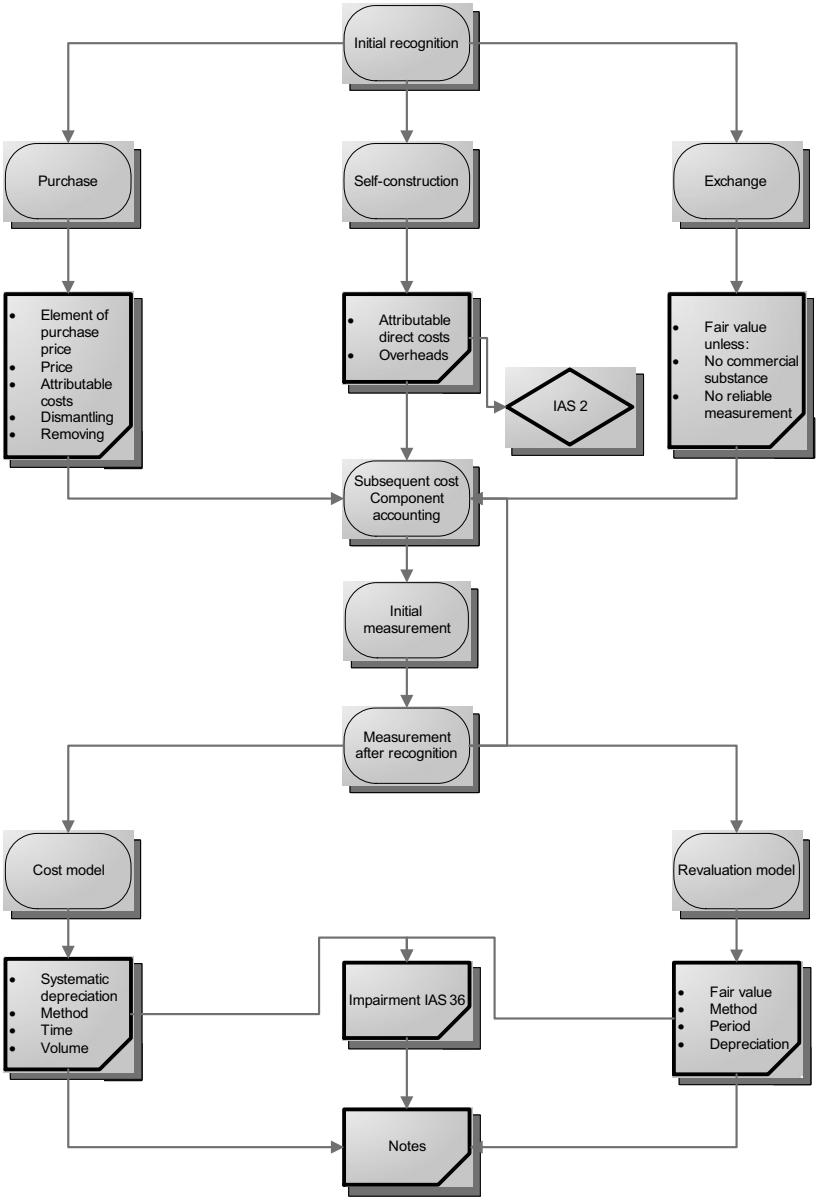
- are held for use in the production or supply of goods or services, for rental to others or for administrative purposes; and
- are expected to be used during more than one period.

In connection with IAS 36 "Impairment of Tangible Long-Lived Assets", the term "cash-generating unit" is introduced. Corporate assets, such as headquarters buildings, which do not themselves generate identifiable cash flows but meet the definition of tangible fixed assets, need to be tested for impairment. IAS 36 requires that corporate assets be allocated among the cash-generating unit or units with which they are most closely associated. For a large and diversified enterprise, this probably implies that corporate assets will be allocated among most or all of its cash-generating units.

This example gives an impression of the complexity of property, plant and equipment recognition and measurement. All IAS statements described in this section have to be reviewed in total and systematically in order to meet the reporting requirements of all IAS standards.

The decision structure of IAS 16 is shown in the following table 15:

IAS 16 – Property, Plant and Equipment



IAS 16 reveals a stringent decision structure which comprises of two major levels. At the first level, the method of valuation is determined by the type of acquisition: purchase, self-construction or exchange. Each branch has individual components and the process leads to the initial measurement value. A special treatment for subsequent costs has to be reviewed which may influence the initial measurement value at first recognition or later after first recognition. The component accounting approach is a special accounting for subsequent costs for large planned replacement costs.

The second level offers two different concepts for subsequent valuation: the cost model and the revaluation model. The revaluation model especially should be viewed as a new valuation approach in most European countries. Impairment accounting according to IAS 36 is a separate new approach which will be discussed later in connection with IAS 36 “Impairment of Assets”.

4.5. Special Problem Area: First-Time Adoption of IFRS

Each company entering a transition process from local GAAP to IAS will face the problem that for initial recognition already existing property, plant and equipment have to be reclassified and valued according to IAS. Companies presenting fixed assets based on the 4th EU Directive are obliged to present a movement schedule according to Art. 15 (3) which shows separately, for each fixed asset item, the additions, disposals and transfers during the financial year, the cumulative value adjustments at the balance sheet date and the rectifications made during the financial year to the value adjustments of previous financial years. Value adjustments shall be shown either in the balance sheet, as clear deductions from the relevant items, or in the notes on the accounts.
IFRS 1 “First-Time Adoption of International Financial Reporting Standards” contains guidance regarding the first-time adoption and includes regulations concerning property, plant and equipment.

At the date of transition to IFRS, the reporting entity is required to prepare an opening IFRS balance sheet which serves as the starting point for accounting under IFRS. The opening balance sheet is different to the entity’s first IFRS financial statements. For example, if a company decides to adopt IFRS as at December 31, 2005 it has to present comparative information for the year 2004. Thus, the beginning of the earliest period for which the entity should present full comparative information would be January 1, 2004 which will be equivalent to the year-end 2003 balance sheet. In the case of two-year comparative information, the beginning of the earliest period for which the company would

present full comparative information would be January 1, 2003 which will be equivalent to the year-end 2002 balance sheet. Accordingly, the opening IFRS balance sheet for purposes of compliance with IFRS 1 would be that as of January 1, 2003.

The general rules for preparing property, plant and equipment in the opening IFRS balance sheet are, except in cases where IFRS 1 grants exemptions:

1. Recognise all property, plant and equipment whose recognition is required under IFRS. Areas which may result in additional assets are assets under finance leases.
2. Derecognise items as assets if IFRS do not permit such recognition.
3. Reclassify items that are recognised under GAAP as one type of property, plant and equipment, but are a different type of asset under IFRS. Investment Property according to IAS 40 is one example.
4. Measure all recognised assets according to principles set forth in IFRS.

Property, plant and equipment which are impaired according to IAS 36 or held for disposal according to IFRS 5 are examples of this case.
Under IFRS 1, a first-time adopter of IFRS may elect to use exemptions from the general measurement and restatement principles. An entity may elect to measure an item of property, plant, and equipment at fair value at the date of its transition to IFRS and use the fair value as its deemed cost at that date. A first-time adopter may elect to use a previous GAAP revaluation of an item of property, plant, and equipment at, or before, the date of transition to IFRS as deemed costs at the date of revaluation if the revaluation amount, when determined, was broadly comparable to either fair value or cost. If a first-time adopter has established a deemed cost under the previous GAAP for any of its assets by measuring them at their fair values at a particular date because of the occurrence of an event such as privatisation or an initial public offering (IPO), it is allowed to use such an event-driven fair value as the deemed cost for IFRS at the date of that measurement.

Regarding the different approaches of allowed revaluation in France and Germany from the application of tax law, the influence of tax-related valuation of property, plant and equipment has to be eliminated in the first-time adoption of IFRS. The main difference between property, plant and equipment and other balance sheet captions, for example inventories, is that inventories contain fast moving items which are replaced within a short time period. Usually, market prices or even price lists exists which allow a sound valuation

for fair value purposes. Because of the long-term character of property, plant and equipment, this balance sheet caption represents the main problem area for first-time adoption of IFRS as well as the application of revaluation models.

4.6. Applying Standard Audit Procedures

4.6.1. Initial Measurement

IAS 16.16 Elements of Costs

Verify system of recording additions and make sure that the following cost elements are included in valuation:

1. Purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.

2. Costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.
   - Examples of directly attributable costs:
     - Costs of employee benefits arising from construction of acquisition
     - Costs of site preparation
     - Initial delivery and handling costs
     - Costs of testing
     - Professional fees

3. Estimate of the costs of dismantling and removing the item and restoring the site. Either when the item is acquired or as a consequence of having used the item during a period other than to produce inventories.

4. The following costs are not part of the carrying amount:
     - Costs of opening a new facility
     - Costs of introducing a new product or service
     - Costs of conducting a business in a new location
     - Administration and other general overheads
     - Costs incurred while an item capable of operating is operated at less than full capacity
     - Initial operating losses
     - Costs of relocating or reorganising part or all of an entity’s operations.

IAS 16.22 Self-constructed Assets

1. Use the same principles as for acquired assets.

2. In the case of similar assets produced for sale in the normal course of business, apply the same principles as assets for sale according to IAS 2.

IAS 16.24 Exchange Transaction

1. An exchange transaction must have commercial substance, that means the cash flow of the asset received differs from the asset transferred or the portion of the entity's operations affected by the transaction changes as a result of the exchange and the difference is significant relative to the fair value of the assets exchanged.

2. The fair value is reliably measurable if the variability of reasonable fair values is not significant and the probabilities of the estimates can be reasonably assessed.

3. If both conditions are met, the item is valued at fair value.

Testing additions for property, plant and equipment is a routine audit procedure and does not entail any technical difficulties because information is usually available from invoices and price lists. Generally, all costs required to bring an asset into working condition should be recorded as part of the cost of the asset. The catalogue of such costs should be reviewed to include allowed cost elements and exclude costs not allowed for recognition.
The elements of costs to be incorporated in the initial recognition of an asset are to include the estimated costs of its dismantlement. The costs of dismantlement are only included if the offsetting credit posted to a liability account meets all the criteria set forth in IAS 37 for the recognition of provisions, that means:

1. The reporting entity has a present obligation, whether legal or constructive, as a result of a past event.
2. It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and
3. A reliable estimate can be made of the amount of the obligation.

The same principles also apply to self-constructed assets. Self-constructed assets may

include the cost of borrowed funds used during the period of construction according to IAS 23. In connection with self-constructed fixed assets, overhead allocations present a major problem because IAS address this concern. The general problem is similar to IAS 2 'Inventories'. Any allocation of general overhead costs require a system of cost accounting, may it be elaborated or not. In the event of the absence of a systematic calculation, a logic similar to determining which acquisition costs may be included in inventory might reasonably also be applied to the costing of fixed assets. If the costs of fixed assets exceed realisable values, any excess costs should be written off to expense and not deferred to future periods.

IAS 16 provides authoritative guidance to the accounting for exchanges of tangible assets. It requires that the cost of an item of property, plant and equipment acquired in exchange for a similar asset is to be measured at fair value, provided that the transaction has commercial substance. Commercial substance is a new notion and is defined as a change of cash flows as a result of the exchange. If the transaction does not have commercial substance, or the fair value of neither the asset received nor the asset given up can be measured reliably, then the asset acquired is valued at the carrying amount of the asset given up.

The general problem of fair value estimation is reduced, because only if the range of possible fair values is limited and different values and related probabilities can be estimated with sufficient reasonableness is a fair value possible.

4.6.2. Costs Incurred Subsequent to Purchase or Self-Construction

A standard audit procedure to verify possible amounts that should have been accounted for as assets is the review of the maintenance and repairs account balance. Generally, ordinary, recurring, relatively small expenditures to maintain normal operating conditions are expensed immediately. But larger amounts may involve an adjustment to the carrying value. Costs can be added to the carrying value of the related asset only when it is probable that future economic benefits beyond those originally anticipated for the asset will be received by the entity. These costs include modifications to extend useful life or to increase capacity of the asset. Similar costs are those which result in an improved quality of output.

Component accounting requires the recognition and depreciation of different components with different useful lives. For example, an engine of a commercial aircraft needs to be replaced before the related airframes themselves must be replaced. The engine should be depreciated independently from the aircraft being depreciated over its shorter useful life. When the replacement takes place, undepreciated costs of the engine would have to be removed from the account and the newly incurred replacement or overhaul costs would be added to the asset accounts.

In addition, costs associated with required inspections could be capitalised and depreciated over the expected period of benefit, for instance the prescribed time periods between main aircraft inspections. That means that subsequent costs may change a given book value on a regular basis. The review of these types of subsequent costs is a continuing process.

IAS 16.12-14 Subsequent Costs

1. If repairs and maintenance expense account balances are material, scan the general ledger activity and examine supporting documentation on a test basis to determine whether the amounts should have been capitalised

a. Review types of assets and analyse the timeframe and costs for regular inspections.
b. Review whether the useful life of assets or quality of output is changed subsequent to repairs.

4.7. Measurement after Recognition

4.7.1. General

IAS 16 offers two methods for measurement after recognition: the cost model and the revaluation model. The cost model is very similar to “historical cost accounting” according to the 4th EU Directive. Once the value for initial recognition is determined, this value is reduced by accumulated depreciation using a systematic method and reduced by any impairment loss. According to Art. 35 (b), the purchase price or production cost of fixed assets with limited useful economic lives must be reduced by value adjustments calculated to write off the value of such assets systematically over their useful economic lives. According to Art. 35 c) (bb) value adjustments must be made, in respect of fixed assets, whether their useful economic lives are limited or not, so that they are valued at the lower

figure to be attributed to them at the balance sheet date if it is expected that the reduction in their value will be permanent. Valuation as a result of impairment at the lower of the values may not be continued if the reasons for which the value adjustments were made have ceased to apply.

Although this regulation is similar, but not identical to impairment of long-lived assets, the concept of the 4th EU Directive contains a general regulation for lower valuation, but is silent regarding further details, whereas IAS contain a specific standard for identification of possible impairment.

Because of the similarities of IAS, the cost method and the 4th EU Directive regulations regarding systematic depreciation, there might be a tendency to adopt the cost method instead of the new revaluation method because this might be considered easier from a standpoint of an entity and involves less complicated calculation procedures. But this decision may not be the best alternative because revaluation offers an opportunity to present the real assets of an entity with more transparency to possible investors, so it is worth analysing both methods before deciding which method should be applied.

Both methods are similar insofar as accumulated depreciation and accumulated impairment losses are deducted from the cost method as well as from the revaluation method initial value. The determination of the value according to the cost method is finished after applying the discussed initial measurement criteria. In comparison, the revaluation method is more complex.

4.7.2. Revaluation Method and Impairment Test

Revaluation of assets is a method in jurisdictions with significant rates of inflation. In the event of high inflation rates, the depreciation charge to income with historical costs leads to overstated profits and will not reflect the cost of maintaining the entity's asset base. IAS 29, "Financial Reporting in Hyperinflationary Economies", addresses adjustments to deprecation under conditions of hyperinflation. Revaluation may also be allowed in specific situations, for example for tax purposes in Poland in 1995 and also in France for similar reasons, to recover tax losses carried forward. But it is not a general valuation method as an alternative accounting treatment to historical cost accounting in most European countries.

Fair value is the basis for the revaluation method, which is defined as the amount for which the asset could be exchanged between knowledgeable, willing parties in an arm's-length transaction.

IAS 16 contains a hierarchy to determine fair value. The notion of an "arm's length"[118] transaction is of great importance. Arm's length is a known concept in the recognition of international transfer prices for tax purposes. Usually, if willing parties in a free market would accept a price in a transaction, this price is seen to be at "arm's length". This approach is also useful for determining market-like prices and adopted in this context.

The first step is the application of market-based evidence, that means market values. If market values are available, the fair value should be derived from this market value by appraisal. Market values for land and buildings are usually available in Europe. There is a free market for the trading of land and buildings within the European Union and market values are published via the Internet or in newspapers. In some jurisdictions, official price lists for land are available from local communities. It might be necessary to engage professionally qualified valuers to determine the fair value of a specific piece of land or building, but the engagement of professional valuers is not legally required if it is possible to derive the fair value from known market values, for example if the production site is part of a larger industrial area with known market prices for land. Similar figures are available for buildings.

For machinery and equipment, the situation is quite different. If machinery and equipment are sold often, market prices are readily available, but if machinery and equipment are used for specialised applications, no market price exists. In this case, they may be valued at depreciated replacement costs. The hierarchy according to IAS 16 is as follows:

1. The highest level is observable market transactions for the same kind of asset.
2. The second best level is observable market transactions for similar assets.
3. The third level is the use of valuation models deriving values from market information or replacement costs.

This approach is similar to FASB's Exposure Draft on the measurement of fair value, which contains five levels of determining fair value[119]:

[118] UNCTAD, "Transfer Pricing", United Nations 1999.
[119] FASB, "Project Update, Fair Value Measurement", August 18, 2006.

Level 1: Quoted prices for identical assets
Level 2: Quoted prices for similar assets
Level 3: Direct market inputs other than quoted prices
Level 4: Indirect market inputs
Level 5: Entity inputs

The frequency of revaluation depends upon the changes in fair value. For property, plant and equipment with only insignificant changes in fair value, revaluation is only necessary every three to five years.

If there is an indication of impairment, the carrying value has to be tested for a possible lower value and adjustments are necessary. Impairment of long-lived assets is always applicable if conditions are met.

The approach of depreciated replacement costs entails some difficult valuation problems which are not addressed in detail in IAS 16 or other IAS statements. Generally, replacement costs refer to the service potential of the asset, that means the current cost of producing a similar asset with the same service potential. Because of technological progress, an asset, for example computer equipment, may be outdated within a short timeframe. Although it might be possible to reproduce the computer equipment at similar or lower costs in comparison to its original purchase price, the resulting replacement value would not represent a sound economic value, because of the different technical capacity. In this case, the impairment concept indicates that a revalued amount should be corrected. Because technically outdated computer equipment would be traded at current or scrap value, even a mathematically correctly calculated replacement value could not be recorded. This example clarifies that impairment is a necessity to prevent the inclusion of exaggerated revalued amounts in the balance sheet as a result of revaluation.

Especially in situations of fast technological progress or changing production technologies, an entity would not apply the revaluation method for this class of assets because it is most likely that the revalued amounts will be impaired.

IAS 16 requires that if any assets are revalued, all other assets in those groupings or categories must also be revalued. According to IAS 16.37, a class of property, plant and equipment is a grouping of assets of similar nature. Examples are: land, land and buildings, machinery, ships, aircraft, motor vehicles, furniture and fixtures and office

equipment[120]. The revaluation in a given category may be accomplished on a rolling or cycle basis which is a question of practicability.

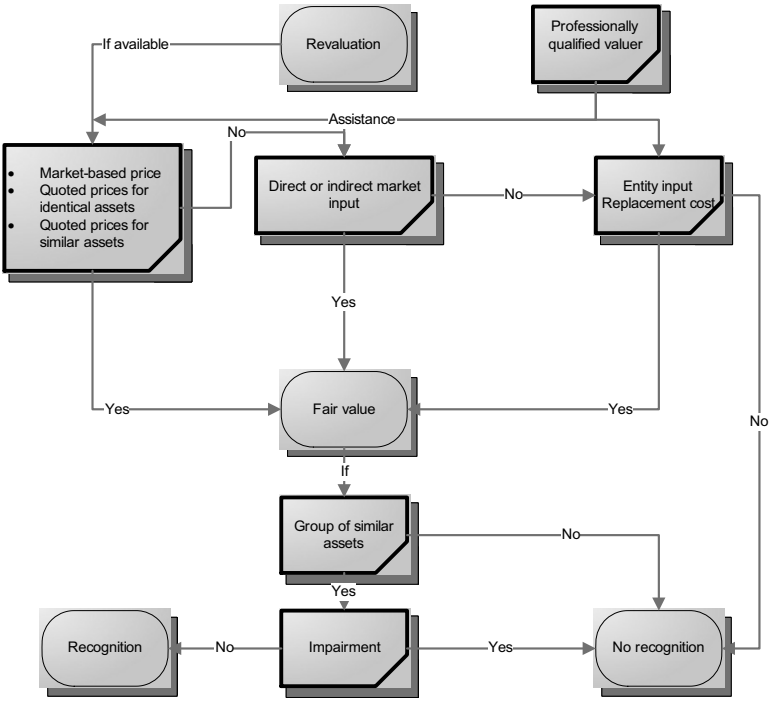
The revaluation approach does not mean that all long-lived assets are revalued, it may apply only to specific groups of similar assets and will usually only be performed in cases where market data is available or the cost of individual appraisal is economically reasonable. In the computer example it would make no sense to invest in professional appraisal determination of replacement costs if it is obvious that any calculated value would be offset by impairment procedures. Thus, economic reasons influence the application of the revaluation method in reality.

In general, revaluation adjustments are to be shown directly in equity as revaluation surplus which will be offset in the case of impairment. Additional impaired amounts are expensed.

The revaluation method offers the opportunity to increase an entity's equity in the balance sheet. Because many performance ratios and rating procedures regard equity as an important value, a higher equity might be of great importance.

The following table 16 (next page) shows the decision process of the revaluation method:

[120] Craner,J., Krzywda,D., Novotny,J., Schroeder,M., "The determination of a group for accounting purposes in the UK, Poland, and the Czech Republic in a supranational context", in International Journal of Accounting, London 2000, pp. 335ff.



Although impairment testing is part of the final evaluation process, obvious indications for impairment for groups of assets should be considered prior to any revaluation procedures to avoid senseless investment of money and time in the work of professional appraisal.

The following programme summarises the main considerations necessary for a decision about the possible application of the revaluation method.

Revaluation Method IAS 12.31

1. Obtain an understanding of the entity's structure of property, plant and equipment, as follows:

   a. Identify the types of groupings of similar assets of property, plant and equipment.

   b. Identify any special risks associated with these groups.

   c. Consider those groups whose fair value measurements might have an inherently higher degree of uncertainty due to factors such as the following:

      (1) Lack of market-based data.

      (2) Costs of professional valuers.

      (3) Possible additional equity as result of revaluation.

      (4) Risk of high variances and fluctuations in fair value.

      (5) Lack of objective data when highly subjective factors are used.

2. Obtain an understanding of the process for determining fair value measurements using professional valuers, by considering factors such as the following:

   a. The qualifications of the persons determining the fair value measurements.

   b. The extent to which information technology is involved in the process.

   c. Whether the entity uses the work of a specialist in determining fair value measurements and disclosures.

   d. The significant assumptions used to determine fair value. The model should be transparent in order to be applied on a regular basis (3 – 5 years).

   e. Evaluate frequency of routine revaluation for a class of similar assets, develop timetable for revaluation on rolling basis.

3. Evaluate overall costs and benefits for each class of assets.

4.8. Systematic Depreciation

Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately[121]. This means that IAS 16 now requires a components approach for depreciation. Each material component of a composite asset with different useful lives or different patterns of depreciation is accounted for separately for the purpose of depreciation and accounting for subsequent expenditure. For transition purposes it might be necessary to separate an existing office building, which was accounted for as a single asset item, in different parts, for example a heating plant, a roof, a kitchen and other discrete components.

Depreciation is based on separate estimated lives for each component. The depreciation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed.
IAS 16 offers a wide range of possible depreciation methods:

1. Straight-line - Depreciation expense is incurred evenly over the life of the asset.
2. Diminishing balance method - Depreciation expense is higher in the early years of the asset's useful life and lower in the later years.
3. Units of production method - Depreciation may also be based on the number of units produced by the asset in a given year.

Each entity applies different depreciation methods in its local GAAP financial statements. The methods according to IAS 16 do not differ from commonly used accounting methods and the transition process does not entail special problems. What should be done in a transition process regarding depreciation is that it might be useful to review the methods, mainly applied for tax reasons, and evaluate alternative depreciation methods. The preparation of the first IFRS balance sheet should be viewed as the perfect moment for a possible change of depreciation methods for a class of assets. Generally, a change of depreciation method is a reportable fact which usually requires a number of additional notes and comparable information. Because of the effect on profit and loss and equity, a change of depreciation method bears the risk of being viewed as unsound accounting treatment and management influence on reporting results. The first-time application of a completely new accounting system offers the opportunity to change methods without any negative impression because the decision for accounting methods is a routine process in applying new accounting treatments. In addition, the application of the compound asset

[121] Burlaud,A., Messina,M., Walton,P.J., "Depreciation: Concepts and practices in France and the UK", in European Accounting Review, London 1996 pp. 299ff.

approach requires the separation of formerly aggregated items and the determination of depreciation methods for these newly identified assets.
The procedures requested reflect this aspect and suggest a general review and evaluation of applied depreciation methods during the transition process.

Depreciation Methods IAS 16.43

Review and test depreciation methods and calculations as follows:

a. Review depreciation methods and depreciable lives according to local GAAP.

b. Evaluate change of depreciation as a result of new compound assets.

c. Recompute depreciation expense in the case of applying alternative depreciation methods and evaluate influence on performance.

d. Evaluate change of depreciation method in the case of revaluation method.

4.9. Notes

A list of different reporting requirements are necessary which are summarised as follows:
For each class of tangible asset, disclosure is required of:

1. The measurement basis used (historical cost or revaluation)
2. The depreciation methods used
3. Useful lives or depreciation rates used
4. The gross carrying amounts and accumulated depreciation at the beginning and at the end of the period
5. A reconciliation of the carrying amount from the beginning to the end of the period, showing additions, dispositions, acquisitions by means of business combinations, increases or decreases resulting from revaluations, reductions to recognise impairments, amounts written back to recognise recoveries of prior impairments, depreciation, the net effect of translation of foreign entities' financial statements, and any other material items.

Additional information is requested regarding restrictions, securities, restoration costs,

outstanding commitments etc. The collection of additional reportable facts is not a matter of special audit or transition procedures.

5. IAS 17 – Leases

5.1. General

IAS 16 centred around transactions in which property, plant and equipment are acquired by outright purchase. However, the rights to these assets might be obtained through lease transactions which can be highly sophisticated and complex[122]. The accounting for lease transactions derives from the range of alternative structures that are available to the parties. Lease contracts can be structured to allow tax benefits through specific lease terms and implied interest rate adjustments. Leases can transfer ownership of the leased asset including the transfer of some or all of the risks of ownership. The accounting for lease transactions reflects the application of the principle of substance over form.

5.2. Type of Leases and IAS 17 Decision Structure

The guidance on lease accounting under IAS 17 is not as fully elaborated as that provided under certain national GAAP. Some more complex types of lease agreements are not addressed, for example leveraged leases. If such types of lease contracts are encountered in a transition process, the regulation gap should be treated according to IAS 8, that means local GAAP rules should be applied if available or corresponding US GAAP regulations may serve as accounting guidance[123].

Special types of lease agreements are excluded from IAS 17:

1. Lease agreements to explore for or use natural resources. IFRS 6 deals with exploration and evaluation assets arising in the mineral exploration process, but offers no accounting guidance for leases.
2. Licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights are addressed by IAS 38.

The decision structure is shown in the following table 17:

[122] Imhoff,E.A., Lipe,R.C., Wright,D.W., "Operating Leases: Impact of Constructive Capitalization", in Accounting Horizon March 1991.
[123] McGregor,W., "Accounting for Leases: A New Approach", Special Report, FASB 1996.

IAS 17 – Leases

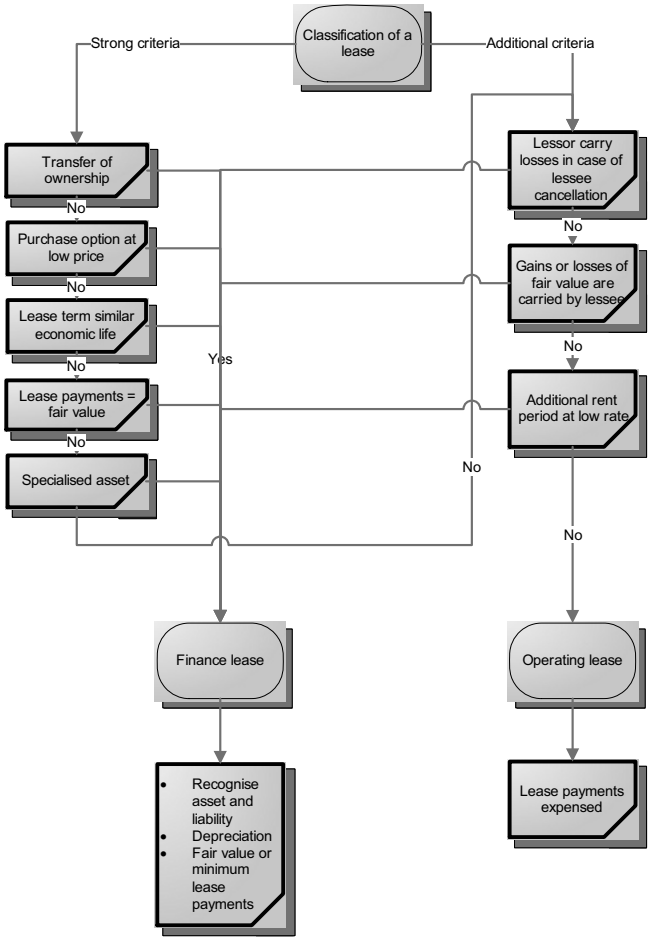


Table 17

IAS 17 deals with accounting for leases in the financial statements of the lessors and lessees. Usually, a lessor will not be the manufacturer of the asset. Assets are transferred to special companies, for example dealer lessors or financing companies who enter a lease agreement with the lessee. Accordingly, accounting for leases in the financial statements of a lessor is a special issue. The decision structure therefore only focuses on

the accounting treatment for lessees, which will be the probable case in a transition process for SMEs[124].

The decision process is straightforward and involves in the first stage the classification of a lease contract into two alternatives:

1. Operating
2. Finance

According to IAS 17, if all of the benefits and risks of ownership have been substantially transferred to the lessee, the lease should be classified as a finance lease. Five criteria are presented that individually or in combination would normally lead to a finance lease:

1. The lease transfers ownership to the lessee by the end of the lease term.
2. The lease contains an option to purchase the leased asset at a price that is expected to be substantially lower than the fair value at the date the option becomes exercisable and it is reasonably certain that the option will be exercised.
3. The lease term is for the major part of the economic life of the leased asset.
4. The present value of the minimum lease payments substantially amounts to all of the fair value of the leased asset.
5. The leased assets are of a specialised nature meaning that only the lessee can use them without major modifications. Additional indicators might be considered:
6. If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee.
7. Gains or losses from the fluctuations in the fair value of the residual accrue to the lessee.
8. The lessee has the ability to continue the lease for a secondary term at a rent that is substantially lower than market rent.

An evaluation of all eight of the criteria would be required to assess whether a lease contract should be accounted for as a finance lease. The first five criteria are more significant; that is, meeting any one of these would normally result in a finance lease. The following three criteria could lead to classification as a finance lease[125].

[124] Ellis,J., "Accounting for Leases", 2006.
[125] Nailor,H., Lennard,A., "Capital Leases: Implementation of a New Approach", in Financial Accounting

In general, the necessary decision process seems simple at first sight. It involves a systematic settlement of the lease contract regulation with the IAS criteria. It is most likely that a finance lease agreement will meet more than one of the eight criteria set forth above and that only in rare cases the decision between finance and operating lease type contracts could not be solved.

Leases involving both land and buildings require a separate analyses of the land and building components. The treatment of the building lease component is not dependent on the land portion of the lease. If the title to the land is not expected to transfer to the lessee, that component will be treated as an operating lease, if criteria for a finance lease are met for the building component, the component is accounted for as a finance lease.

The accounting treatment for an operating lease is relatively simple; rental expense should be charged to income as the payments are made or become payable which will usually be on a straight-line basis. The payments are accounted like a rental payment.

In the case of a finance lease, the lessee has to record an asset and a liability at an amount equal to the lesser of:

1. The fair value of the leased property at the inception of the lease.
2. The present value of the minimum lease payments.

The minimum lease payments are the payments that the lessee is obligated to make or can be required to make and include the minimum rental payments and any guarantee of the residual value made by the lessee or a party related to the lessee. The present value shall be computed using the implicit rate computed by the lessor.

The depreciation method used depends on the criteria met. If ownership is transferred, the asset is to be depreciated over the estimated useful life of the leased property. If the criterion of encompassing the major part of the asset's economic life or the criterion of the present value of the minimum lease payments substantially representing all of the fair value of the underlying asset are met, then it must be depreciated over the shorter of the lease term or the useful life of the leased property.

Series No. 206A, FASB 2000.

5.3. Applying Standard Audit Procedures

The audit programme centres on the question of whether a lease contract should be accounted for as a finance lease in the balance sheet of the lessee.

IAS 17 – Finance Lease

Obtain a summary of all leases in force, and perform the following procedures to determine if the leases should be capitalised based on criteria in IAS 17:

a. Verify if one of the following criteria is met:

   (1) The lease transfers ownership to the lessee by the end of the contract.

   (2) The lessee has the option to purchase the asset at a price lower than the fair value at the date of the option.

   (3) The lease term is for the major part of the economic life of the asset.

   (4) The present value of the lease payments amounts at least substantially to all of the fair value.

   (5) The leased assets are specialised for the use of the lessee.

b. If none of the criteria are met, review the following additional criteria:

   (1) Losses resulting from cancellation of the lease are borne by the lessee.

   (2) Fluctuations in the fair value of the residual value accrue to the lessee.

   (3) The lessee may continue the lease term at a rent substantially lower than the market rent.

c. In the case of a finance lease, calculate asset and liability value.

d. Determine depreciation method rate according to criteria met.

Sale-leaseback transactions may occur which represent two separate and distinct economic transactions. First, the sale of property, and second, a lease agreement for the same property in which the original seller is the lessee and the original buyer is the lessor. Usually, the sales price of the asset is greater than or equal to the current market value and has the effect of a higher rental payment over the lease term.

Under IAS 17, the accounting treatment depends on whether the leaseback results in a finance lease or an operating lease. In the case of a finance lease, any excess of sale proceeds over previous carrying value is deferred and amortised over the lease term. In

the case of an operating lease, accounting treatment depends on whether the sale was on arm's-length terms. In the case of arm's-length terms, any profit or loss should be recognised immediately. If the sales price is below fair value, any profit or loss should be recognised immediately; if the sales price is above fair value, the excess over fair value should be deferred and amortised over the period for which the asset is expected to be used.

Entities adopting IFRS for the first time will have to determine if leased assets need to be capitalised, with the associated debt obligation shown as liabilities. The transition process involves an evaluation of all existing lease contracts.
Capital lease accounting by lessee varies across national GAAP, while under US GAAP and IFRS the financial reporting considerations are similar. The accounting treatment itself is not complex, but criteria for accounting finance lease contracts may be different from country to country and adjustments might be necessary[126]. In general, the transition process should be viewed as less complicated as long as standard lease contracts are concerned, representing a medium of financing assets. In these cases, the application of the eight criteria will probably classify a contract as a finance lease and the following accounting treatment is clearly defined.

5.4. Notes

IAS 17 requires a number of disclosures for finance and operating leases as well as for lessors and lessees. Because in the transition process of an SME a finance lease in the balance sheet of a lessee will be the standard in most cases, the following disclosure requirements are requested for this situation:

Lessee Disclosures

Finance Leases

1. For each class of asset, the net carrying amount at balance sheet date
2. A reconciliation between the total of minimum lease payments at the balance sheet date and their present value.

In addition, an enterprise should disclose the total of the minimum lease payments at the balance sheet date and their present value for each of the following periods:

[126] Riahi-Belkaoui,A., "Long-Term Leasing: Accounting, Evaluation, Consequences", 1998.

1. Due in one year or less
2. Due in more than one but no more than five years
3. Due in more than five years

- Contingent rents included in profit or loss for the period
- The total of minimum sublease payments to be received in the future under noncancelable subleases as of the balance sheet date

A general description of the lessee's significant leasing arrangements including, but not necessarily limited to the following:

1. The basis for determining contingent rentals
2. The existence and terms of renewal or purchase options and escalation clauses
3. Restrictions imposed by lease arrangements such as on dividends or assumptions of further debt or further leasing.

The disclosure of payments in the three categories: less than one year, more than one year but no more than five years and more than five years is similar to the reporting requirements of Art. 43 (6) and Art. 10 of the 4th EU Directive.

6. IAS 40 – Investment Property

6.1. IAS Concepts in Comparison to the 4th EU Directive

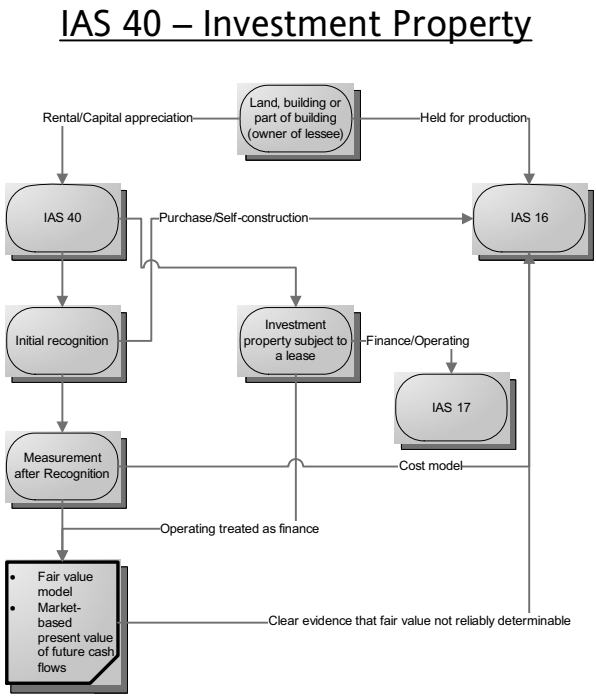
The 4th EU Directive does not distinguish between tangible fixed assets held for production or investment purposes. The valuation rules for tangible fixed assets are not divided within the group 'Land' and 'Buildings' and in general the same for long-lived assets used in production and inventories.

This is different according to the IAS concept. A company may decide to apply the historical cost approach according to IAS 16 for land and buildings used in the production process and decide to use the fair value approach for investment property according to IAS 40[127].

The choice between the two valuation models in one category is independent from the choice made in the other category. Thus, the balance sheet may show two different valuation concepts for one type of asset.

[127] Beck,M., "Bilanzierung von Investment Properties nach IAS 40", Kostenrechnung 2004, pp. 498ff.

The decision structure of IAS 40 is as follows (Table 18):



The first step involves a classification of land, buildings and parts of buildings according to the criteria of IAS 40. If the assets are for rental or capital appreciation purposes and not used in production or supply of goods and services, not for administration or not intended for sale in the ordinary course of business, a reclassification from property, plant and equipment to investment property is necessary.

For initial measurement in the case of purchase or self-construction, the same approach as in IAS 16 should be applied. If the cost model for measurement after recognition is selected, the same procedures for depreciation and impairment according to IAS 16 are relevant[128].

[128] Frieß,R., "Fair-Value-Ermittlung von Investment Properties mit Hilfe des Ertragswertverfahrens nach WertV?", in Deutsches Steuerrecht 2004, pp. 2025ff.

6.2. Fair Value Method

The alternative measurement according to fair value has similar and different components to the revaluation model according to IAS 16 because of the nature of investment property.

Fair value of investment property is defined as:

> The price at which the property could be exchanged between knowledgeable, willing parties in an arm's length transaction.

The best evidence of fair value are current prices in an active market for similar property in the same location and condition. In the absence of this information, current prices in active markets for properties of a different nature or recent prices of similar properties in less active markets should be considered.

The reference to market prices is similar to the revaluation approach of IAS 16, where market prices and quoted prices for identical or similar assets are used. If this information is not available, IAS 40 refers to the discounted cash flow based on reliable future estimates of future cash flows. IAS 40 assumes that in the case of rental income for investment property, the income of future rental payments could be estimated or predicted on the basis of the present rental agreements. Thus, it is possible to calculate a present value or discounted cash flow. IAS 40 is silent on the specific discounted cash flow method, which will be discussed later in connection with impairment of long-lived assets. But in cases where it is not possible to estimate future rental income reliably, the cost model according to IAS 16 should be applied. Other direct or indirect methods or replacement costs which are alternative methods according to the revaluation model of IAS 16 are not possible under IAS 40. The accounting treatment of adjustments as a result of fair value or revaluation amounts represent a further difference.

A gain or loss from a change in fair value of investment property is charged to profit or loss in the period in which it arises, whereas an increased amount resulting from revaluation is credited directly to equity and only recognised in profit to the extent that it reverses a previous revaluation decrease of the same asset. A decrease as a result of revaluation is generally charged to profit or loss with the exception that the revaluation surplus reserve contains an amount in respect of that asset. In this case, a decrease is debited to the revaluation surplus to the extent of any credit balance attached to that asset.

The following table 19 summarises the general accounting treatments of the revaluation method of IAS 16 and fair value method of IAS 40.

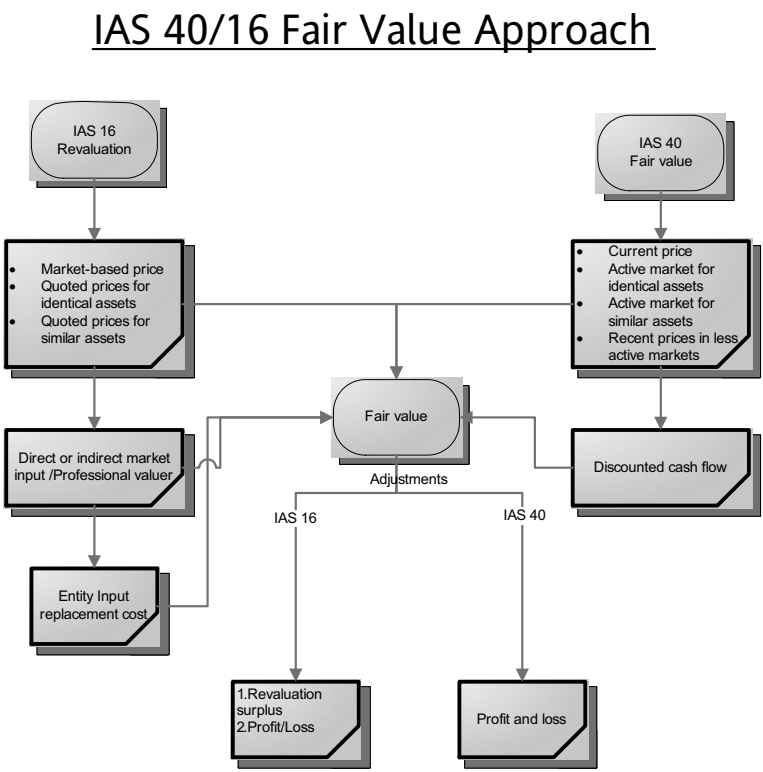


Table 19

The fair value approach of IAS 40 and the revaluation method of IAS 16, which also refers to fair value, are examples of possible confusion as a result of different definitions for same or similar transactions or procedures. For example, it should have been possible to use the same terms or wording for market-based prices in IAS 40 and IAS 16 because in both cases the same reference to market prices are made. But different terms are used and the question arises as to whether these mean different accounting treatments. A systematic approach clarifies this situation and makes the transition process easier and more transparent.

6.3. Applying Standard Audit Procedures

The audit programme follows the decision structure of IAS 40 and refers to the procedures of IAS 16 where applicable.

IAS 40 – Investment Property

Obtain a summary of all land and buildings and parts of buildings with rental income or not in the use of production and perform the following:

a. For rental income:

(1) Reclassify asset to investment property.

(2) Evaluate application of cost and fair value method.

(3) For the fair value method, investigate if market-based prices are available.

(4) Calculate present value of rental payments.

(5) Decide which method should be applied.

b. For lease agreements:

(1) If finance lease, refer to IAS 17 for proper accounting.

(2) Evaluate if, in the case of operating lease, the option for treatment as finance lease should be applied.

c. Determine possible fair value fluctuations and impairment test methods.

6.4. Notes

The notes required under IAS 40 request information about the methods applied, the major assumptions, the engagement of independent valuers, profit and loss recognition of rental income and a number of additional information which does not present a problem to collect because the information is already required to apply the different methods. The different reporting requirements are listed in IAS 16.74ff and could be summarised as follows:

General disclosure requirements:

Whether the fair value or cost model is applied, major assumptions, criteria for classification if classification is difficult, amounts recognised in profit and loss, operating expenses, changes in fair value recognised in profit and loss.

Fair value model

Additions distinguished between acquisition and subsequent expenditure, assets classified as held for sale, net gains or losses from fair value adjustments, transfers from and to inventories.

Cost model

Depreciation method, useful lives, gross carrying amounts and accumulated depreciation, detailed reconciliation between beginning and ending period, amount of impairment losses.

7. IFRS 5 – Non-Current Assets Held for Sale and Discontinued Operations

7.1. General

IFRS 5 is not a primary Level I IAS statement for transition purposes, but it specifies accounting for assets held for sale and the presentation and disclosure of discontinued operations, for example complete production lines.

The accounting treatment is quite different to the 4th EU Directive. In the case of an intention to sell a formerly long-term material fixed asset, a reclassification from fixed assets to current assets is required according to the 4th EU Directive. Only the individual assets affected are reclassified without any concern for related additional costs. If criteria for provisions are met, the 4th EU Directive requires that costs for closing factories or dismissed employees are provided. The reclassified assets are subject to valuation at possible lower market values and no longer depreciated.

Because the classification and disclosure is quite different under IAS, IFRS 5 should be reviewed in a transition process and necessary reclassifications should be made. IFRS 5 defines more precisely when a reclassification should be made and focuses on the whole part of the discontinued operation instead of single asset items.

7.2. Decision Structure

IFRS 5 combines fixed assets and related provisions and additional costs in one process and also includes costs and losses for the remaining period until the sale or disposition of the discontinued operation. The decision structure for the complete process is reflected in the following table 20, including provisions, which are discussed later in connection with IAS 37.

IFRS 5 – Non-Current Assets Held for Sale and Discontinued Operations

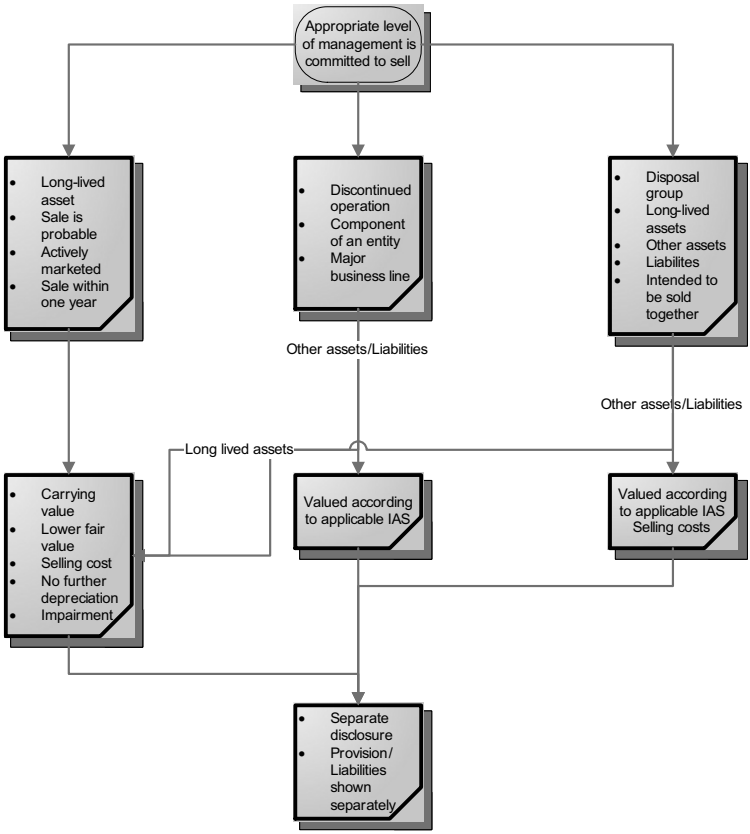


Table 20

The application of IFRS 5 requires a management decision to sell an individual asset or a complete part of the business. It should be probable that the selling process will be finished within a year.

Three different types of assets are distinguished:

1. The decision to sell might affect a single asset,
2. a whole part of an entity or
3. a group of assets, which do not represent a separate major line of a business but which are intended to be sold complete.

For example:

1. The decision to sell an office building including land would be treated as a single asset including different components, e.g. heating, roof etc.
2. The decision to sell all department stores including the trade name in a geographical area would be treated as a major line of business.
3. The decision to sell 10 trucks would be treated as a disposal group.

There may be cases where the classification to one of the three groups is difficult, but this does not lead to severe additional accounting problems because the accounting treatment of all groups is quite similar. IFRS does not contain any additional valuation rules. The general rule is that in the case of long-lived assets, regardless of whether individually sold or part of a discontinued operation or a disposal group, the assets are recorded at the carrying value or lower fair value minus estimated selling cost. Depreciation is ceased and the assets are reclassified.

Other assets or corresponding liabilities or provisions are valued according to the specific IAS standards which apply individually. This concerns mainly provisions or additional liabilities in connection with the disposal process.

Revalued and reclassified assets are subject to impairment and should not be netted with related liabilities and provisions.

In the event of changes to plans to sell, the whole reclassification is reversed. Additional regulations exist for a subsidiary acquired only with the intention to be sold, but this is rarely the business of SMEs. Generally, it should be sufficient to review the accounting treatment of IFRS 5 during a transition process and reclassify assets, discontinued operations or disposal groups according to the regulations and collect required reporting information.
IFRS 5 is accompanied by additional guidance on implementing IFRS 5 which contains a large number of illustrative examples.

7.3. Applying Standard Audit Procedures

The necessary audit steps are basic in nature:

IFRS 5 – Assets Held for Sale

Investigate if management has decided to sell individual long-lived assets, major lines of business or groups of assets.

a. Review management decision in detail and evaluate whether the sale is likely to be completed within one year.

b. Reclassify assets as individually held for sale, being part of a major line or a group of assets to be sold.

c. Identify the carrying amount before reclassification.

d. Evaluate lower fair value and estimate additional costs to sell.

e. Collect disclosure information according to IFRS 5.

8. IAS 36 – Impairment of Assets

8.1. Background

In June 2001, FASB issued Accounting Standard FAS 141 'Business Combinations' and FAS 142 'Goodwill and Other Intangible Assets'. After the 'Pooling of Interest' method, which was very popular for consolidation of new acquired companies because of the possibility to add the profit of the acquired company for the whole financial year to the profit of the purchasing company, even if the acquisition took place on the last day of the financial year, could no longer be applied, the US government offered a compensation and allowed that intangible assets and especially goodwill should no longer be depreciated. For consolidation purposes, the method to calculate and define a goodwill was regulated with more detailed precision and the 'impairment only approach' was introduced to review any nondepreciable goodwill for possible lower values.

Since then, impairment testing and fair value accounting became a combination and a necessity. Because the fair value method without systematic depreciation always bears the risk of overvalued amounts in comparison to historical-cost-based purchase prices with systematic depreciation, companies are required to review any fair value for possible lower market values and adjust any undervaluation[129].

[129] Meeting,D.T., Luecke,R.W., “Asset Impairment and Disposal”, in JoA, March 2002, pp. 49ff.

The idea of fair value and impairment testing became more popular and made its way from consolidation of financial statements to financial statements of a single company. This new international accounting trend is also reflected within IAS. Generally, any revaluation or accounting at fair value is inevitably linked to impairment testing. The revision of IAS 36 in 2005 was a result of the IASB project on business combination and reflected the US GAAP developments.

8.2. Comparison to the 4th EU Directive

Art. 33 of the 4th EU Directive offers the opportunity for member states to declare to the Commission that they reserve the power, by way of derogation from Article 32 and pending subsequent coordination, to permit or require in respect of all companies or any classes of companies:

> (a) valuation by the replacement value method for tangible fixed assets with limited useful economic lives and for stocks;
> (b) valuation by methods other than that provided for in (a) which are designed to take account of inflation for the items shown in annual accounts, including capital and reserves; (c) revaluation of tangible fixed assets and financial fixed assets.

These types of revaluation methods should, however, be viewed as being valid only in very limited circumstances and could not be compared to the fair value and impairment approach of IAS, where revaluation and fair value accounting is an alternative method to historical-cost-based accounting.

Valuation at lower market prices or general lower values is also required under Art. 35 of the 4th EU Directive. If a lower figure is attributable to a carrying value, regularly depreciated on a systematic basis, an adjustment must be made to the value of fixed assets if it is expected that the reduction is permanent. The exception that a lower value should only be accounted for if the reduction is permanent is understandable because fixed assets are subject to systematic depreciation and the carrying value will automatically become lower from year to year and thus it would make no sense to adjust for temporary lower values.

Generally, impairment of assets in connection with fair value accounting is a new general accounting method formerly not allowed under the 4th EU Directive and it requires detailed review work during a transition process[130].

8.3. Scope of IAS 36

IAS 36 is a further example of possible confusion. The intention of IAS 36 is to ensure a valuation of all assets not higher than their recoverable amount, but the standard should not be applied in the following cases:

1. Accounting for the impairment of inventories (IAS 2),
2. Construction contracts (IAS 11),
3. Deferred tax assets (IAS 12),
4. Investment property (IAS 40),
5. Non-current assets held for sale (IFRS 5)

and other specified assets because the individual standards contain requirements for measuring these assets[131].

But this does not mean that the methods of the individual standards are different.

For example:

> If management decides to sell a complete line of business, the valuation according to IFRS 5 may be very similar or identical to IAS 36, because the line of business would be evaluated according to possible and attributable future cash flows which is also a method according to IAS 36.
>
> Impairment of investment property would require a comparison between carrying value and present value of future cash flows. According to IAS 36, a similar approach would be used.
> In the case of a rented building, rent payments would be the best basis of estimated future cash flows and impairment testing according to IAS 36 would be similar to IAS 40.

[130] Paul,J., "International review of Accounting Standards specifying a recoverable amount test for long-lived assets",1997 no location.
[131] Cearns,K., "Impairment of Assets", in Accountancy February 1999 pp. 94ff.

Inventories are usually fast moving items and generally replaced. They are produced for the market and market prices are readily available. Slow-moving inventories are an indication of lower values. The adjustment to fair value in the sense of market values is automatically included in the replacement process of fast-moving inventory items. Construction contracts are special inventories for a special purpose and subject to detailed contracts, which allow individual calculation procedures.

Deferred tax assets result from the application of tax rates and the question of fair value relates more to tax legislation than formal mathematical impairment test methods. Tax rules must allow the recovery of recorded tax assets and they determine possible lower values.

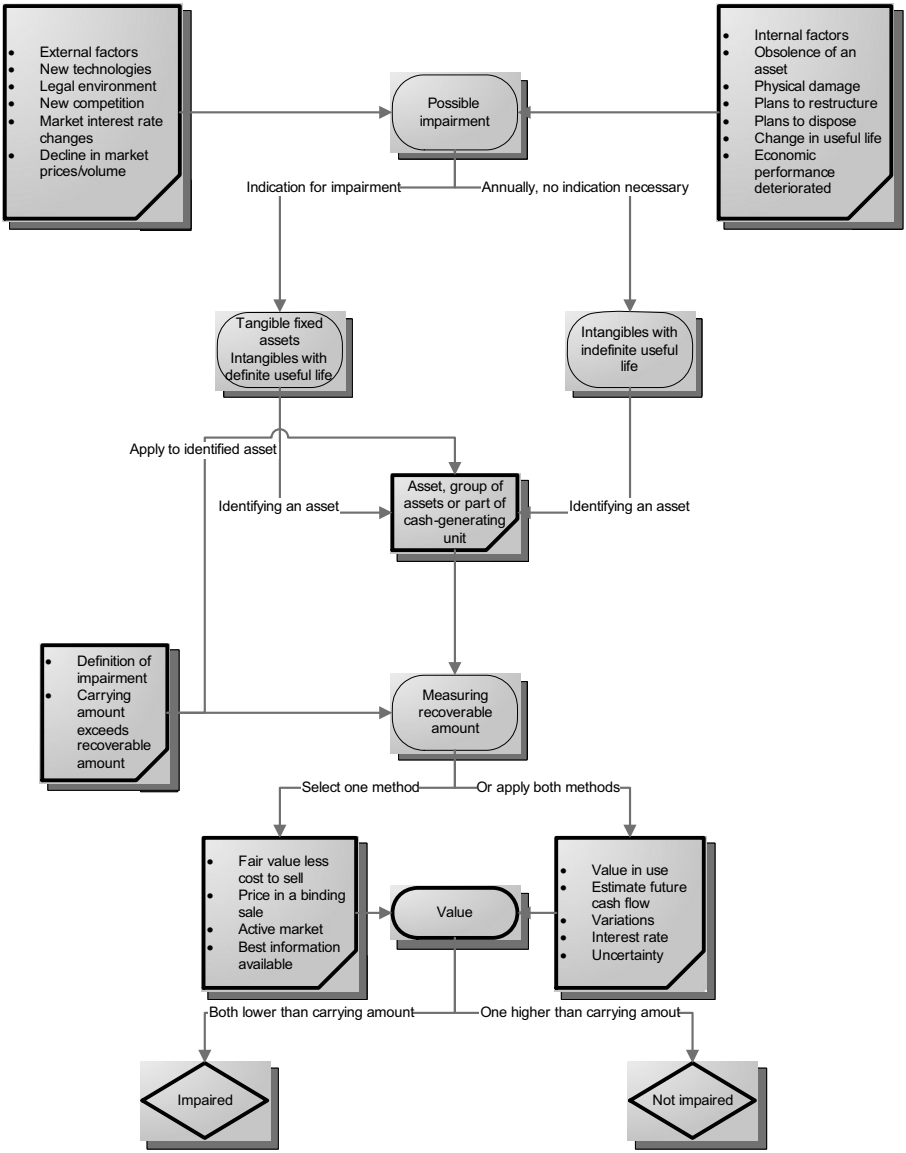
The main area of IAS 36 application are long-term fixed assets, according to IAS 16 'Property, plant and equipment' and IAS 38 'Intangible assets'. All other cases are treated in the individual IAS statements but are similar to the concept of IAS 36[132].

8.4. Decision Structure

The general decision structure of IAS 36 is shown in table 21 on the following page.

[132] Titard,P.L., Pariser,D.B., “Impaired Assets: Meeting Users' Information Needs”, in JoA, December 1997, pp. 55ff.

IAS 36 – Impairment of Assets



In general, a triggering event or an indication is necessary to require that the entity tests

for impairment. Only in the event of intangible assets having an indefinite useful life, for example goodwill, is the test for impairment required annually regardless of any indication for impairment.

It is not a requirement that possible impairments be calculated for all assets at each balance sheet date, only in the case that there might be a higher risk of impairment should such indicators be further analysed. Regarding the example of selling all office stores in a region, this might be an indication that central headquarter assets may be impaired, e.g. idle capacities in different central departments.

The standard itself provides a set of indicators of potential impairment following internal and external factors:

- Significant market value declines more than would be expected;
- Significant changes with an adverse effect on the entity in the technological, market, economic, or legal environments in which the enterprise operates, or the market to which the asset is dedicated;
- Increases in the market interest rate or other rate of return with a resultant effect on the discount rate used in calculating an asset's value in use and decreasing the recoverable amount materially; enhanced likelihood that impairments will emerge;
- Evidence of obsolescence or of physical damage of an asset;
- Significant changes with adverse effect on the entity, such as restructuring the operation or plans to discontinue the asset; and
- Internal reporting data suggest that the economic performance of an asset is or will become worse than previously expected.

Regarding the aforementioned indicators, the general business environment of an entity should be evaluated in connection with entity-specific developments.

8.5. Applying Standard Audit Procedures

Possible audit steps mainly reflect these circumstances and could be part of general audit and review procedures during the planning phase of a transition process.

IAS 36 – Indication of possible Impairments

Obtain an understanding of the entity's transactions and environment relating to fair value measurements and disclosures, as follows:

a. Identify the types of accounts or transactions requiring fair value measurements or disclosures (e.g. whether the accounts arise from the recording of routine and recurring transactions or whether they arise from non-routine or unusual transactions).

b. Identify any special risks associated with these accounts or transactions.

c. Consider those accounts or transactions whose fair value measurements have an inherently higher degree of uncertainty due to factors such as the following:

(1) The length of the forecast period.

(2) The number of significant and complex assumptions associated with the fair value measurement process.

(3) A higher degree of subjectivity associated with the assumptions and factors used in the process.

(4) A higher degree of uncertainty associated with the future occurrence or outcome of events underlying the assumptions used.

(5) Lack of objective data when highly subjective factors are used.

Assets or groups of assets which are subject to a higher risk due to environmental or technical reasons in combination with less predictable future developments should be verified in advance to assess possible impairment problems. For example, a company producing computer hardware for private users with special features for computer games faces the risks of fast technological changes. Because it might be the case that the whole market will change within one year and may use mobile telephone equipment instead of computer hardware to run electronic games, the complete production line could become idle. This possible development is difficult to predict and bears a high risk of uncertainty. A systematic screening of any higher risk areas for impairment problems should be made at the beginning of any transition process.

The test is applied to the smallest group of assets for which the entity has identifiable cash flows, called a “cash-generating unit.” If cash flows cannot be related to an individual asset, groups of assets must be identified which allow an assessment of future cash flows. This grouping represents the smallest aggregation of assets for which discrete cash flows can be identified and which are independent of other groups of assets.
This unit may be a department, a product line or a factory, for which the output of product and the input of raw materials, labour and overheads can be identified.

It is necessary to find an aggregation at a minimum level to develop cash flow information for impairment assessment, and to avoid too high a level of aggregation which is prohibited in order to omit offsetting of impairment losses against productivity or profitability gains derived from the expected future use of other assets.

8.6. Cash-Generating Unit Formation

IAS 36 requires that cash-generating units be defined consistently from period to period which also means that calculation methods for impairment should be applied consistently.
The grouping of assets and the defining of a relationship of specific groups of assets to cash flows in the implementation phase of IAS will influence future possible impairment testing requirements and the complexity of impairment calculations.

IAS 36 defines impairment as the excess of carrying value over recoverable amount, and this definition is applied to the cash-generating unit comprised of a group of assets.

The problem in identifying cash-generating units is more complex because of the scope for possible groupings of assets and the allocation of goodwill to cash-generating units. Goodwill may also be part of the assets section of a single company. For example, if a trading company has bought a regional business from a competitor and part of the acquisition price was paid for the brand name, goodwill will arise in the balance sheet, which is usually depreciated on a systematic basis. The concept of cash-generating units would suggest identifying all recorded assets of the acquired region as being part of a single cash-generating unit and the goodwill should be allocated to this unit. Additional problems arise if corporate assets like central EDP equipment or headquarters buildings are affected by impairment. In these cases, corporate assets must be allocated to a cash-generating unit. If this is not possible on a consistent basis, a weighted allocation is requested.

The following illustration in table 22 shows an example of cash-generating unit formation and allocation of goodwill and corporate assets.

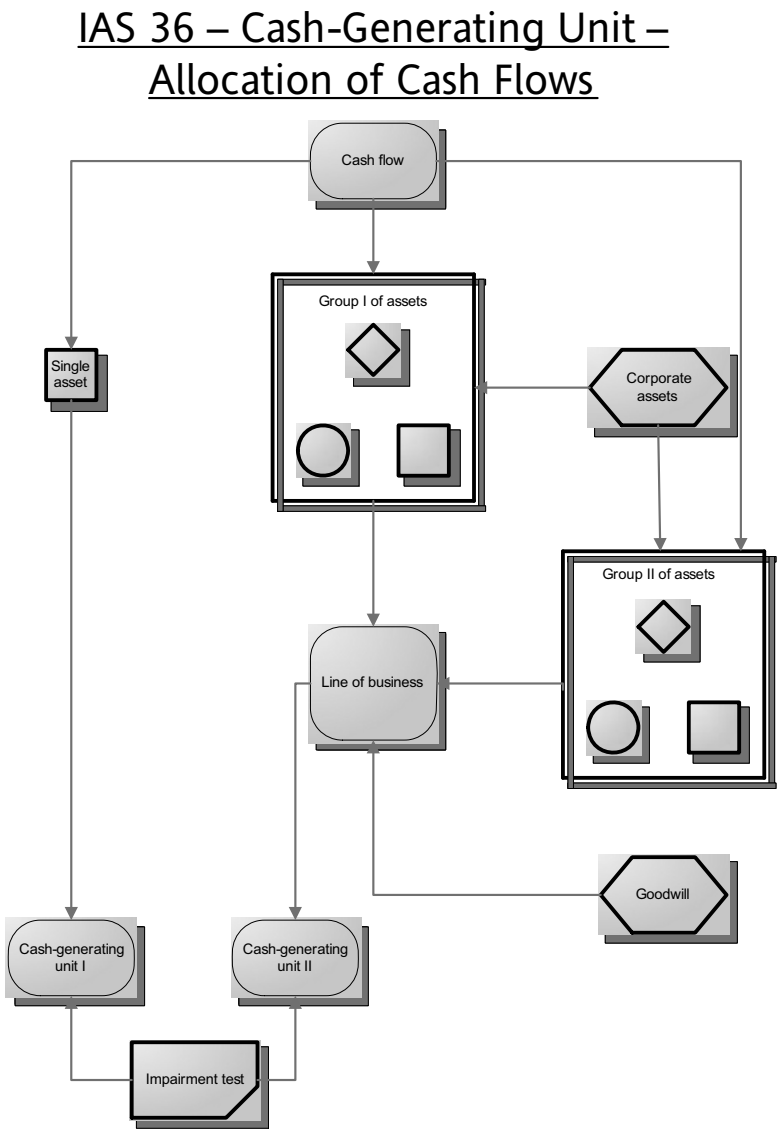


Table 22

If it is possible to allocate cash flows to a single asset, the asset represents a cash-

generating unit. In the case presented above cash flow is additionally allocated to two different groups of assets. The corporate asset can only be allocated to both groups of assets, which together form a line of business, the goodwill is part of the whole line of business. The table shows how complex a detailed definition of cash-generating units and impairment test calculations could be in the case of interrelated assets. Thus, it is not possible to give detailed guidance on how to define groups of assets beyond the general rules contained in IAS 36 and additional illustrative examples contained in the annex of IAS 36. In the end, the process is subject to professional judgement and testing possible results of different groupings within the range of IAS 36. It is necessary to apply the grouping of assets consistently and therefore the initial grouping of assets influences the frequency and volume of future impairment testing. This should be seen as a strategic decision.

8.7. Fair Value Determination

According to the general concept of IAS 36, impairment is defined as the excess of carrying value over recoverable amount, and recoverable amount is defined as the greater of two alternative measures: fair value less cost to sell and value in use. If one of the two alternative measures is higher than the carrying amount, the asset or group of assets is not impaired.

Fair value is based on market prices. For actively traded assets, fair value can be ascertained by reference to binding sales agreements or from price lists or dealer quotations with an adjustment for costs to sell. Tangible assets used in production, for example machinery, will not be traded on active markets and in this case recent transactions of similar assets may serve as a reference, including adjustments for age, condition, productive capacity, and other variables.

If industry trade data is available, trends in market values and development of sales volumes are often published which allow an evaluation of possible impairment problems.

The following table 23 illustrates the process of fair value computation.

IAS 36 – Fair Value Determination

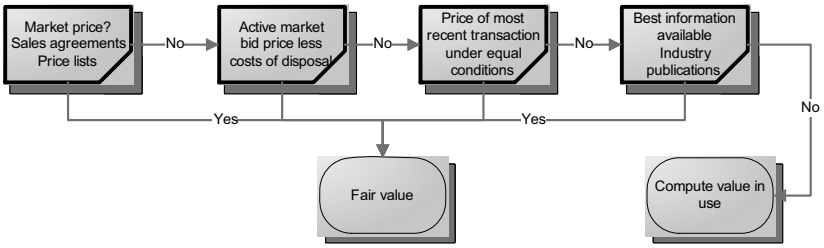


Table 23

The two alternatives fair value and value in use are equal methods for measuring the recoverable amount[133]. In the case of market prices or other available information which allows a computation of fair value less costs to sell, it is not necessary to compute a value in use if the carrying value is lower than fair value. Fair value computation seems to be easier because of the market-oriented relationship and usually an entity will begin any impairment test using this alternative.

Value in use is an entity-specific value and not based on market prices. Measurement of value in use affords a validation of factors available only to the individual business.
The concept is similar to IAS 40 discounted cash flow but in contrast to IAS 40, future cash flows must be estimated without rental agreements that allow the projection of relatively constant and stable cash inflows; and secondly, the present value of these cash flows must be calculated by application of an appropriate discount rate.

Generally, if value in use calculation should be applied, it is important to bear in mind that any method or assumption must be applied consistently. The value in use method especially offers more opportunities to influence the result depending on decisions on how to reflect, for example, risk factors for future cash flow variances.

The process is summarised in the following table 24:

[133] Menelaides,S.L., Graham,L.E., Fischbach,G., “The Auditor's Approach to Fair Value”, in JoA, June 2003, pp. 73ff.

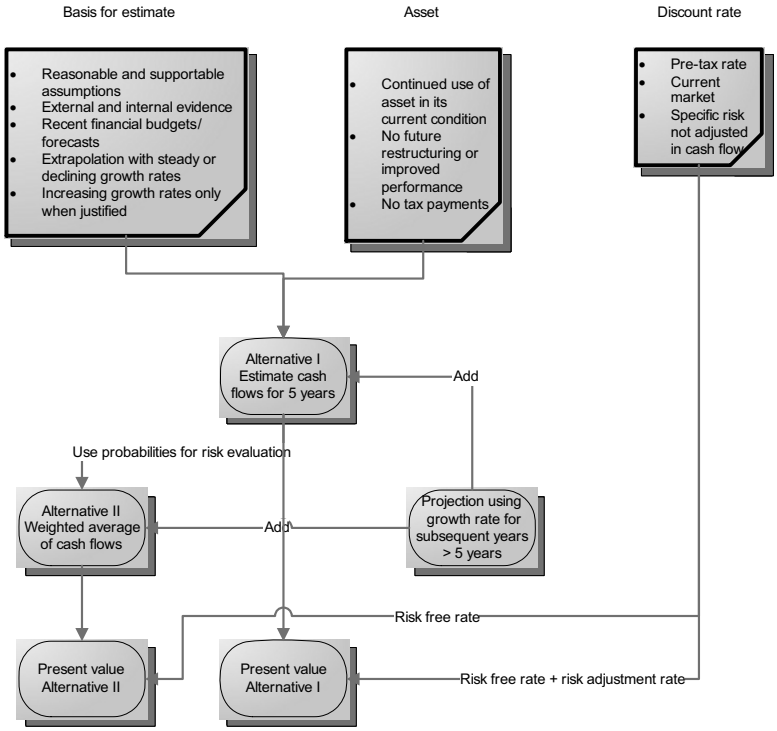


Table 24

Projection of future cash flows must be based on reasonable assumptions, that means market data and growth rates which are in line with known developments and relate to management's own budgets and forecasts[134]. Increasing revenue growth rates are only possible in specific circumstances and the estimation is based on recent past experience.

The comparison between growth rates over the last years and the projected rates in connection with developments of cost increases and other factors allow an evaluation of the prospective cash flows.

[134] Meeting,D.T., Luecke,R.W., Garceau,L., "Future Cash Flow Measurements", in JoA October 2001, pp. 57ff.

IAS 36 prescribes a five-year projection and steady or declining growth rates. In the event of increasing rates, the growth rate should not exceed the long-term growth rate of the industry in which the entity participates.

Industries with increasing and high growth rates are, for instance: telecommunication, personal computers, mobile phones, Internet gaming etc.

The discount rate applied to projected future cash flows is a further component which comprises of subcomponents. The current market rate for risk-free transactions is the basis for impairment testing at any given date and must be adjusted for the risks allocated to the asset. IAS 36 offers another alternative for risk adjustment. Different cash flows with probabilities can be projected and the weighted average is then calculated. If the forecast of cash flows is directly adjusted for uncertainties, the market rate is used for the discount. The present value of the two alternatives will be different in most cases.

For example:

- The projected cash flows for the years 2008, 2009 and 2010 are 100,000 euro. The risk-free market rate is 5%. There are no growth rates in the market and management believes that the general industry risk of cash flow variances would be reflected by an adjustment of 6% in the discount rate. The present value would be calculated with an 11% discount rate and results in 224,371 euro.
- The probability of the projected cash flows for the years 2008, 2009 and 2010 are as follows: 100,000 euro 65%, 85,000 euro 25% and 110,000 euro 10%. The weighted average would be 97,250 euro cash flow, the discount rate is equal to the risk-free market rate and the resulting present value is 264,835 euro.

This simple example illustrates the possible variances in connection with different assumptions.

Regarding the transition process for SMEs, impairment testing according to IAS 36 will be a new method for most companies. Usually, the business of SMEs is more transparent than that of large internationally operating companies listed on stock exchanges because they operate in industry segments or are located only in a specific region. In addition, SMEs operate in larger markets with competitive structures. In the case of impairment testing, market data according to the “fair value less costs to sell” approach should be available. The IASB draft of IAS for SMEs suggests that the “value in use” approach is not

necessary for SMEs. This means that if it is not possible to compute a “fair value less costs to sell”, no further investigation is required with the result that a possible impairment will not be recorded. This approach is not sound because impairment testing is only required if there is a clear indication or triggering event to suggest that impairment of long-term fixed assets exists and only in this event is additional testing necessary.

8.8. Impairment Test Methods – Standard Audit Procedures

The audit steps in evaluating impairment test methods concentrate on the general assumptions underlying any calculation and estimation of cash flows. The initial step in the process of defining a method is the most important. Any false assumptions will result in difficulties regardless of the alternatives used in computing the present value.
Standard audit procedures should be applied in the process of determining impairment methods. The following audit programme includes the main steps which should be adjusted under the specific circumstances.

Impairment Test: Investigation of Major Assumptions

Based on the circumstances and available information, test the fair value measurements by using one or more of the following approaches:

a. Test management’s significant assumptions, the valuation model and the underlying data. When using this approach, perform the following steps:

(1) Evaluate the source and reliability of evidence supporting management’s assumptions.

(2) Consider the assumptions in light of historical and market information and whether they are consistent with the entity’s plans and past experience.

(3) Consider whether management has identified the significant assumptions (e.g. those that are sensitive to variation or bias) and factors influencing the measurement of fair value.

(4) If management has not identified particularly sensitive assumptions, consider techniques to identify those assumptions.

(5) Ensure that there is no contrary data indicating that marketplace participants would use different assumptions (e.g. discount rates that do not appear to reflect current market assumptions).

(6) Identify any sources of documented support for management's assumptions.

(7) Determine whether management's reliance on historical financial information, if any, is justified in developing assumptions.

(8) Review related written plans and other documentation such as budgets and minutes.

(9) If the entity used a valuation model, review the model and evaluate whether the assumptions used are reasonable and the model is appropriate.

(10) Test the data used to develop the fair value measurements and disclosures (e.g. by verifying the source of the data, mathematical recomputation and reviewing information for internal consistency).

(11) Evaluate whether the fair value measurements have been properly determined from such data and management's assumptions.

b. Develop independent fair value estimates to corroborate management's measurement. Under this approach, the auditor can use his or her own developed model, or develop an independent estimate to corroborate management's measurement. In such circumstances, the auditor nevertheless should understand management's assumptions and use that understanding to:

(1) Determine the appropriateness of the assumptions that he or she developed.

(2) Ascertain that his or her independent estimates take into account all significant variables.

(3) Evaluate any significant differences from management's estimates.

c. Review subsequent events and transactions. Under this approach, consider those subsequent events or transactions that reflect circumstances existing at the balance-sheet date and their effect on the entity's fair value measurements and disclosures.

Developing impairment test methods according to IAS 36 is one of the most challenging accounting requirements, because IAS guidance is limited insofar as general methods are

described but further details are missing, although the IAS 36 appendix contains some illustrative examples. Reference to US GAAP according to IAS 8 will not offer more details because FASB itself has not yet finalised a statement regarding impairment testing.

From its introduction into US accounting, the impairment approach has been a major task for consolidated financial statements instead of single entity statements and has been discussed mainly in connection with the assignment of an enterprise acquisition price to individual items in the fixed asset section, especially intangible assets.

IAS impairment testing is a general measurement method and affects all long-term balance sheet items and requires general decisions about grouping of assets, possible market information and mathematical methods. One advantage could be seen in the fact that, because of systematic depreciation of tangible fixed assets, the probability of overestimation will automatically be reduced since depreciation advances over time and reduces the carrying value . If a company applies the revaluation method to fixed asset sections for which market price information is readily available, the practical problems of assessing impairment will be limited. Therefore, the decision for selecting the revaluation method and related impairment testing as an accounting method is a question of professional judgement at the time of the first adoption of IAS, market information available and possible calculation methods[135].

9. IAS 38 - Intangible Assets

9.1. General

The increasing importance of intangible assets required a general review of accounting treatments since the introduction of the 4th EU Directive[136]. Intangible assets are part of the asset section of the 4th EU Directive balance sheet but recording is only possible in the case of acquisition[137]. The main difference between the 4th EU Directive and IAS 38 is that IAS 38 also allows the recording of self-generated intangibles and offers the revaluation method as a general alternative measurement method equal to historical cost accounting[138]. In addition, IAS 38 distinguishes between intangibles with a definite and

[135] Tools and techniques for determining the value of any asset see: Damodaran, A., “Investment Valuation”, 2nd Ed. New York 2002.
[136] Donohue,J., Vallario,C.W., “A new Scorecard for Intellectual Property”, in JoA, April 2002, pp. 75ff.
[137] D'Arcy,A., Mori,M., Roßbach,Ch., “The impact of valuation rules for intangibles assets in Japanese and German accounts of listed companies”, in Finance and Accounting No. 107, Frankfurt 2003, pp. 32. ff.
[138] Hoegh-Krohn,N.E., Knivsfla,K.H., “Accounting for intangible assets in Scandinavia, the UK, the US, and by the IASC”, in International Journal of Accounting, London 2000, pp. 243ff.

indefinite life[139]. This reflects one of the main differences to traditional EU Directive accounting and is a result of the emerging number of new types of intangibles[140].

9.2. Valuation Concept

The concept of revaluation and impairment is similar to that already discussed for property, plant and equipment, but the main accounting problems regarding intangibles arise in connection with their different forms and types. The challenge during the transition process is to define possible intangibles that may not have been recorded and then assign a value and classification between definite and indefinite useful life. But the recognition is limited insofar as the carrying amount of intangible assets recognised at the date of the first IFRS financial statement shall not be adjusted. Thus, only subsequent costs or additional payments after the beginning balance are subject to a possible recognition. This facilitates the whole process[141].

The following examples illustrate the general problem and the main difference to IAS 16.

Example 1: An acquired customer list

A company acquired a customer list from a former competitor and expects that it will derive benefits from the information on the acquired customer list for at least one year but for no more than three years.

Solution: The best estimate of its useful life, following the pattern in which the expected benefits will be consumed or otherwise used up, would be 18 months.

Example 2: An acquired patent that expires in 15 years

The product protected by the patented technology is expected to be a source of cash flows for at least 15 years. The reporting entity has a commitment from a third party to purchase that patent in 5 years for 60% of the fair value of the patent at the date it was acquired, and the entity intends to sell the patent in 5 years.

Solution: The patent would be amortised over its five-year useful life to the reporting entity following the pattern in which the expected benefits will be consumed or otherwise used up. The amount to be amortised is 40% of the patent's fair value at

[139] Grovind,H., “Tax treatment of intangible assets”, in Interntax, Deventer 1995 pp.21ff.
[140] Blodinger,A., “Intangible assets in Germany and Great Britain”, Frankfurt 1998.
[141] General methods for the Valuation of Assets see: Andriessen,D., “Making Sense of Intellectual Property“, Amsterdam 2004.

the acquisition date. The patent would be reviewed for impairment at each balance sheet date.

Example 3: An acquired copyright that has a remaining legal life of 50 years

An analysis of consumer habits and market trends provides evidence that the copyrighted material will generate cash flows for approximately 30 more years.

Solution: The copyright would be amortised over its 30-year estimated useful life, following the pattern in which the expected benefits will be consumed or otherwise used up. The copyright would be reviewed for impairment.

Example 4a: An acquired broadcasting license that expires in 5 years

The broadcasting license is renewable every 10 years if the company provides at least an average level of service to its customers and complies with applicable licensing rules and regulations. The license may be renewed indefinitely at little cost and was renewed twice prior to its recent acquisition. The acquiring entity intends to renew the license indefinitely, and evidence supports its ability to do so. Historically, there has been no challenge to the license renewal. The technology used in broadcasting is not expected to be replaced by another technology in the foreseeable future. Therefore, the cash flows are expected to continue indefinitely.

Solution: The broadcasting license would be deemed to have an indefinite useful life. The license would not be amortised until its useful life is deemed to be no longer indefinite.

Example 4b: The broadcasting license in the previous example

The government decides that it will no longer renew broadcasting licenses, but rather auction these licenses. At the time the decision is made, the broadcasting license has 3 years until it expires. The cash flows from that license are expected to continue until the license expires.

Solution: Because the broadcasting license can no longer be renewed, its useful life is no longer indefinite. Therefore, the acquired license would be tested for impairment in accordance with IAS 36. The license would then be amortised over its remaining 3-year useful life following the pattern in which the expected benefits will be consumed or otherwise used up. Because the license will be subject to

amortisation, only in the case of a triggering event would it be reviewed for impairment.

Example 5: An acquired airline route authority from Gdansk to Berlin that expires in 3 years

The route authority may be renewed every five years, and the acquiring entity intends to comply with the applicable rules and regulations surrounding renewal. Route authority renewals are routinely granted at minimal cost and have historically been renewed when the airline has complied with the applicable rules and regulations. The acquiring entity expects to provide service from its hub airports indefinitely and expects the related supporting infrastructure (airport gates, slots, terminal facility leases) will remain in place at those airports for as long as it has the route authority. An analysis of demand and cash flows supports those assumptions.

Solution: Because the facts and circumstances support the acquiring entity's ability to continue providing air service to Germany from its Gdansk airport indefinitely, the intangible asset related to the route authority is considered to have an indefinite useful life. The route authority would not be amortised until its useful life is deemed to be no longer indefinite and would be tested for impairment.

Example 6: An acquired trademark that is used to identify and distinguish a leading consumer product that has been a market-share leader for the past 8 years

The trademark has a remaining legal life of 5 years but is renewable every 10 years at little cost. The acquiring entity intends to continuously renew the trademark, and evidence supports its ability to do so. An analysis of product life cycle studies, market, competitive, and environmental trends, and brand extension opportunities provide evidence that the trademarked product will generate cash flows for the acquiring entity for an indefinite period of time.

Solution: The trademark would be deemed to have an indefinite useful life because it is expected to contribute to cash flows indefinitely. Therefore, the trademark would not be amortised until its useful life is no longer indefinite. The trademark would be tested for impairment at each balance sheet date.

Example 7: A trademark that distinguished a leading consumer product that was acquired 10 years ago

When it was acquired, the trademark was considered to have an indefinite useful life because the product was expected to generate cash flows indefinitely. During

the annual impairment test of the intangible asset, the entity determines that unexpected competition from China has entered the market that will reduce future sales of the product. Management estimates that cash flows generated by that consumer product will be 20 percent less for the foreseeable future; however, management expects that the product will continue to generate cash flows indefinitely at those reduced levels.

Solution: As a result of the projected decrease in future cash flows, the entity determines that the estimated fair value of the trademark is less than its carrying amount, and an impairment loss is recognised. Because it is still deemed to have an indefinite useful life, the trademark would continue to not be amortised and would continue to be tested for impairment.

Example 8: A trademark for a line of automobiles that was acquired several years ago in an acquisition of an automobile company

The line of automobiles had been produced by the acquired entity for 35 years with numerous new models developed under the trademark. At the acquisition date, the acquiring entity expected to continue to produce that line of automobiles, and an analysis of various economic factors indicated there was no limit to the period of time the trademark would contribute to cash flows. Because cash flows were expected to continue indefinitely, the trademark was not amortised. Management recently decided to phase out production of that automobile line over the next four years.

Solution: Because the useful life of that acquired trademark is no longer deemed to be indefinite, the trademark would be tested for impairment. The carrying amount of the trademark after adjustment, if any, would then be amortised over its remaining four-year useful life following the pattern in which the expected economic benefits will be consumed or otherwise used up. Because the trademark will be subject to amortisation, in the future it would be reviewed for impairment only in the case of a triggering event.

Property, plant and equipment other than land always have a definite useful life which is usually known or could be easily estimated. Intangible assets may have an indefinite life although the legal regulations include a limited timeframe. Intangibles may be indefinite because of their form and legal and economic circumstances, and in this case, impairment test methods cannot be avoided. An entity may avoid accounting and information problems

in connection with impairment testing by applying the historical cost method with systematic depreciation for property, plant and equipment by simply not selecting the revaluation method, but this is not possible in the case of intangible assets with indefinite useful lives. If intangibles of such a type are identified, they often represent the basis for the whole business, for example in the case of a radio or airway licence[142].

It may be the case that, for example, the airline route licence from Gdansk to Berlin has been granted by the government without any substantive additional payments. Although this licence forms the basis for any business of an airline company, the licence should not be recorded at fair value. If the airline is acquired by another company, the buyer may pay a specific part of the total price for the licence and it should be capitalised in a business combination as an intangible asset. That means that not all intangible assets are recognised in a single entity financial statement automatically. Usually, the possibilities for recording individual intangibles are much wider in consolidated accounts than in single entity financial statements. Accounting treatments of intangibles have been developed mainly in connection with consolidated financial statements but it is important to bear in mind that these accounting treatments could not be applied to single entity financial statements[143].

9.3. Decision Structure

Generally, the decision process for IAS 38 should be divided into two main parts:

- Intangible assets arising from market transactions
- Self-generated intangible assets

The accounting treatment for self-generated intangible assets, for example computer software, is a completely new approach and because of the possibility of overvalued recorded amounts requires a detailed investigation. If material self-generated intangibles are identified, they often represent the main product or product line of the entity, for example in the case of software or Internet companies. IAS 38 offers the opportunity to record these types of assets which may not be recognised under any given regulation of the 4th EU Directive.

[142] Mueller,J.M., "Amortization of Certain Intangible Assets", in: JoA, December 2004, pp. 74ff.
[143] Powell,S., "Accounting for intangible assets: current requirements, key players and future directions", in European Accounting Review, London 2003, pp. 797ff.

9.3.1. Intangible Assets - Transactions

The decision process of intangible assets resulting from transactions is shown in the following table 25:

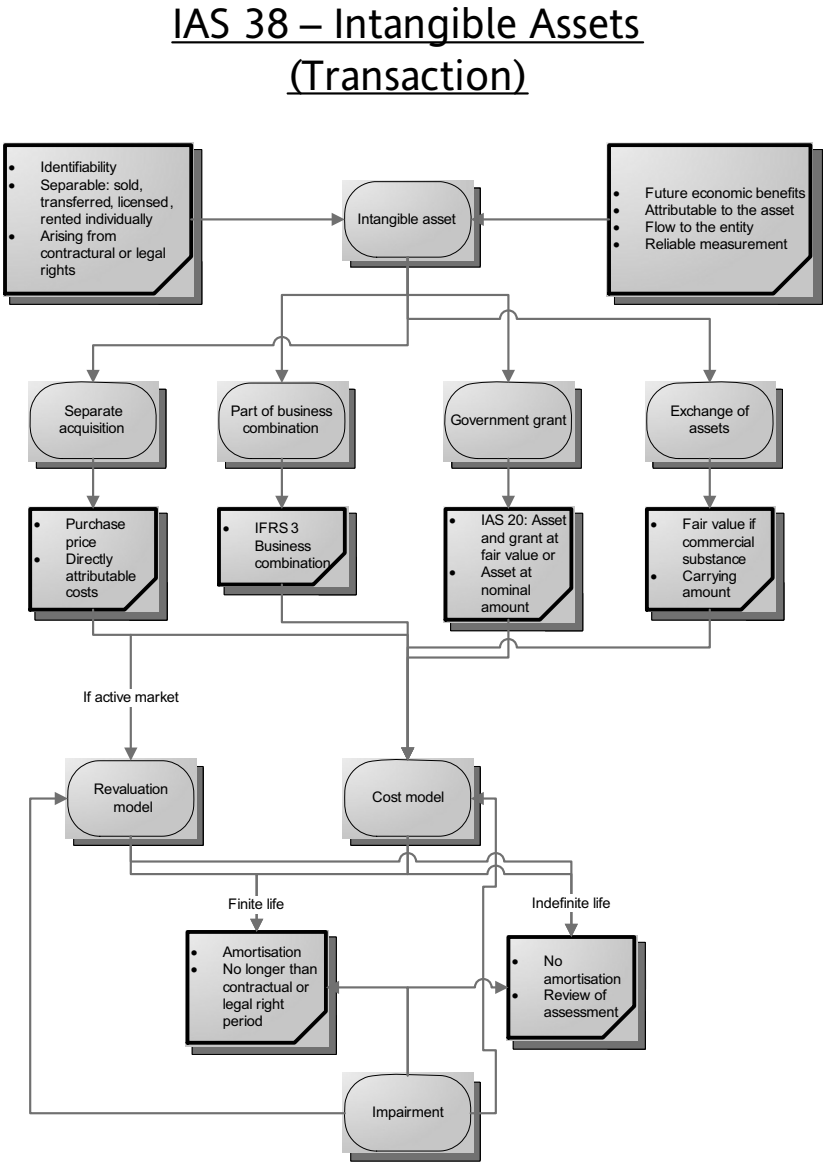


Table 25

In the first stage of the process, recognition criteria for intangibles which are similar to those of property, plant, and equipment, must be met. The two key criteria for determining whether intangible assets are to be recognised relate to the IAS Framework and require a separation from other assets, the inflow of cash flows to the enterprise and a reliable measurement of cost.

Intangibles are often defined by licences and franchise agreements, in patent descriptions or in other forms of agreements which usually contain a definition and amounts of payments in exchange for the rights. This is in contrast to dividing an acquisition price in a business combination where the total amount is paid for the whole company and not divided into separate parts. The problem of identifying an intangible asset in a single entity financial statement will be much easier in the case of contracts which should be the standard case involved in a transition process.

An asset is recognised only if it is probable that future specifically associated economic benefits will flow to the entity, and the cost of the asset can be measured reliably. If the future cash flow is more likely than not to occur, the item is recognised, but if the cash flow is less likely to occur, nothing is recognised. A probability of more than 50% is necessary.
Usually, a company signs a licence contract or a franchise agreement to use the intangible rights in the production process or in the generating of services, for example the acquisition of software licences to construct buildings. In similar cases, the contract is the condition to set up a business, for example the franchise of a restaurant concept including trade name, products and corporate marketing, for instance to establish a hamburger drive-in in a certain location. This means that identification of intangibles and the determination of values will probably be possible referring to the underlying contracts. Contracts and legal agreements are a condition to arrive at an acquired intangible.

The conditions under which the intangible asset has been acquired determine the measurement of its cost. In the case of acquisition, the determination of cost is analogous to that for tangible long-lived assets. Costs include the purchase price less any trade discounts and rebates plus any directly attributable expenditures.

Intangible assets acquired as part of a business combination at its fair value are not a problem in the transition process of a single entity's financial statement.

If intangibles are acquired through an exchange of assets for other dissimilar intangible or other assets, the same commercial substance rules apply under IAS 38 as under IAS 16. If the exchange has commercial substance, the acquired asset is recognised at its fair value, and the asset given up is also measured at fair value. If there is no commercial substance or the fair values cannot be measured reliably, then the value used is the carrying amount of the asset given up.

If the intangible is acquired by means of a government grant, the asset is accounted at historical cost, which will lead to little or no amount.
For SMEs, the accounting treatments in the case of contractual rights, which is the probable case in a transition process, do not represent additional accounting problems in comparison to IAS 16.

The measurement after initial recognition offers the two alternatives historical cost model and revaluation model. If the revaluation method is used, it should be applied to the whole class of assets. The regulation is similar to IAS 16, but in the case of intangible assets, an active market is a necessary condition for the application of the revaluation model.

Usually, intangible assets, for example contractual rights, are not traded on an active market; conditions are agreed between the parties of the agreement individually. Although contracts and licence agreements may exist for certain type of rights and franchises, it is unlikely that this situation will meet the criteria of an active market and the asset must be recognised at cost. Regarding the example of the hamburger drive-in chain, the franchise owner may be in a market position to select its partners for possible new locations. The situation may be different in the case of standard software packages with official price lists and alternative software products.

The revaluation model according to IAS 38 is practically not as important as the revaluation model of IAS 16 for two reasons:

1. Individual agreements and contracts are an indication that no active markets exist and the application of the revaluation method is not possible.
2. If an active market exists, the determination of a market price is easily possible.

Only under very rare circumstances does a market-like fair value calculation seem necessary.

This reduces the accounting problems to the identification of the useful life of an intangible.

IAS 38 offers further guidance that, in the case of contractual rights, the economic useful life should not be longer than the contractual term. In the case of the examples regarding the broadcasting licence and the airline route, IAS only allows an indefinite useful life assumption if the renewal is for little additional cost.

9.3.2. Applying Standard Audit Procedures

In standard audit procedures, the treatment of intangible assets is similar to property, plant and equipment regarding acquisition, depreciation and revaluation methods. The following audit programme should be used in addition to that for property, plant and equipment.

Usually, both sections are investigated together because the documentation is part of the same data programmes and the day-to-day business covered by the same departments. Audit steps that require a review and evaluation of an entity's accounting policies should be seen as necessary steps to establish accounting policies as part of the transition process where such policies have not yet been implemented.

Where appropriate, the reference to regulations of US GAAP accounting is listed for further guidance in addition to IAS regulations. The IAS 38 statement is largely influenced by US GAAP which are more detailed in some aspects.

Intangible Assets Subject to Amortisation

Note: The impairment testing of intangible assets subject to amortisation as described in this audit programme is based on the guidance in IAS 36 (Impairment of Assets) and FAS-144 (Accounting for the Impairment or Disposal of Long-Lived Assets). When intangible assets are not subject to amortisation, additional guidance for impairment testing is included in FAS-142 (Goodwill and Other Intangible Assets).

1. Evaluate the entity's accounting policies for intangible assets subject to amortisation by performing the following procedures:

a. Obtain an understanding of the entity's accounting policies for intangible assets subject to amortisation, including initial method of recognition and measurement, amortisable lives, method of amortisation, and method of evaluating recoverability of intangible assets.

b. Evaluate whether the entity's policies are reasonable considering the industry, history of intangible asset additions, and other factors (e.g. changes in the asset's use, adverse legal or regulatory environment, changing market values).

2. Prepare or obtain an analysis of intangible assets subject to amortisation showing (1) description of the asset, (2) balance at the beginning of the period, (3) additions, (4) write-offs, (5) amortisation, and (6) balance at the end of the period, and perform the following:

a. Test the mathematical accuracy of the detailed listing.

b. Scan the detailed listing to identify, and investigate, any significant or unusual items (e.g. items that may be operating expense, asset no longer in use).

c. Examine support for any significant adjustments made in reconciling the detailed intangible asset listing with the general ledger accounts.

d. For significant additions to intangible assets subject to amortisation, perform the following:

(1) Examine supporting documentation (e.g. invoices, agreements, closing statements).

(2) Verify that the client has ownership rights to intangible asset additions by examining supporting documentation and performing, as applicable, confirmation procedures with the appropriate agency (e.g. patent office, licensing bureau).

(3) Ascertain that capitalised costs are in compliance with IAS requirements (e.g. technological feasibility met, product design has been completed).

(4) Evaluate the reasonableness of the amount and the amortisation period.

e. Recompute amortisation expense either on a major asset clarification (by making approximations on an overall basis) or by testing amortisation recorded for individual assets, and investigate significant differences.

f. Review valuations (prepared by independent third party or internally) for intangible assets and obtain an understanding of the method used and assess reasonableness.

g. Identify fully amortised assets and ascertain that they are still utilised or held by the entity.

3. For long-lived intangible assets subject to amortisation that are to be held and used (including assets that are to be abandoned or exchanged for similar productive assets), perform the following procedures to evaluate such assets for impairments or write-offs:

a. Discuss with management its policies and procedures to identify asset impairments and assess management's responses in light of known business and environmental conditions.

b. Review the useful lives of the long-lived intangible assets to determine their reasonableness in the current operating environment.

c. Consider the existence of conditions such as the following, which may indicate that an asset has been impaired:

(1) A significant decrease in the market value of the asset, particularly in the case of assets held for sale or expected to be sold in the near future.

(2) A significant adverse change in the extent or manner in which an asset is used.

(3) A significant adverse change in legal factors or in the business climate that could affect the value of an asset or an adverse action or assessment by a regulator.

(4) An accumulation of costs significantly in excess of the amount originally expected to acquire or develop an asset.

(5) A current period operating or cash flow loss combined with a history of operating or cash flow losses.

(6) A projection or forecast that demonstrates continuing losses associated with an asset used for the purpose of producing revenue.

(7) A current expectation that, more likely than not (i.e. a level of likelihood that is more than 50 percent), an asset will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.

d. If conditions are present that indicate that intangible assets may be impaired, perform the following:

(1) Ascertain that management has grouped its assets appropriately for purposes of performing an impairment assessment (for example, grouping at the lowest level for which there are identifiable cash flows).

(2) Determine whether the carrying values of these assets are recoverable (if the sum of the future cash flows expected to result from the use and eventual disposition of the assets is less than the carrying amounts of the assets, the carrying values of the assets are not recoverable, and the entity has an impairment loss).

e. If an impairment loss should be or is recognised, test the calculation of the loss as follows:

(1) Determine that the impairment loss is measured as the amount by which the carrying amount of the asset exceeds its fair value.

(2) Test the fair value by vouching to quoted market prices, if available, or by reviewing the valuation techniques used by management.

(3) If the fair value is based on the present value of estimated future cash flows, test for accuracy and ensure that the assumptions used in the present value calculation are reasonable.

(4) For allocated impairment losses, determine that the loss is allocated to the long-lived intangible assets of the group on a pro rata basis using the relative carrying amounts of those assets. (Note: The loss allocated to an individual long-lived asset of the group should not reduce the carrying amount of that asset below its fair value whenever that fair value is determinable without undue cost and effort.)

(5) Ascertain that any impairments or write-offs have been authorised and approved by appropriate officials and examine related supporting documentation (e.g. board minutes, agreements, correspondence).

4. For long-lived intangible assets subject to amortisation that are to be disposed of by sale, perform the following procedures to evaluate such assets for impairments or write-offs:

a. Ascertain that long-lived intangible assets (disposal group) classified as to be disposed of by sale meet the criteria for such classification as that in IFRS 5.

b. Verify that assets held for sale are measured at the lower of their carrying amount or fair value less cost to sell.

c. Determine that an impairment loss was recorded in the income statement to the extent that the carrying amount of the long-lived intangible assets exceeds their fair value less costs to sell. (Note: Subsequent revisions, upward and downward, should be reported as adjustments to the carrying amount of a long-lived asset to be disposed of; however, under no circumstances should the increase in fair value result in the long-lived asset being recorded at an amount in excess of its carrying amount immediately before it being classified as held for sale.)

d. Verify that management has ceased recording amortisation as of the date the assets are reclassified to held for sale.

e. Ascertain that any impairments or write-offs have been authorised and approved by appropriate officials and examine related supporting documentation (e.g. board minutes, agreements, correspondence).

f. If a previously intended sale will not occur, determine the new value for the asset group. (Note: Assets and liabilities should be recorded at the lower of their carrying value—adjusted for depreciation that would have been recognised had the asset been continuously classified as held and used—or fair value less costs to sell at the date the disposal plans were changed.)

Goodwill and Intangible Assets Not Subject to Amortisation

1. Evaluate the entity's accounting policies for goodwill and intangible assets not subject to amortisation by performing the following procedures:

a. Obtain an understanding of the entity's accounting policies for goodwill and intangible assets not subject to amortisation.

b. Evaluate whether the entity's policies are reasonable considering the industry, history of goodwill and intangible asset additions, and other factors (e.g. adverse legal or regulatory environment, changing market values).

c. Assess management's or third-party's capabilities to perform appropriate valuations and the process and assumptions used by management to develop the fair values to complete the second step of the goodwill impairment test and to determine the fair value of intangible assets not subject to amortisation.

d. Consider the need to use a valuation specialist in connection with evaluating the client's or third-party's valuation methodology and assumptions used in the calculations.

2. Test intangible assets not subject to amortisation for impairment as follows:

a. Test management's analysis for each intangible asset not subject to amortisation by comparing its fair value against its carrying value.

b. If the carrying amount exceeds fair value, ascertain that an impairment loss has been recognised in the income statement in an amount equal to that excess.

c. After the impairment loss is recognised, ascertain that management appropriately adjusted the carrying amount of the intangible asset so the adjusted carrying amount becomes its new basis. (Note: Subsequent reversal of an impairment is prohibited.)

d. Evaluate whether events or circumstances such as the following have occurred that would require an impairment test of intangible assets not subject to amortisation more frequently than annually:

(1) A significant decrease in the market value of the asset, particularly in the case of assets held for sale or expected to be sold in the near future.

(2) A significant adverse change in the extent or manner in which an asset is used.

(3) A significant adverse change in legal factors or in the business climate that could affect the value of an asset or an adverse action or assessment by a regulator.

(4) An accumulation of costs significantly in excess of the amount originally expected to acquire or develop an asset.

(5) A current period operating or cash flow loss combined with a history of operating or cash flow losses.

(6) A projection or forecast that demonstrates continuing losses associated with an asset used for the purpose of producing revenue.

(7) A current expectation that, more likely than not (i.e. a level of likelihood that is more than 50 percent), an asset will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.

e. Verify that management evaluates "indefinite useful life" classifications each reporting period to determine whether events and circumstances continue to support an indefinite useful life.

f. For intangible assets that were not being amortised because they were previously determined to have indefinite useful lives and whose useful lives have subsequently been determined to be no longer indefinite, perform the following:

(1) Ascertain that they are subjected to appropriate amortisation prospectively over their estimated useful lives.

(2) Verify that they are accounted for in the same manner as other intangible assets that are subject to amortisation.

3. When goodwill and intangible assets not subject to amortisation have not been identified and tested in connection with the original business combination or other initial transaction, perform the following:

a. Obtain a detailed listing of the goodwill and intangible assets not subject to amortisation and test the mathematical accuracy of the listing.

b. Scan the detailed listing to identify, and investigate, any significant or unusual items (e.g. items that may be an operating expense, asset no longer in use).

c. Examine support for any significant adjustments made in reconciling the detailed listing with the general ledger accounts.

d. Examine supporting documentation (e.g. invoices, agreements, closing statements) for significant additions and determine that they were recorded at the appropriate amounts.

e. Verify that the client has ownership rights to such intangible asset additions by examining supporting documentation and performing, as applicable, confirmation procedures with the appropriate agency (e.g. patent office, licensing bureau).

f. Review valuations (prepared by independent third party or internally) and obtain an understanding of the method used and assess reasonableness.

The programme is more elaborate and is separated into three major parts:

1. Audit steps for intangibles with definite useful life,
2. Audit steps for intangibles with indefinite useful life,
3. Goodwill not subject to a business combination.

The initial recognition and measurement of intangibles will probably be a greater challenge

in a transition process due to the development of accounting procedures during the introduction of the 4th EU Directive. It is likely that SMEs have not applied or introduced detailed accounting procedures for intangibles and especially in cases where know-how, software and engineering knowledge is part of the business it is more likely than not that additional intangible items will be identified during a transition process and that these items represent a major part of the entity's total assets. Investigation and discussion with management, grouping of intangibles and review of possible future adjustments are a major task in this process.

9.3.3. Self-Generated Intangible Assets

A second major accounting novelty of IAS 38 is the possibility for recording self-generated intangible assets which is not allowed under any 4th EU Directive regulation. IASB has decided not to allow a retrospective application to expenditure previously recorded in the profit and loss account. Even if this expenditure meets the criteria for recording as an asset, a reversal is not allowed[144]. The decision structure is shown in table 26:

[144] DuLaney,W., "Capitalizing Software and Creating Business Value", in JoA, July 2000, pp.33ff.

IAS 38 – Intangible Assets (Self-Generated)

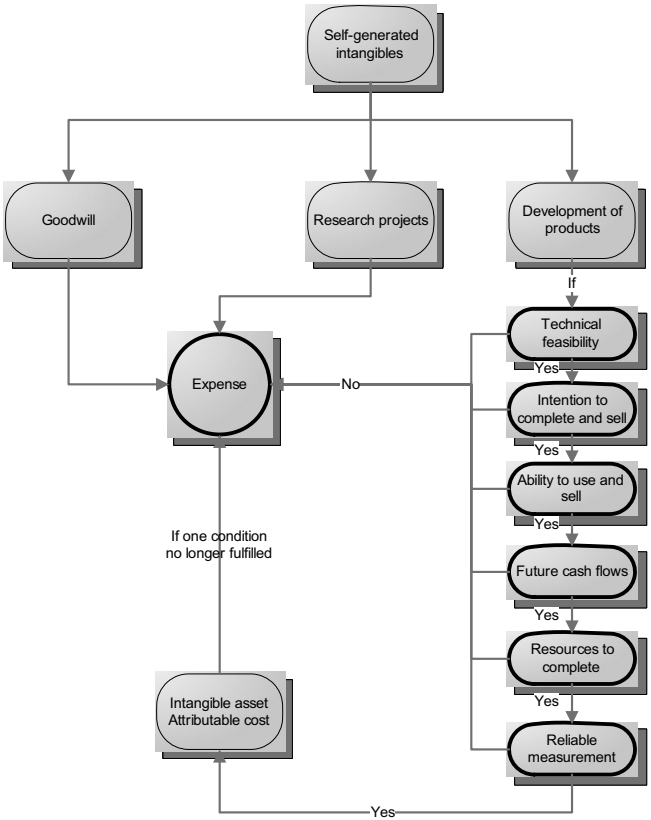


Table 26

Self-generated goodwill and the costs of research are expensed immediately. Only in the case of developing a product, several conditions must be tested and if all are met an intangible asset should be recorded.

In the case of a software-developing company, all expenses incurred in the research phase and until technological feasibility would be expensed. After completing planning, designing, coding, and testing activities and establishing that the product can be successfully produced, the company must be capable of producing the software and also must have the intention to do so. Copyrights or patents would support the intention to sell.

Only if all stages are met, can the software programme be capitalised and amortised as an intangible asset.

Software internally developed for in-house use is treated differently. Because there is no intention to sell the software it is difficult to demonstrate the generation of future economic benefits to the enterprise. For example, software developed internally for payroll accounting will probably not meet the criteria for recognition. A software programme that facilitates the sales process and enables the sales department to contact customers more easily resulting in additional sales transactions will probably meet all criteria for recognition.

10. IAS 37 – Provisions, Contingent Liabilities and Contingent Assets

10.1. General

IAS 37 prescribes the accounting treatment for nearly all of an entity's liabilities. Only liabilities resulting from financial instruments, from so-called executory contracts, under which neither party has performed any or only partially to an equal extent of its obligations, those arising in insurance entities and those covered by another standard[145].

IAS 37 addresses the recognition of provisions and reporting requirements for contingent assets and liabilities. If the criteria are met, contingent assets and liabilities are not recorded in the balance sheet; only additional information has to be included in the notes section of the financial statements. This facilitates the transition process regarding contingent assets and liabilities because the process consists only of an examination of the reporting requirements and a preparation of a list of additional notes.
IAS 37 should be reviewed in connection with IAS 1. According to IAS 1, financial statements must present current and non-current liabilities.

Current liabilities can be divided into four categories:

1. Both the amount and the payee are known;
2. The payee is known but the amount may have to be estimated;
3. The payee is unknown and the amount may have to be estimated; and
4. The liability has been incurred due to a loss contingency.

[145] Lennard,A., "Liabilities and how to account for them", in Accountancy January 2003, pp. 90ff.

If amount and payee are known, a classification between current and non-current according to the payment term is easily possible. Usually, payments due within one year are current, all other are non-current. The classification of liabilities with known amounts and payees does not present a problem during a transition process. Known amounts and known payees generally mean that invoices or contracts with payment terms are available that allow a proper classification.

The other three types of liabilities are subject to IAS 37. Under IAS 37, those liabilities for which the amount or the timing of expenditure is uncertain are deemed to be provisions. The comprehensive definition of the term “provision” according to IAS 37 contains three aspects:

1. The enterprise has a present obligation as a result of a past event.
2. It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation.
3. A reliable estimate can be made of the amount of the obligation.

Besides the general definition, IAS 37 includes additional guidance for specific situations: future operating losses, onerous contracts and restructuring. The decision structure of IAS 37 will therefore be divided into separate parts:

1. General criteria for recording a provision and specific situations
2. Contingent assets and liabilities

10.2. Provisions and Contingencies According to the 4th EU Directive

According to Art. 20, provisions for liabilities and charges are intended to cover losses or debts, the nature of which is clearly defined and which at the date of the balance sheet are either likely to be incurred, or certain to be incurred but uncertain as to the amount or as to the date on which they will arise.

This description is similar to IAS. The Directive authorises member states to create provisions intended to cover charges which have their origin in the financial year under review or in a previous financial year, the nature of which is clearly defined and which at the date of the balance sheet are either likely to be incurred, or certain to be incurred but uncertain as to the amount or as to the date on which they will arise.

The valuation rule of Art. 40 only prescribes that provisions for liabilities and charges may not exceed in amount the sums which are necessary.

The reasoning behind the less precise guidance of the 4th EU Directive regulations lies in the different importance of the prudence principle in the member states. Continental European GAAP are traditionally more focused on the prudence principle than Anglo-Saxon-based GAAP, which means that possible future risk factors in evaluating losses determine the recording of provisions in Continental European GAAP frameworks. The framework of the 4th EU Directive allows a wider range of national measurement rules concerning provisions, so different national accounting treatments and traditions are not in conflict with the Directive.

This is different in IAS 37, where the role of the prudence principle is still important but not dominant in relation to other accounting principles. Regarding the transition process, in European countries with traditional Continental European accounting like France and Germany, the narrower regulations of IAS 37 will probably reduce the number and amounts of provisions.

The main challenge of the transition process is to agree the existing provisions to the criteria of IAS 37 and the additional catalogue of specifically named provisions. The following table 27 highlights the general audit steps.

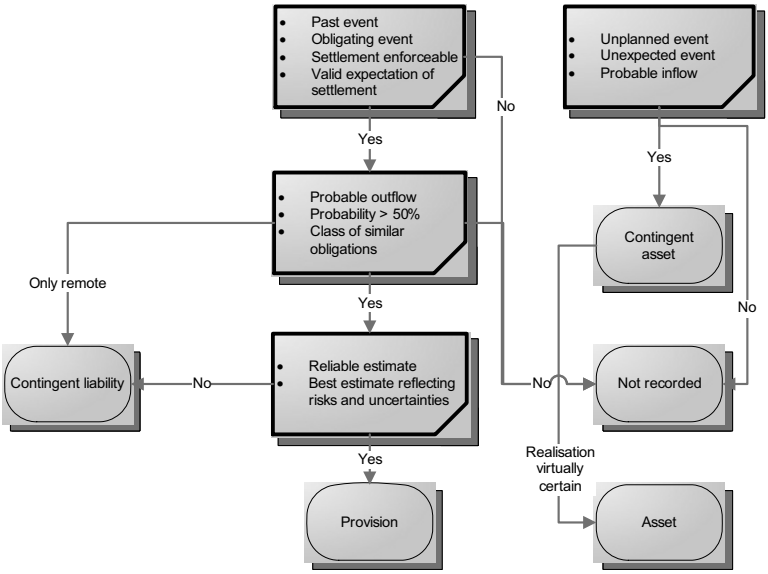


Table 27

10.3. Applying Standard Audit Procedures

Standard audit procedures include several audit steps to identify possible unrecorded liabilities. The so-called "Search for unrecorded liabilities"[146] is part of each audit in connection with the examination of financial statements within the "Accounts payable and purchases" section. The test intends to find possible liabilities not recorded and may also identify provisions or contingencies whenever the criteria are met.

Traditionally, the search for accrued liabilities is part of the "Payroll and other liabilities" section of an audit. Typical accruals or provisions for payroll payments include, for example:

- Provisions for compensated absence (sick pay, vacation),

[146] Saunders,G.D., Munter,P., "The Search for Unrecorded Liabilities – The Implications of Maislin", in The CPA Journal, February 1991, pp. 48ff.

- Employee benefit plans,
- Deferred compensation agreements,
- Post-employment benefits (salary continuation, severance benefits, disability and health care benefits, job training and counselling),

The different types of provisions may be required by law or trade union agreements and usually national accounting standards with more detailed descriptions exist.

Other typical provisions include warranties, legal risks, audit fees, taxes, environmental costs[147] etc. The transition process does not require the introduction of new audit steps, because the recording of provisions and search for unrecorded liabilities and possible provisions is a standard procedure, but all individual items have to be tested against the criteria of IAS 37 and this may lead to adjustments.

The following two examples should help to clarify the procedures:

Example 1:

A company has signed a contract to deliver machine parts at a fixed price in the following financial year. The parts are usually in stock. Price increases for raw materials used in the production of machine parts during the year indicate that the fixed contract price may lead to a loss when the contract is settled. It is not clear if the price increase for raw materials will continue.

Solution: According to traditional European accounting, the prudence principles would require a recording of a possible loss in the financial statements. According to IAS 37, this recording is forbidden because the loss is not probable. It is not possible to forecast the further development of the prices for raw materials and therefore it is more likely than not that a loss will occur.

Example 2:

A company is being sued for compensation and in the event of a negative judgement, the company may be sentenced to pay 500,000 euro plus additional costs for lawyers. In the event of a positive judgement, nothing has to be paid. It is not possible to predict the outcome of the court case.

[147] United Nations Conference of Trade and Development, “Accounting and Financial Reporting for Environmental Costs and Liabilities”, New York 1999.

Solution: The prudence principle would require the recording of a provision, even if the outcome of the court case could not be predicted. According to IAS 37, a reporting requirement as a contingent liability instead of recording a provision would be the accounting solution.

The transition process requires the introduction of new measurement criteria according to IAS 37 instead of new audit procedures. The magnitude of new accounting procedures to be introduced depends on the national GAAP systems and the former importance of the prudence principle.

The general audit steps in IAS 37 require further investigation regarding the necessary procedure in order to calculate probabilities and estimates and incorporate risks and uncertainties. IAS 37 offers further guidance on this subject including general measurement criteria and specific cases for provisions.

The first step in the measurement process involves a separation into single obligations with possible different values and a group of similar obligations. In the case of a single obligation, the most likely value determines the provision.

Example 3:

A company has an obligation to pay licence fees and the outcome depends on mutual negotiations. The probabilities of reaching an agreement will be 70% for a 100,000 euro payment, 15% for 200,000 euro and 15% for 20,000 euro. The 100,000 euro will be provided. Adjustments to a higher value should be made if the 15% probabilities relate to 120,000 euro and 150,000 euro.

The typical example of a group of similar obligations is the selling of goods with a warranty which covers repairs for a certain period after purchase. The amount is calculated using expected defects in the group of sold products which may be minor defects, major defects or a change or cancellation of the sales contract. The different types of defects and related costs are calculated using probabilities and the weighted average represents the expected value.

Example 4:

A company sells electric parts in large quantities (100,000) including a one-year warranty. Statistical figures from the past indicate that 0.2% of the sold parts will have severe defects within the first year and have to be exchanged for free with

new parts. An additional 0.5% will show minor defects. Although these parts will be exchanged for new items, the exchanged parts will be repaired and sold again as used parts at 50% of the listed price for new parts. Production costs are 10 euro, sales price is 25 euro and repair costs 5 euro. The warranty provision would be calculated as follows: 200 (severe defects) x 10 euro (production costs) = 2,000; 500 (minor defects) x 10 euro (production costs) + 500 x 5 euro (repair costs) – 500 x 12.50 (selling price for used items) = 1,250. Total warranty provision: 3,250 euro.

IAS 37 requires the calculated amount being adjusted for possible material effects of the time value of money, possible future events, for example reduced repair costs because of new technologies, and possible reimbursements, for example compensation agreements with suppliers or insurance companies. The possible influence of the adjustments named must be reviewed systematically for each single provision.

Example 5:

In the case of the above example, the company

a) has insured the risk that the number of defects will be more than 200 per year and will get compensation for any additional costs. In this case, the warranty provision would be 2,000 euro.

b) has reduced the repair costs to 2 euro. The provision would be 1,750 euro.

Future operating losses are not subject to any type of provision. The example regarding the future contract with possible future losses would be treated as a future operating loss. Future operating losses are an indication of possible asset impairment. The spare parts have to be analysed for possible impairment in case of a probable future loss according to IAS 2.

Onerous contracts may require a provision. For example: a company has signed a leasing contract for 36 months for computer equipment used in a store. The leasing contract is not cancellable. The store is closed after 18 months and there is no alternative use for the computer equipment. Monthly payments are 2,000 euro. The remaining lease payments for 18 months = 36,000 are provided using a market discount rate.

Restructuring costs usually require funds for closure of business locations, reorganisation or other types of restructuring. If one of the criteria are met, a provision is required. In connection with IFRS 5 “Discontinued Operations”, criteria for provisions will usually be met because of the management decision to close an operation[148].

[148] Alexander,E.R., Hiner,R.R., “Accounting for Asset Retirement Obligations”, in JoA December 2001, pp.

Generally, no additional audit steps are necessary. The main task is to apply the measurement process to the calculated amounts and review each amount according to the requirements. Thus, the transition of national GAAP to IAS 37 could be seen as a technical process.

10.4. Connection with IFRS 5

The following audit steps illustrate the procedures in connection with an asset retirement according to IFRS 5.

Provisions in Connection with IFRS 5

If the company has obligations in connection with the retirement of long-lived assets under IFRS 5, “Non-current assets held for sale and discontinued operation”, perform the following procedures:

Determine that the company recognised the fair value of a liability for an asset retirement obligation or a discontinued operation in the period in which the retirement obligation is incurred, if a reasonable estimate of fair value can be made. (If such an estimate cannot be made in the period the asset retirement obligation is incurred, the liability should be recognised when the fair value can be reasonably estimated.)

Determine that quoted market prices in active markets, if available, were used to measure fair value.

If quoted market prices are not available, evaluate the reasonableness of the method used by the company to measure fair value (e.g. present value techniques).

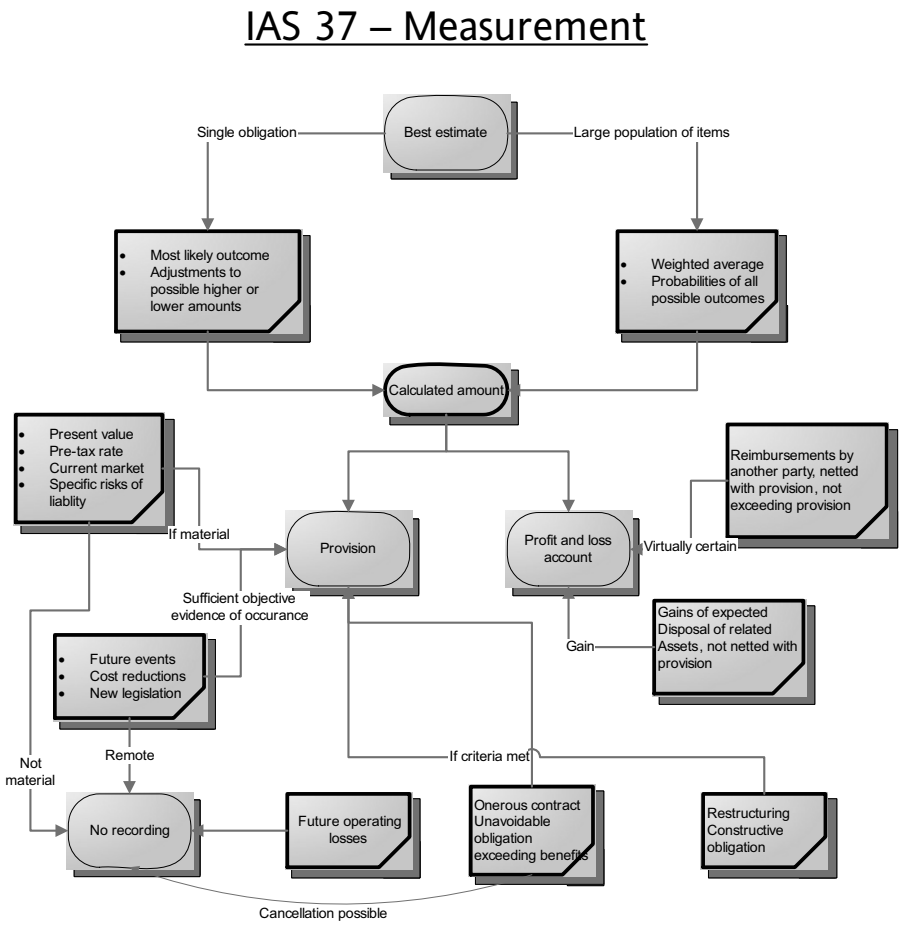
After initial measurement of the asset retirement obligation, ascertain that the liability is adjusted for changes resulting from: (1) the passage of time or (2) revisions to the timing or the amount of the original estimate of undiscounted cash flows.

When asset retirement or disposition costs change as a result of revisions to estimated cash flows, determine that the company adjusted the amount of asset retirement cost allocated to expense in the period of change if the change affects that period only, or in the period of change and future periods if the change affects more than one period.

49ff.

10.5. Measurement Structure of IAS 37

The following table 28 summarises the structure of the measurement process according to IAS 37.



11. IAS 12 – Income Taxes

11.1. General

The appropriate reporting of income tax expense in the event of timing differences in the recognition of revenue and expense for tax and financial reporting purposes are subject to IAS 12[149]. This accounting problem is not addressed in the 4th EU Directive, but different national GAAP treatments exist within the European Union which mainly depend on the influence of tax reporting on financial reporting. Traditionally, this influence is strong in Continental European countries, as already discussed, because accounting has been a reporting medium for purposes of the state and national authorities. As a result of the predominant influence of tax legislation, for example in France and Germany, revenue and expense transactions are treated identically for tax and financial reporting purposes. For tax computation, some expense amounts are not deductible, but this does not lead to deferred taxes because these differences are definite and will not be compensated for in future accounting periods. In Anglo-Saxon-oriented GAAP systems, computation of deferred tax has always been subject to accounting statements because tax and financial reporting are generally different.

Regarding the transition process, for countries with an Anglo-Saxon accounting background, the accounting problems for deferred taxation are well known and have been applied according to national standards. The main task of the transition process is to adjust the formerly national procedures to those of IAS 12, but in general no additional accounting problems will arise. In Continental-European-based accounting systems, the transition process is more complicated because entities are used to reporting for tax and financial reporting purposes with one set of financial statements. The computation of deferred taxes represents a new accounting treatment and new procedures have to be introduced[150].

But IAS 12 does not introduce new assets or liabilities. Implementation should be seen from a technical accounting standpoint. Entities are used to computing for example provisions for warranties, and now they have to compute deferred tax liabilities as well as deferred tax assets according to a mathematical approach similar to that for warranties or other provisions. That means the methods are similar, but the procedures different in detail.

[149] Derwent,R., "Accounting for deferred tax", in Accountancy, August 1992 pp.73ff.
[150] Jacobs, O.H., Spengel,Ch., "The financing and taxation of corporations – a comparing analysis for the EC-member countries Germany, France and Great Britain", in Intertax 1993, pp. 4ff.

It could be seen as an additional advantage in the process of introducing IAS 12 into Continental European accounting systems that model standard audit procedures of Anglo-Saxon origin contain standard procedures for testing and evaluating deferred tax assets and liabilities[151]. These procedures can now also be applied in these countries.

11.2. Methods

IAS 12 prefers the liability method for computing income taxes. According to the liability method, a reporting entity's total income tax expense in the current period must be calculated as the sum of the current tax expense and deferred tax expense. This amount will not usually be the same if the current tax rate were applied to pre-tax profit.

> For example: A company's profit before taxes is 200,000 euro. Taxable temporary differences amount to 16,000 euro, and deductible temporary differences are 6,000 euro. The tax rate is 30%. Current tax expense is 57,000 euro (200,000 – 16,000 + 6,000 = 190,000 x 30%), deferred tax asset is 1,800 euro (6,000 x 30%) and deferred tax liability is 4,800 euro (16,000 x 30%).

The liability method is a balance-sheet-oriented method. Deferred tax expense is defined as the change in the deferred tax asset and liability accounts occurring in the current period, and the computation involves more than the mere effect of the current tax rate applied to the profit of the reporting period. Current period tax expense may also include tax effects of items reported previously.

IAS 12 is very similar to current US GAAP. Former IAS 12 versions allowed additional methods of computing deferred taxes. The deferral method, which focused on the matching principle and the measurement of profit and loss, was a popular method in the 1960s and subsequently, but is no longer permitted since the revision of IAS 12 in 1998[152].

The liability method is the predominant method in deferred tax computation in Anglo-Saxon and US-GAAP-oriented accounting systems[153].

[151] Petree,Th.R., Gregor,G.J., R.Vitray,J., "Evaluating deferred tax assets", in JoA March 1995, pp. 71ff.
[152] Cocco,A., Ivancevich,D.M., Vent,G., "FASB 106's deferred tax implications" in JoA October 1994, pp. 89 ff.
[153] Givoly,D., Hayn,C., "The Valuation of the Deferred Tax Liability: Evidence from the Stock Market", in The Accounting Review April 1982.

11.3. Recognition

The following table 29 summarises the procedures according to IAS 12 for recognition of a deferred tax asset and liability.

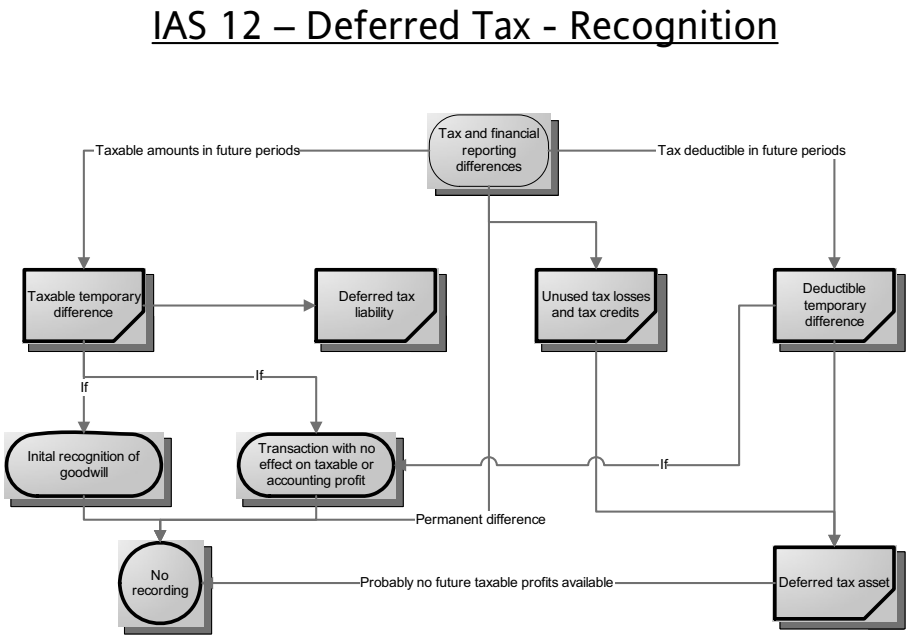


Table 29

To qualify for deferred tax, the period in which the income or expense is recognised is different for tax and accounting purposes. If the timing is not reversed, a permanent difference exists with no further reporting requirements. Timing differences may arise from different depreciation methods, deferred compensation plans or percentage-of-completion accounting for long-term construction contracts resulting in a difference between the carrying amount of an asset or liability in the balance sheet and its value for tax computation[154].

In general, revenue recognised for financial reporting purposes before being recognised for tax purposes and expenses that are deductible for tax purposes prior to recognition in the financial statements are taxable temporary differences, which give rise to deferred tax

[154] Peavey,D.E., Nurnberg,H., "FASB 109: Auditing considerations of deferred tax assets", in JoA May 1993, pp. 77ff.

liabilities. Revenue recognised for tax purposes prior to recognition in the financial statements and expenses that are reported in the financial statements prior to becoming deductible for tax purposes are deductible temporary differences, and give rise to deferred tax assets.

Besides the above-named standard timing differences, additional differences give rise to deferred taxes.

> An entity may qualify for a tax credit for certain qualifying investments in assets and is permitted either full accelerated depreciation coupled with a reduced investment tax credit, or a full investment tax credit coupled with reduced depreciation allowances. In the case of reduced tax depreciation, the difference between the depreciable amount for financial reporting purposes gives rise to a deferred tax liability.

Business combinations accounted for by the acquisition method assign costs to assets or liabilities of the acquired business resulting in a difference for tax reporting purposes.

Assets which are revalued under IAS 16 and IAS 40 and adjusted to higher current fair values with no effect on the values for tax purposes result in discrepancies between the adjusted book carrying values and the tax bases. These temporary differences give rise to deferred tax liabilities.

Acquired assets or liabilities in transactions other than business combinations which are not deductible or taxable in determining taxable profit due to jurisdiction, for example no tax deduction of intangible depreciation or a liability generally not tax deductible, are defined as a temporary difference but no recognition of deferred tax liabilities or assets is permitted.

Assets and liabilities acquired in business combinations may be valued at fair value with the tax basis not adjusted. Deferred tax needs to be recognised for these differences.

Goodwill that cannot be amortised for tax purposes in some tax jurisdictions is not permitted for computing deferred taxes.

Deferred tax assets should be included in the balance sheet only if it is likely that they will be realised in future periods and this depends on future profits[155].

IAS 12 sets forth several criteria:

- It is probable that taxable profit will be available against which a deductible temporary difference can be utilised when there are sufficient taxable temporary differences relating to the same taxation authority and will reverse either in the same period or in periods into which the deferred tax asset can be carried back or forward; or

- If there are insufficient taxable temporary differences relating to the same taxation authority, it is probable that the enterprise will have sufficient taxable profits in the same period or in periods to which the deferred tax can be carried back or forward, or tax planning opportunities are available that will create taxable profit in appropriate periods.

11.4. Measurement

The measurement concept of IAS 12 is straightforward. Tax assets or liabilities are measured at the amount expected to be paid or received with no discounting allowed and with a necessary review at each balance sheet date with adjustments to the extent that deferred tax assets will no longer be utilised or tax rates change.

The following table 30 highlights the measurement process:

[155] Miller,G.S., Skinner,D.J., "Determinants of the Valuation Allowance for Deferred Tax Assets under SFAS No. 109", in The Accounting Review April 1998.

IAS 12 – Deferred Tax - Measurement

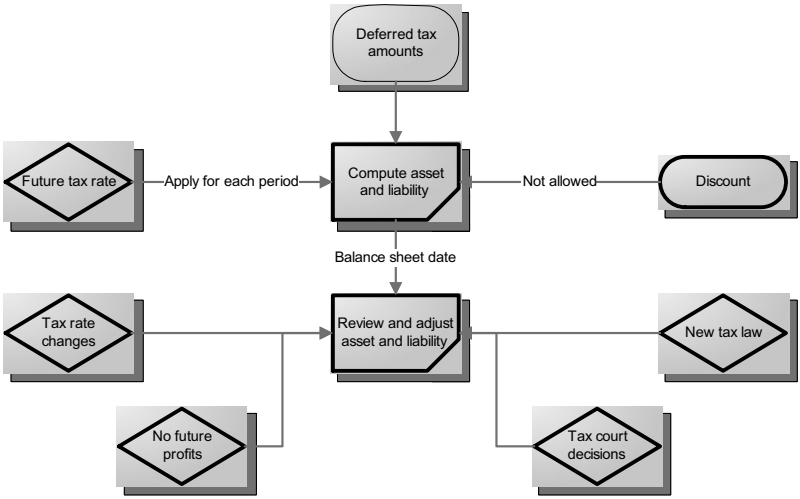


Table 30

The procedure for computing the gross deferred tax is quite simple:

1. All temporary differences existing are segregated into those that are taxable and those that are deductible.
2. Those deferred tax benefits which are not probable of being realised are not computed.
3. The tax effect of the aggregated taxable temporary differences are multiplied with the expected tax rates.

At each balance sheet date, the amounts are subject to review and new developments must be considered, for example:

1. The expectations of a deferred tax asset to be realised may have deteriorated because of negative economic developments. If this change in expectation occurs, the deferred tax asset will no longer be recorded.
2. Similarly, tax law may have changed and deductibility of certain depreciation may no longer be allowed.
3. Lower tax rates require a new computation of deferred tax.

These changes require new computations of deferred taxes with possible adjustments. Additional disclosure requirements of the effects of accounting changes made for tax purposes are included in the notes.

Because deferred tax computations are under review on each balance sheet date, a documentation of previously computed amounts should be kept available.

11.5 Applying Standard Audit Procedures

The standard audit procedures contain steps to introduce formal routine accounting and review procedures for deferred tax assets and liabilities, taking into account the different factors that may influence computation.

IAS 12 – Deferred Tax Assets and Liabilities

1. Prepare or obtain an analysis of current income taxes and related receivables, liabilities, and provisions, including (a) balance at the beginning of the period, (b) current-period provisions, (c) refunds received in the current period, (d) payments made in the current period including date, amount, and the year to which the payment relates, and (e) balance at the end of the period.

2. Calculate the deferred tax provision and related deferred tax asset or liability as follows:

   a. Identify the amounts and types of existing temporary differences and the nature and amount of each type of operating loss and tax credit carryforward and the remaining length of the carryforward period.

   b. Measure the total deferred tax liability for taxable temporary differences using the applicable tax rate.

   c. Measure the total deferred tax asset for deductible temporary differences and operating loss carryforwards using the applicable tax rate.

   d. Measure deferred tax assets for each type of tax credit carryforward.

   e. Reduce deferred tax assets by a valuation allowance if it is more likely than not that some or all of the deferred tax assets will not be realised. In determining the need for and calculating the amount of the valuation allowance, perform the following:

(1) Determine the amount of the deferred tax asset recognised on deductible temporary differences and operating loss and tax credit carryforwards. These are not offset by the deferred tax liability on taxable temporary differences.

(2) Assess the sources of future taxable income that may be available against which to recognise the deductible differences and carryforwards by considering the following:

i. Future reversals of existing temporary differences

ii. Taxable income in prior carryback years, if carryback is permitted under tax law

iii. Future taxable income exclusive of reversing differences and carryforwards

iv. Tax-planning strategies that would make income available at appropriate times in the future that would not be available otherwise

(3) Based on all available evidence, make a judgement concerning the realisability of the deferred tax asset.

(4) Record the amount of the valuation allowance or the amount of the change in the valuation allowance.

f. Determine the deferred tax provision or benefit by calculating the net change between the deferred tax liability or asset at the beginning of the period and the deferred tax liability or asset at the end of the period.

3. Document the following items regarding income tax accruals:

a. Significant elements of the analysis of tax contingencies or reserves, including roll-forward of material changes to such reserves.

b. The position and support for income-tax-related disclosures, such as its effective tax rate reconciliation, and support for its intraperiod allocation of income tax expense or benefit to continuing operations and to items other than continuing operations.

c. The basis for assessing deferred tax assets and related valuation allowances

d. If the support for the tax accrual or matters affecting it, including tax contingencies, is based on an opinion issued by an outside adviser, include (1) the actual advice or opinions rendered by an outside adviser or (2) other sufficient documentation or abstracts supporting both the transactions or facts addressed as well as the analysis and conclusions reached by the client and the adviser.

4. Document the following items when an analytical procedure is used as the principal substantive test:

a. The expectation, if not readily determinable from the documentation of the work performed, and the factors that were considered in developing the expectation.

b. Results of the comparison of the expectation to the recorded amounts or ratios developed from recorded amounts.

c. Any additional auditing procedures that were performed in response to significant unexpected differences arising from the analytical procedure and the results of such additional procedures.

5. Determine whether additional tax liabilities are due to any new jurisdictions in which the client conducts business.

6. Update permanent workpaper analyses for the composition of all deferred tax accounts, income tax liability accounts, and carryforwards.

7. Determine if provisions for income taxes and related liabilities, receivables, and deferrals are properly classified in the financial statements between current and non-current amounts and if disclosures are made in accordance with IS 12. Deferred tax assets and liabilities should not be classified as current.

Finally, IAS 12 requires that deferred tax assets and liabilities should never be included in the current category. The offsetting of tax assets and liabilities is generally not allowed in the balance sheet, except to the extent that they pertain to taxes levied by, and refund due from, the same taxing authority. Because due dates of amount owed and expected refund dates do not match, offsetting is almost never applied even when the same authority is the counterparty.

12. IAS 18 – Revenue Recognition

12.1. General

IAS 18 prescribes the accounting treatment for revenue arising from certain types of transactions and events. During an audit of financial statements, the revenue and expense section is regarded as an integrated component of the total audit process, because it is intertwined with other parts of the audit. The procedures interrelate with the different types of tests covered in the other audit programmes. During the audit and the transition process of the various balance sheet sections, it is necessary to gather evidence about the fair presentation of various income statement accounts. Recognition and measurement criteria of IAS statements covering balance sheet items also define amounts and additional reporting requirements for revenue recognition. Therefore, the transition programme for revenues focuses primarily on general procedures and should refer to other applicable transition programmes where appropriate[156].

The 4th EU Directive does not include a specific regulation concerning revenue recognition. This is also true for most national GAAP. Thus, accounting guidance of IAS 18 exceeded that of most national GAAP standards. One reason to introduce a standard for revenue recognition is that financial reporting irregularities that have come to light have largely evolved from improper revenue recognition in connection with aggressive accounting[157], that is recording profits as high as possible by selecting accounting treatments offering high profit recognition or developing accounting treatments in the event of missing accounting standards with a similar effect.

The so-called “New Economy”, with companies mainly doing business through e-commerce or the Internet, the new importance of barter transactions and product development becoming a bundle of goods, services and finance agreement, give rise to the question as to at what time and to what amount should revenues be included in the financial statements.

Existing accounting standards did not address these new economic developments immediately, leaving accounting of revenues more or less to the companies themselves, and allowing a wide range of revenue recognition and, in the case of aggressive accounting, pulling up revenues and postponing related expenses.

[156] Phillips,Th.J., Luehfling,M.S., Daily,C.M., “The Right Way to Recognize Revenue”, in JoA June 2001, pp. 39ff.
[157] Grant,C.T., Depree,Ch.M., Grant,G.H., “Earnings Management and the Abuse of Materiality”, in JoA, September 2000, pp. 41ff.

Standard setters have therefore concluded that more prescriptive guidance is needed, and the IASB started independently but later decided to work with the FASB as part of their joint convergence programme.

12.2. Decision Structure

IAS 18 applies to the accounting for revenue arising from:

- The sale of goods;
- The rendering of services; and
- The use by others, yielding interest, dividends and royalties.

The standard does not apply to revenue arising from lease agreements that are covered by IAS 17; dividends arising from investments in associates (IAS 28); insurance contracts within the scope of IFRS 4; changes in fair values of financial instruments (IAS 39); natural increases in herds, agriculture and forest products (IAS 41); changes in the value of other current assets.

The decision structure of IAS 18 is shown in the following table 31:

IAS 18 – Revenue Recognition

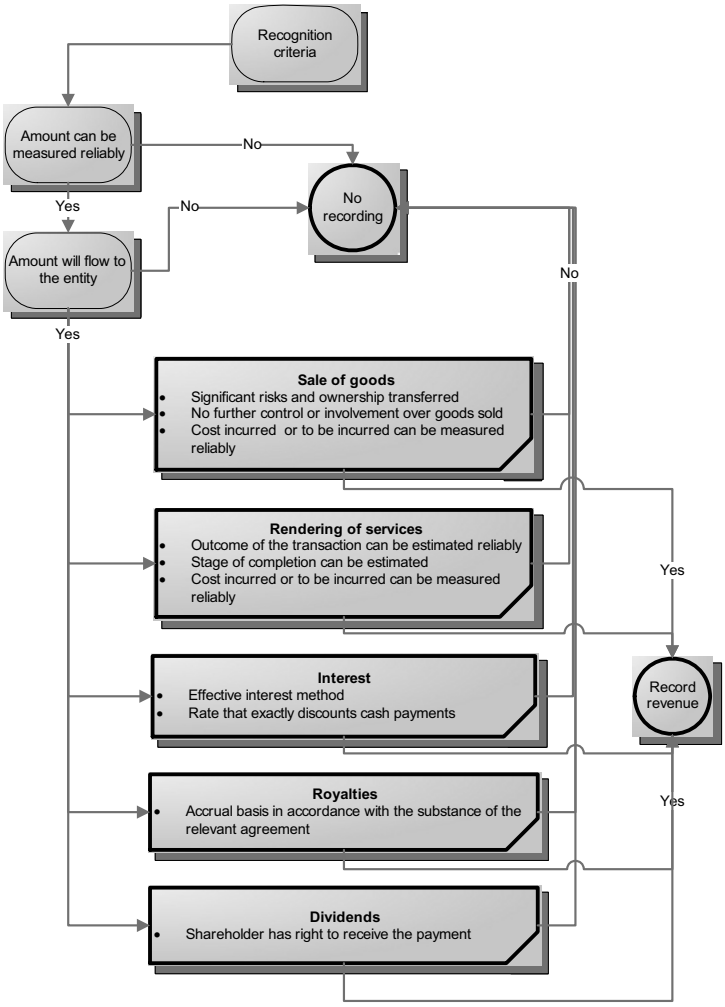


Table 31

12.3. Recognition Criteria of Revenue

IAS 18 establishes two general criteria for recognition of revenue:

1. It must be possible to measure revenues reliably.
2. The amounts must flow to the entity (and not to third parties).

The standard prescribes certain additional criteria for five specific cases which clearly describe the accounting treatments.

In the case of complex sales agreements, the standard clarifies that these should be applied separately to each transaction. In other words, the recognition criteria should be applied to the separately identifiable components of a single transaction consistent with the principle of “substance over form.”

> For example: A software company offers a software programme for a fixed price of 100 euro and the sale includes the delivery of a future software update without additional payment. Part of the fixed sales price is for the future development and delivery of the update programme.
> Solution: According to IAS 18, the additional cost of developing the update has to be measured and part of the sales price should be treated as advanced payment.
>
> Another example is the sale of cars including full service and financing agreement without interest payments.
> The monthly payments have to be divided into three components:
> 1. Sale of the car,
> 2. Warranty and service agreement and
> 3. Financing agreement.

The main challenge of the transition process is to identify specific revenue recognition problem areas and introduce accounting treatments according to IAS 18.

13. IAS 8 – Accounting Policies, Changes in Accounting Estimates and Errors

13.1. General

IAS 8 establishes accounting guidance for three different areas:

- Selecting accounting policies and changes in accounting policies
- Changes in accounting estimates
- Correction of errors

The common link between the three areas is the importance of the accounting principle of comparability and consistency in financial reporting. Comparability among financial statements is necessary to facilitate informed economic decision making by users of financial statements and is one of the key qualitative characteristics of financial statements identified in the IABS's Framework as well as in US GAAP Statements of Financial Reporting Concepts[158]. Changes in accounting policies need to be disclosed too and comparable financial information has to be given in order to secure the information needs of financial statement users[159].

Consistent application enhances the utility of financial statements to users by facilitating analysis and the understanding of comparative accounting data and includes the consistent presentation and classification of items in the financial statements from one period to the next.

Consistent application of accounting policies can become inappropriate for an entity if the policies adopted lack qualitative characteristics of relevance and reliability. If more reliable and relevant accounting policy alternatives exist, a change of accounting methods are adequate accompanied by disclosure of the nature of the change and of its effects.

Effects on comparability may also be the result of changes in estimates or the correction of errors and consequently, both are integrated in IAS 8.

13.2. Decision Structure

The following table 32 illustrates the decision structure of IAS 8:

[158] Watts,R.L., Zimmerman,J.L., "Positive Accounting Theory: A Ten-Year Perspective", in The Accounting Review, January 1990.
[159] Morris,J.L., "The Change Game", in JoA December 2005, pp. 67ff.

IAS 8 – Accounting Policies

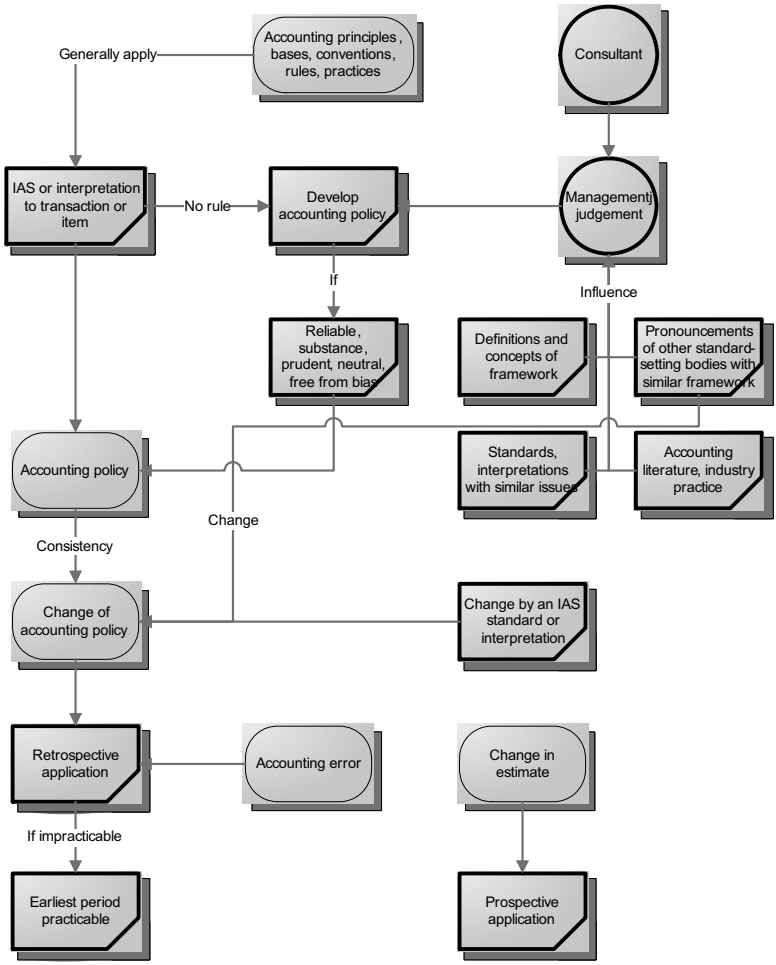


Table 32

13.2.1. Defining Accounting Policies

According to IAS 8, if an IFRS standard, or an interpretation of a standard applies to an item in the financial statements, the standard defines the accounting policy. When there is no accounting guidance in any standard or interpretation, management must use its judgement in developing and applying an accounting policy. The resulting accounting

policy should be neutral, prudent and complete in all material respects[160].

In making this judgement, management must give consideration to different sources:

- The definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses set out in the Framework;
- The requirements and guidance in standards and in interpretations dealing with similar and related issues, and appendices and implementation guidance issued in respect of those standards,
- Pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards (US GAAP concepts and framework is similar to that of IFRS, many IFRS statements are based on former US GAAP FAS),
- Other accounting literature (e.g. textbooks, handbooks, scholarly articles), and accepted industry practices, to the extent that these are consistent with the promulgated standards and interpretations cited above (one source for accepted industry standards is the FASB publication “Accounting Trends & Techniques”. Although US-GAAP-based, the annual survey of accounting practices followed in 600 stockholders' reports gives an overview of applied accounting policies).

A change in an accounting policy is generally permitted if the change is required by a standard or an interpretation, or the change in accounting principle will result in a more relevant and reliable presentation of events or transactions in the financial statements of the entity.

13.2.2. Use of Estimates

Estimates about future conditions are necessary to determine values for a variety of balance sheet items, for example estimate of the useful life of property, plant and equipment, possible residual values, collectibility of accounts receivable, probabilities of provisions to distinguish between a recording of a provision or reporting a contingent liability and so on. These future conditions may change or new and better information may become available and may indicate that formerly applied estimates should be corrected.

IAS 8 requires that changes in estimates are recorded currently and prospectively. No retrospective adjustment of financial statements is required, if it is difficult to distinguish

[160] Dhaliwal,D.S., “The Effect of the Firm's Capital Structure on the Choice of Accounting Methods”, in The Accounting Review January 1980.

between changes in accounting policy and changes in accounting estimates.

13.2.3. Accounting Errors

US GAAP standard APB 20 concludes that a change in accounting estimate that is in essence affected by a change in accounting principle should be reported as a change in accounting estimate. IAS standards do not contain guidance on this situation.

Especially in the situation of a transition from local GAAP to IAS, first-time estimates might be subject to correction in later accounting periods. Additionally, a general higher risk of possible errors exists in first-time adoption cases[161]. In the event of an accounting error, only a prior period adjustment is permitted, that means a restatement of financial statements as they would have been, had the error never taken place.

If it is impracticable to correct an error retrospectively, the opening balance of retained earnings for the next period must be restated for the cumulative effect of the error before the beginning of that period.

The 4th EU Directive does not contain similar accounting regulations. The true and fair view principle stipulates that where the application of the provisions of the Directive would not be sufficient to give a true and fair view, additional information must be given. Where in exceptional cases the application of a provision of the Directive is incompatible with the obligation of a true and fair view, that provision must be departed from in order to give a true and fair view. Any such departure must be disclosed in the notes on the accounts together with an explanation of the reasons for it and a statement of its effect on the assets, liabilities, financial position and profit or loss.

A departure from an accounting provision could be seen as a change in accounting policies, but according to the 4th EU Directive it would be possible to deviate from existing accounting provisions in cases where appropriate. The 4th EU Directive does not need additional guidance concerning possible departures because the concept of the 4th EU Directive itself contains the possibility of different accounting treatments according to national accounting law and traditions.

[161] DeFord,M.L., Jiambalvo,J., “Incidence and Circumstances of Accounting Errors”, in The Accounting Review, July 1991.

Summary and Conclusion

The concept of the 4th EU Directive as a common basis for all national GAAP within the European Union has preserved national accounting traditions. The Directive is a compromise between Anglo-Saxon and Continental European accounting traditions and with the introduction of International Accounting Standards, a shift to the Anglo-Saxon accounting tradition takes place, with the result that national GAAP with Continental European accounting traditions will probably face more problems during a transition process than those national GAAP with an Anglo-Saxon background.

Statutory audit procedures include a number of standard audit tests which simultaneously address accounting problems during a transition process and it has been demonstrated that for all IFRS Level I statements standard audit procedures are available. This allows an integrated approach of a transition and an audit process. The application of audit theory facilitates the transition process. It is not necessary to develop a new transition theory.

Although IFRS statements show a more heterogeneous structure and sometimes include confusing wording and definitions, it has been possible to develop decision structures for all IFRS statements under review and, furthermore, structure complex accounting requirements, for example fair value methods. These decision structures in connection with standard audit procedures are able to serve as a model for developing software routine procedures allowing an integration into existing audit software programmes. This streamlined process, compared to a manual transition process, will reduce the cost of any transition process and is a condition for supporting the efforts of the group of small and medium-sized companies in a transition process.

With the growing importance of International Accounting Standards for SMEs the need for software-based solutions will increase and the results of this work offer software programmers, who are not usually experts in financial reporting, an opportunity to develop programme routines according to the elaborated decision structures. It has been demonstrated that an integration of the presented research results from the standpoint of financial reporting with the needs of software programming is possible and a technical solution suitable for companies within the European Union seems to be a logical consequence.

Bibliography

AICPA Control Risk Audit Guide Task Force, “Audit Guide: Consideration of the Internal Control Structure in a Financial Statement Audit”, New York 1990.

Alexander,D., “A European True and Fair View”, in European Accounting Review 1993, pp. 59-80.

Alexander,E.R., Hiner,R.R., “Accounting for Asset Retirement Obligations”, in JoA December 2001, pp. 49ff.

American Accounting Association, A Statement of Basic Accounting Theory, Evanston, 1966

American Accounting Association, “Report of the American Accounting Association Committee on International Accounting Operations and Education 1975-1976”, Accounting Review, No. 52, 1977, p. 65-101.

Andriessen,D., “Making Sense of Intellectual Property”, Amsterdam 2004.

Auditing Practices Board: “The audit of small businesses”, London 1996.

Beck,M., “Bilanzierung von Investment Properties nach IAS 40”, Kostenrechnung 2004, pp. 498ff.

Bhamornsiri,S., “Losses from Construction Contracts”, in JoA April 1982 pp. 26ff.

Blodinger,A., “Intangible assets in Germany and Great Britain”, Frankfurt 1998.

Bohan,M.P., Rubin,S., “LIFO/FIFO: How Would It Work?”, in JoA September 1986, pp.106ff.

Bräunig,K., “IFRS für den Mittelstand?”, in Die Wirtschaftsprüfung, No. 3 2007, pp. 114ff.

Brock,H.R., “Cost Accounting: Principles and Applications”, 5th ed. 1989.

Burlaud,A., Messina,M., Walton,P.J., “Depreciation: Concepts and practices in France and the UK”, in European Accounting Review, London 1996 pp. 299ff.

Carter,W.K., “Job Order Cost Accounting Practice Case: Printwrite Inc.”, 1998.

Cearns, K., “Impairment of Assets”, in Accountancy February 1999 pp. 94ff.

Chastney,J.G., “True and Fair View”, Research Committee of the ICAEW, London 1975.

Choi,F.D.S., Mueller,G.G. “International Accounting”, 2nd ed. New Jersey 1992, pp. 32.ff.

Choi,F.D.S., Levich,R.M., “International Capital Markets in a World of Accounting Differences“, New York 1994.

Cocco,A., Ivancevich,D.M., Vent,G., “FASB 106's deferred tax implications” in JoA October 1994, pp. 89 ff.

Cosserat,G.W., “Modern Auditing”, Chichester 2000.

Craner,J., Krzywda,D., Novotny,J., Schroeder,M., “The determination of a group for accounting purposes in the UK, Poland, and the Czech Republic in a supranational context”, in International Journal of Accounting, London 2000, pp. 335ff.

Da Costa,R.C., Bourgois,J.C., Lawson,W.M., “A classification of international financial accounting practices”, in International Journal of Accounting, Spring 1978.

Damodaran, A., “Investment Valuation”, 2nd Ed. New York 2002.

D´Arcy, “Accounting classification and the international harmonization debate – an empirical investigation”, in Accounting, Organizations and Soc, Vol. 26, 2001.

D'Arcy,A., Mori,M., Roßbach,Ch., “The impact of valuation rules for intangible assets in Japanese and German accounts of listed companies”, in Finance and Accounting No. 107, Frankfurt 2003, pp. 32. ff.

DeFord,M.L., Jiambalvo,J., “Incidence and Circumstances of Accounting Errors”, in The Accounting Review, July 1991.

Derwent,R., “Accounting for deferred tax”, in Accountancy, August 1992 pp. 73ff.

Dhaliwal,D.S., “The Effect of the Firm's Capital Structure on the Choice of Accounting Methods”, in The Accounting Review January 1980.

Donohue,J., Vallario,C.W., “A new Scorecard for Intellectual Property”, in JoA, April 2002, pp. 75ff.

Doubnik,T.S., Salter,S.B., “An empirical test of a judgemental international classification of financial reporting practices”, in Journal of International Business Studies, No. 1, 1993.

Doubnik,T.S., Salter,S.B., “External environment, culture and accounting practice: a preliminary test of a general model of international accounting development”, in International Journal of Accounting, Vol. 30 No. 3, 1995.

DuLaney,W., “Capitalizing Software and Creating Business Value”, in JoA, July 2000, pp. 33ff.

Dutta,S.K., Graham,L.E., “Considering Multiple Materialities for Account Combinations in Audit Planning and Evaluation: A Cost Efficient Approach”, in Journal of Accounting, Auditing and Finance Vol. 13 No. 2 Spring 1989, pp. 151ff.

Eberhartinger,E., “The Impact of Tax Rules on Financial Reporting in Germany, France and the UK”, in: The International Journal of Accounting, Vol. 34, No. 1, pp. 93-119,1999.

Ellis,J., “Accounting for Leases”, 2006.

Engelmann,B., Rauhmeier,R., “The Basel II Risk Parameters”, Berlin 2006.

Epstein,B.J., Nach,R., Bragg,S.M., “GAAP 2006”, New York 2006, pp. 27ff.

European Central Bank, “Foreign Direct Investment and International Business Cycle Comovement”, Working Paper Series No. 40, October 2004.

European Commission, 4th EU Directive officially released on 18.8.1978, suppl.L222.

European Commission, 4th EU Directive, preliminary draft, EU Document 2800/IV/2/68-D, 9.3.1968.

European Commission, 4th EU Directive, draft 16.11.1971, EU Bulletin suppl. C7 28.1.1972.

European Commission, 4th EU Directive, draft 26.2.1974, EU Bulletin suppl. 6/74

Evans,Th.G., Taylor,M.E., Rolfe,R.J., “International Accounting and Reporting”, 3rd ed. Houston 1999.

FASB, “The IASC-US Comparison Project”, Norwalk 1996.

FASB, “Project Update, Fair Value Measurement”, August 18, 2006.

Fédération des Experts Comptables Europeéns, “Statutory Audit in Europe” Brussels 1998.

Flint,D., “The Philosophy and Principles of Auditing”, Macmillan Education, 1988.

Flower,J., “Introduction-The EU's role in financial reporting”, in: J.Flower, Ch.Lefebvre (eds.) Comparative Studies in Accounting Regulation in Europe, Leuven, p. 21f.

Frank,W.G., “An empirical analysis of international accounting principles”, in Journal of Accounting Research, Autumn 1979.

Frieß,R., “Fair-Value-Ermittlung von Investment Properties mit Hilfe des Ertragswertverfahrens nach WertV?”, in Deutsches Steuerrecht 2004, pp. 2025ff.

Frydlender,A., Pham,D., “Relationship between accounting and taxation in France”, in: European Accounting Review 1996, p. 845ff.

Galbraith,J.K., “A Journey Through Economic Time”, 1994.

Gélard,G. “Comparative financial statements – United Kingdom, Germany, France”, KPMG ed. 1999.

Georgiades,G., “Miller Audit Procedures 2006, Chicago 2005.

Giot,H., “Règles comptables francaises et référentiels IASC et FASB: différences et convergences”, in: Revue francaise de comptabilité 1997,Oct., pp. 45ff.

Givoly,D., Hayn,C., “The Valuation of the Deferred Tax Liability: Evidence from the Stock Market”, in The Accounting Review April 1982.

Grant,C., “Changes in university-level accounting education in Poland”, in European Accounting Review, 1992, pp. 407-412.

Grant,C.T., Depree,Ch.M., Grant,G.H., “Earnings Management and the Abuse of Materiality”, in JoA, September 2000, pp. 41ff.

Gray,S.J. “Towards a Theory of Cultural Influence on the Development of Accounting Systems Internationally” Abbacus, 24 No. 1, 1988.

Green,J.W., “Section 404 for Small Caps”, in JoA March 2006, pp. 67ff.

Gross,G., Schruff,L., “Der Jahresabschluß nach neuem Recht”, 2nd ed. Düsseldorf 1986.

Grovind,H., ”Tax treatment of intangible assets”, in Interntax, Deventer 1995 pp. 21ff.

Hadnot,B.L., “Audit Evidence – What Kind and How Much?”, in CPA Journal, October 1979, pp. 23ff.

Hartmut,H., “Europäisches Bilanzrecht in Frankreich”, in: Internationales Steuerrecht 1997, pp. 697ff.

Hawthorne,W.H., Herring,H.C., “A Quantitative Approach to the Illustration of the Percentage-Of-Completion Method”, in The Accounting Review, July 1975 pp. 615-616.

Hellier,C., Lyon,R., Monroe, G.S., Ng,J., Woodliffe,D.R., “UK Auditors Perceptions of Inherent Risk”, in British Accounting Review, March 1996, pp. 45ff.

Herrmann,D., Saudagaran,S.M., Thomas,W.B., “The Quality of Fair Value Measures for Property, Plant and Equipment”,2005.

Hickok,R.S., “New Guidance for Construction Contractors: A Credit Plus”, in JoA March 1982 pp. 46ff.

Hoegh-Krohn,N.E., Knivsfla,K.H., “Accounting for intangible assets in Scandinavia, the UK, the US, and by the IASC”, in International Journal of Accounting, London 2000, pp. 243ff.

Hofstede,G., “Culture’s Consequences: International Differences in Work-Related Values”, Beverly Hills 1980.

Horau,Ch., “International accounting harmonization: American hegemony or mutual recognition with benchmarks?”, in: European Accounting Review 1995, pp. 217ff.

IASB, “Preliminary View on Accounting Standards for Small and Medium-Sized Entities”, Discussion Paper, London 2004.

IASB, Staff Draft: “International Financial Reporting Standard for Small and Medium-Sized Entities”, London 2006.

Imhoff,E.A., Lipe,R.C., Wright,D.W., “Operating Leases: Impact of Constructive Capitalization”, in Accounting Horizon March 1991.

Jacobs, O.H., Spengel,Ch., “The financing and taxation of corporations – a comparing analysis for the EC-member countries Germany, France and Great Britain”, in Intertax 1993, pp. 4ff.

Jaruda,A., Szychta,A., “The origin and evolution of charts of accounts in Poland”, in European Accounting Review, London 1997, pp. 509ff.

Jaruga,A., “Changing rules of accounting in Poland”, in European Accounting Review, 1993, pp. 115-126.

Jaruga,A., Walinska,E., Baniewicz,A., “The relationship between accounting and taxation in Poland”, in European Accounting Review 1996, pp. 883-897.

Kern,A., Dhumale,R., Eatwell,J., “Global Governance of Financial Systems: The International Regulation of Systematic Risk”, New York 2005.

Kieso,D.E., Weygandt,J.J., Warfield,T.D., “Intermediate Accounting”, 10th ed. New York 2001.

Krzywda,D., Bailey,D., Schroeder,M., “A theory of European accounting development applied to accounting change in contemporary Poland”, in European Accounting Review, 1995, pp. 625-657.

Lamb,M., “The relationship between accounting and taxation: The United Kingdom”, in: European Accounting Review 1996, pp. 937-948.

La Porta,R., Lopez-de-Salines, Shleifer,A., Vishny, R.W., “Law and Finance”, in Journal of Political Economy 106, No. 6, 1998, pp. 1142-1143.

Leffson,U. “Die grundsätze ordnungsmässiger Buchführung”, Düsseldorf 1964.

Lennard,A., “Liabilities and how to account for them”, in Accountancy January 2003, pp. 90ff.

Leslie,D.A., “Materiality, the Concept and its Application to Auditing”, Canadian Institute of Chartered Accountants, Toronto 1985.

Lévy-Bruhl,H., “Histoire juridique des sociétés de commmerce en France aux 17ème et 18ème siècles”, Paris 1938.

Lindow,P.E., Race,J.D., “Beyond Traditional Audit Techniques”, in JoA July 2002, pp. 28ff.

Lopez Combarros,J.L., “Accounting and financial audit harmonization in the European Union”, in European Accounting Review, London 2000, pp. 643ff.

Loth,R., “Evaluating a Company's Capital Structure”, in Investopedia, October 2006.

Marchant, G., “Analogical Reasoning and Hypothesis Generation in Auditing”, in Accounting Review, July 1989, pp. 500ff.

McGregor,W., “Accounting for Leases: A New Approach”, Special Report, FASB 1996.

Meeting,D.T., Luecke,R.W., “Asset Impairment and Disposal”, in JoA, March 2002, pp. 49ff.

Meeting,D.T., Luecke,R.W., Garceau,L., “Future Cash Flow Measurements”, in JoA October 2001, pp. 57ff.

Menelaides,S.L., Graham,L.E., Fischbach,G., “The Auditor's Approach to Fair Value”, in JoA, June 2003, pp. 73ff.

Mikol,A., “The history of financial reporting in France”, in: P.Walton (ed.), “European Financial Reporting”, San Diego 1995, pp. 91ff.

Miller,G.S., Skinner,D.J., “Determinants of the Valuation Allowance for Deferred Tax Assets under SFAS No. 109”, in The Accounting Review April 1998.

Moeckel,C.L., Plumlee,R.D., “Auditors’ Confidence in Recognition of Audit Evidence”, in Accounting Review October 1989, pp. 653ff.

Mueller,G.G., “Accounting Principles Generally Accepted in the United States versus Those Generally Accepted Elsewhere”, International Journal of Accounting, Spring 1968, pp. 91-103.

Mueller,J.M., “Amortization of Certain Intangible Assets”, in: JoA, December 2004, pp. 74ff.

Morris,J.L., “The Change Game”, in JoA December 2005, pp. 67ff.

Nailor,H., Lennard, A., “Capital Leases: Implementation of a New Approach”, in Financial Accounting Series No. 206A, FASB 2000.

Nair,R.D., Frank,W.G., “The impact of disclosure and measurement practices on international accounting classifications”, in Accounting Review, July 1980.

Napier,Ch., “The history of financial reporting in the United Kingdom” in: P.Walton (ed.) “European Financial Reporting”, San Diego, 1995, pp. 259ff.

Nobes,C.W., “An empirical analysis of international accounting principles: a comment”, in Journal of Accounting Research, Spring 1981.

Nobes,C.W., “A judgemental international classification of financial reporting practices”, in Journal of Business Finance and Accounting, Spring 1983.

Nobes, Ch., Parker,R., “Comparative International Accounting”, 9th ed., Essex 2006.

Norby,W.C., “Accounting for Financial Analysis”, in Financial Analysts Journal, March-April 1982, p. 22.

OECD “Economic Survey", Paris, 2000, p. 23 and A. Aslund, “Building Capitalism. The Transformation of the former Soviet Bloc”, Cambridge 2002.

Ordelheide, D., and KPMG, “Transnational Accounting”, London 1995.

O`Reilly,V.M., McDonnell,P.J., Winograd,B.N., Gerson,J.S., Jaenicke,H.R., "Montgomery's Auditing" 12th ed., New York 1998.

O'Sullivan,A., Sheffrin,S.M., "Economics, Principles & Tools", 2003.

Pacter,P., "International Financial Reporting Standards", in: F.D.S.Choi (ed.), International Finance and Accounting Handbook, 3rd ed. New Jersey 2003, p. 16.1f.

Pany,K., Wheeler, S., "A Comparison of Various Materiality Rules of Thumb", in The CPA Journal, June 1989, pp. 62ff.

Paul,J., "International review of Accounting Standards specifying a recoverable amount test for long-lived assets",1997 no location.

Peavey,D.E., Nurnberg,H., "FASB 109: Auditing considerations of deferred tax assets", in JoA May 1993, pp. 77ff.

Petree,Th.R., Gregor,G.J., R.Vitray,J., "Evaluating deferred tax assets", in JoA March 1995, pp. 71ff.

Phillips,Th.J., Luehfling, M.S.,Daily,C.M., "The Right Way to Recognize Revenue", in JoA June 2001, pp. 39ff.

Pomeranz,F., "The successful audit", Homewood 1992.

Porcano,Th.M., Tran,A.V., "Relationship of Tax and Financial Accounting Rules in Anglo-Saxon Countries", in: The International Journal of Accounting, Vol. 33, No. 4, pp. 433-454, 1998.

Powell,S., "Accounting for intangible assets: current requirements, key players and future directions", in European Accounting Review, London 2003, pp. 797ff.

Price Waterhouse, "Accounting Principles and Reporting Practices: A survey in 38 countries", London 1973.

PricewaterhouseCoopers ed.,"IAS,US GAAP and UK GAAP – Similarities and Differences", London 1998.

Quadackers, L.M., "Audit Risk and Audit Programmes: Archival Evidence from Four Dutch Audit Firms", in The European Accounting Review 1996, pp. 217ff.

Radebaugh,L.H., Gray,S.J.M, "International Accounting and Multinational Enterprises", 3rd ed. New York 1993.

Riahi-Belkaoui,A., "Long-Term Leasing: Accounting, Evaluation, Consequences", 1998.

Samuels,J.M., Brayshaw,R.E., Cramer,J.M., "Financial Statement Analysis in Europe", London 1995.

Saunders,G.D., Munter,P., "The Search for Unrecorded Liabilities – The Implications of Maislin", in The CPA Journal, February 1991, pp. 48ff.

Savary,J., "Le parfait négociant ou Insruction générale pour ce qui regarde le commerce de toute sorte de Marchandise, tant de France, que de Pay Etrangers", 1st ed. Livre 1, Paris, Reprint 1993, Düsseldorf.

Savich, R.S., "Cherry-Picking Sarbanes-Oxley", in JoA, June 2006, pp. 71ff.

Schmalenbach,E., "Dynamische Bilanz", Cologne 1962.

Schneider,D., “The history of financial reporting in Germany”, in: P.Walton (ed.) European Financial Reporting, San Diego 1995, pp. 123ff.

Schneider,D., “Die Anfänge der Steuerbilanz und die Entstehung des Massgeblichkeitsprinzips”, in: N.Herzig (ed.) Betriebswirtschaftliche Steuerlehre und Steuerberatung, Wiesbaden 1991, pp. 175-190.

Singer,H.W. “Standardized Accountancy in Germany”, Cambridge 1944.

Sokolov,Y.V., Kovalev,V.V., Bychiva,S.M., Smirnova,I.A., “Russian Federation”, in Alexander and Archer, European Accounting Guide, Apsen, New York, pp. 1642-84, 2001.

Taylor,D.H., Glezen,G.W., “Auditing: An Assertion Approach” 7th ed. New York 1997.

Tigue,J.R., “Standard & Poor's Guide to Long Term Investing”, New York 2003.

Titard,P.L., Pariser,D.B., “Impaired Assets: Meeting Users' Information Needs”, in JoA, December 1997, pp. 55ff.

Toffler, B.L., “Final Accounting – The Fall of Arthur Andersen” , New York 2003.

Trombetta,M., “International regulation of audit quality: full harmonization or mutual recognition”, in European Accounting Review, London 2003 pp. 3ff.

United Nations Conference of Trade and Development, “Accounting and Financial Reporting for Environmental Costs and Liabilities”, New York 1999.

United States Securities and Exchange Commission, “Survey of Financial Statement Reconciliations by Foreign Registrants”, Washington D.C., 1993.

Wagner,A., “Beiträge zur Lehre von den Banken”, Leipzig 1857.

Walton,P.J., “The True and Fair View: A Shifting Concept”, Occasional Research Paper No. 7, ACCA 1991.

Walton,P.J. “Introduction: the true and fair view in British accounting”, in European Accounting Review 1993, pp. 48-58.

Walton,P.J., “European Harmonization”, in F.Choi, International Finance and Accounting Handbook, 3rd ed. New Jersey 2003, pp. 17.1ff.

Watts,R.L., Zimmerman, J.L., “Positive Accounting Theory: A Ten-Year Perspective”, in The Accounting Review, January 1990.

Weirich,Th,R., Avery,C.G. and Anderson,H.R., “International Accounting: Varying Definitions”, International Journal of Accounting, autumn 1971, pp. 80ff.

Wheldon,H.J., Brown,J.L., Owler,L.W.J., “Wheldon's Cost Accounting and Costing Methods”, 1978.

Whittington,R., Zulinski,M., Ledwith,J.W., “Completeness – The Elusive Assertion”, in JoA August 1983, pp. 89ff.

Wilmowski,B., “Kommentar zum Preussischen Einkommensteuergesetz vom 24.Juni 1891”, Breslau 1891.

Yardley,J., “Explaining the Conditional Nature of the Audit Risk Model”, in Journal of Accounting, Vol. 7 1989, pp. 107ff.