THE IMPACT OF THE EURO ON EUROPEAN ACCOUNTING HARMONIZATION

by

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Financial reporting standards among European Union (EU) countries vary significantly. As a result, in order for European companies to solicit capital from a source outside their domestic market, they have to produce financial statements in accordance with the financial reporting standards of another country. Not only is the production of financial statements costly, but when a single company issues several versions of financial statements, international investors feel a great deal of confusion. The movement to eliminate this problem is known as accounting harmonization.

The question now facing Europe is how the movement to a single currency will impact the financial reporting harmonization movement.

This paper, through an analysis of four obstacles to financial reporting harmonization in Europe, identifies the areas of the movement which stand to be affected by a single currency, and allows a reader to see how a single currency will help to accelerate the harmonization of financial reporting.

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I. Introduction

Financial reporting standards among European Union (EU) countries (Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom) are as varied as the environments from which they evolve. Some EU nations, such as the United Kingdom and the Netherlands, require much more disclosure of financial information from companies than countries such as Portugal and Greece. As a result, in order for European companies to solicit capital from a source outside their domestic market, they have to produce financial statements in accordance with the financial reporting standards of another country. Not only is the production of financial statements costly, but when a single company issues several versions of financial statements, international investors feel a great deal of confusion. These costs and confusions have historically hampered the movement of capital in European nations as evidenced by the ongoing reliance on bank financing versus a development of capital markets (Mellyn, 1999). The effort to bring international financial reporting standards into a state of comparability, known as accounting harmonization, should eliminate the confusion and the costs of producing multiple financial statements.

Leaders of the EU saw the above situation as a threat to their goal of the free flow of capital, goods, people, and services. In an effort to reduce the differences in reporting standards for EU member nations, the 4th and 7th Directives were enacted. These Directives are more fully discussed in Section II but they did not result in European financial reporting being much closer to a state of comparability than the nations had been previously.

The International Accounting Standards Committee (IASC) is also actively involved in the financial reporting harmonization effort in Europe. They have issued a set of International Accounting Standards (IAS) which are currently being reviewed by the International Organization of Securities Commissions and Similar Organizations (IOSCO) for endorsement. More and more companies are opting to produce statements in accordance with IAS, but they are not yet accepted as the only potential set of international standards.

Several reasons exist for the differences in financial reporting and much has been written and conjectured on those issues (Radebaugh and Gray 1993, Nobes 1998). Environmental factors such as financing systems, culture, taxation, and legal and political systems affect the development of nations' financial reporting standards.

The question now facing Europe is how the movement to a single currency will impact the financial reporting harmonization movement. The Economic and Monetary Union (EMU) is the result of an agreement between eleven of the fifteen EU member nations to unite under a single currency to be called the Euro. Slated to have profound impacts on all levels of business enterprise (PricewaterhouseCoopers 1998), the Euro should result in more fluid capital markets as well as lower costs of capital.

This paper, through an analysis of four obstacles to financial reporting harmonization in Europe, identifies the areas of the movement which stand to be affected by a single currency. The paper demonstrates where these two issues overlap, and allows the reader to see how a single currency may help to accelerate the harmonization of financial reporting. The discussion centers on those nations participating in the EMU but also addresses the four nations not currently participating.

Obstacles to financial reporting harmonization in Europe have been identified by authors such as Nobes and Parker (1998) and by members of the International Accounting Standards Committee (IASC) such as Peter Clark. From an analysis of the available literature, this author has determined the obstacles most pertinent to achieving financial reporting harmonization in the European Union to be:

- The difference in relative importance of sources of finance.
- The different institutional arrangements for national standard-setting.
- The perception that financial reporting harmonization is not important.
- The fear of a loss of sovereignty and a resistance to change on the part of individuals, groups, and entire nations.

The first section of this paper describes and defines the harmonization movement in Europe. The second section outlines the movement to a single currency providing timelines and definitions necessary for an understanding of what the EMU is intended to achieve. The third section examines and analyzes each of the four identified obstacles in light of the Euro and explains how each might be affected as a result of a single currency. The fifth section describes the benefits derived for non-EMU participating nations. The final section summarizes the ideas presented and provides conclusions regarding the future of accounting harmonization in Europe.

II. Accounting Harmonization

The greatest potential for influence between the single currency in Europe and the harmonization movement lies in the obstacles still facing harmonization. The impediments to harmonization may be explained and evaluated by examining why differences among financial reporting standards exist. This section identifies the major reasons international financial reporting standards differ and reports the history of the accounting harmonization movement.

Accounting Harmonization - A definition

Accounting has come to be known as the language of business. In the same way that spoken languages of the world vary from nation to nation, the language of accounting differs by nation as well. The effectiveness of communication via spoken language is usually uninhibited within a nation's boundaries, but can become ineffective when individuals from different nations express their ideas to one another without the aid of an interpreter. The same is true of accounting.

The problem, as stated by Choi and Levich (1990), "to put the matter succinctly, is that when the accounting measures for two firms are presented to a reader, can the reader determine whether observed differences are the result of (*a*) accounting measurement differences, (*b*) economic, cultural, and institutional differences across countries, or (*c*) real differences in the attributes being measured? In practice, this difficult problem is compounded by the fact that certain accounting data are not disclosed in some countries. And even where disclosures are similar, differences in auditing standards or practices may affect the reader's confidence in reported figures." (Choi & Levich, 1990, p. 8).

Philips, an electronics company located in the Netherlands produces annual financial statements in accordance with Dutch Generally Accepted Accounting Principles (Dutch GAAP). They also produce a reconciling report to translate their national figures into United States Generally Accepted Accounting Principles (US GAAP) in order to gain access to American capital markets.

In this example, an investor in the Netherlands with access only to the Dutch GAAP financial statements and an investor in the United States with access to the US GAAP statements, could trade shares of Philips at the same moment in time, and base their investing decisions on two very different 1997 net income figures as shown in the following table:

Table 1

Dutch GAAP versus US GAAP

Location of Investor	*Net Income*	*Shareholders' Equity*
Netherlands	5,733	19,457
The United States	5,881	20,735

In millions of Dutch guilders

The reasons for these differences include the treatment of goodwill, the treatment of pension plans, and the treatment of subsidiaries, as well as several others.

If both investors were comparing Philips and Finland-based Valmet as investment opportunities, the situation would become even more clouded. Valmet's consolidated financial statements are in accordance with Finnish GAAP (Valmet, 1998). They too produce a reconciling report to translate their national figures in accordance with US GAAP. Investors even within Europe have access to different sets of figures. A comparison of figures reported by Philips and Valmet are presented below. It is also important to note that investors would be comparing Dutch guilders to Finnish markka. The conversion rates an individual investor chooses to use to make comparisons will also have a significant impact on their evaluation of the companies. Dutch GAAP figures are compared to Finnish GAAP figures for 1997 as shown in Table 2.

Table 2

Dutch GAAP versus Finnish GAAP

Company	*Net Income*	*Shareholder's Equity*
Philips	5,733	19,457
Valmet	863	3893

In millions of Dutch guildes and Finnish markka

Determining how much of these differences are attributable to variances in accounting measurement, how much is attributable to currency fluctuations, and how much can be attributed to real differences in economic financial position is nearly impossible.

The benefit of a common standard set can be seen by comparing these two companies in Euros on the basis of US GAAP as in Table 3.

Table 3

US GAAP versus US GAAP

Company	*Net Income*	*Shareholder's Equity*
Philips	2601.5	8829.2
Valmet	145.2	654.8

In millions of Euro

The differences in figures in this table can be relied upon to give a more meaningful evaluation of how these companies compare. Differences are no longer masked by accounting principle variations or by currency translation issues.

A word of caution is still necessary however. Though International Accounting Standards (IAS), as developed by the International Accounting Standards Committee (IASC), have done much to improve comparability, there are still several different acceptable treatments available to companies which have the potential of rendering statements incomparable when IAS are used as the common set of standards. One such area is the measurement of property, plant, and equipment addressed by IAS 16. The standard allows companies to either measure property, plant and equipment at cost or at revalued amounts (Haskins, Ferris, & Selling, 1996). Philips, for example, carries assets at historical cost (what they paid for them) which causes them to have a seemingly lower amount of assets than if they carried them at fair market value (what they could reasonably expect to sell the assets for today). Philips estimates the difference in value to be 2.9 billion guilders for 1997 (Philips, 1998). The difference has very little to do with how well a company is performing economically and may in fact mislead readers of these financial statements.

Confusion reigns in the international capital markets and the reasons are evident. These two companies, that both participate in international capital markets, produce reports in accordance with three different sets of reporting standards. Where an investor is located in the world determines which set of figures they will have easiest access to. Take for instance the German-based Hoechst Group. In 1994, in reconciling its IAS prepared accounts with US GAAP, the company went from a profit of DM1.7bn to a loss of DM57m (Gietzmann & Quick, 1998). This tends to make investors wary and reluctant to invest: "The available data suggests that the level of foreign investment in each country's market is significantly correlated with how foreign investors are being treated and how easily they can gain access to timely, accurate investment-related information. Needless to say, markets with an adequate disclosure system which is in accordance with international disclosure standards will be relatively more attractive and give more confidence in the level of transparency to foreign investors, and hence will be able to induce more capital inflows." (Pakorn Malakul Na Ayudhya, Secretary-General, Thailand Securities and Exchange Commission, 1998). It is the author's assumption that investors will be more apt to invest in a foreign company if they feel that investment information, of which financial statements are a major part, is freely shared and gives a clear view of a company's financial situation.

In addition to the confusion among investors, a lack of comparability between accounting reports can increase the costs of producing financial reports for companies:

> ...A multinational company may have to prepare different reports on its operations for use in different countries. Businesses will also want to have a uniform system for assessing financial performance in their operations in different countries. They will want their external reports to be consistent with internal assessments of performance (IASC, 1998).

Hence, individual companies that have been producing multiple versions of annual financial statements in order to list their stock on worldwide stock exchanges, are also anxious to see a single set of financial reporting standards gain global acceptance.

Reasons for the Differences - Environmental Variables

Christopher Nobes was motivated to create a model using the equity/creditor distinctions to classify accounting systems, largely in part because of the difficulty of analyzing the many individual factors that affect accounting systems. Factors including colonial inheritance, invasions, taxation, inflation, level of education, age and size of accountancy profession, stage of economic development, legal systems, culture, history, geography, language, influence of theory, political systems, social climate, religion, and accidents, have all been cited as having influenced accounting systems in various European nations (Nobes, 1998). The most pertinent of these factors to evaluating the feasibility of harmonization in Europe are discussed here; sources of capital, culture, taxation systems, and legal and political systems.

Sources of Capital

Christopher Nobes, in his article, "Towards a General Model of the Reasons for International Differences in Financial Reporting" (Nobes, 1998), proposes that the intended use of financial statements is the key factor in shaping the accounting standards that a nation adheres to. Nobes sets out four classifications that a country's financing system might fit into as summarized in the following table:

Table 4

Classifications for Financing Systems

	Strong Credit	Strong Equity
Insiders Dominant	I	III*
Outsiders Dominant	II*	IV

* These types of financial markets are unlikely and thereby less common.

Each of the four variables used in this analysis is fully described in the explanations that follow.

Central to his argument is Nobes' distinction between 'insiders' and 'outsiders':

Outsiders are not members of the board of directors and do not have a privileged relationship with the company (e.g., such as that enjoyed by a

> company's banker who is also a major shareholder). They include both private individual shareholders and some institutions.... By contrast, insiders such as governments, banks, families, and other companies are all likely to have close, long-term relationships with their investees. This will involve the private provision of timely and frequent accounting information (Nobes, 1998, p. 167).

The equity/creditor distinction is the same distinction that has been used consistently in financial discussions. A creditor, such as a bank or other lender, takes no ownership interest in a company. In an equity system, those who contribute funds expect an ownership interest in the company. Financial institution creditors and governmental creditors are included in the 'insider' classification whereas capital market based shareholders are considered 'outsiders' by this model. The significance of these classifications can be demonstrated by an examination of the United Kingdom, Germany, and France's financing systems.

The United Kingdom relies heavily on capital markets for financing businesses. British companies therefore focus on providing financial statements geared toward the individual investor: "In these systems there will be a demand for public disclosure and for external audit" (Nobes, 1998, p. 167). Investors in these situations do not enjoy the benefit of the information provided to management or by private access. They will therefore look to protect their investments through public disclosure. The concern in an outsider-based market is providing financial reports that enable outside users to predict future cash flows for large, publicly traded companies.

Germany and France both rely heavily on credit-based systems to finance business. Germany generally utilizes bank lending while France relies on governmental lending. These systems are concerned with the protection of creditors and are prudent in calculating profit for distribution, the implication being that by distributing excessive amounts to shareholders, creditors are in a more precarious position. Because these creditors have insider status, they do not put as much value on externally audited financial statements. Prudent behaviors include pessimistic estimations of the collectibility of accounts and a correspondingly high allowance for doubtful accounts. This will decrease the net income shown for a year and will lessen the risk creditors are asked to take on.

Culture

Several authors (Bindon and Gernon (1995), Nobes and Parker (1995)) have accepted Hofstede's 1987 definition of culture: "The collective programming of the mind which distinguishes one category of people from another." Hofstede's work was a pioneering effort to relate business practices to cultural attitudes. After surveying over 116,000 IBM employees, he identified the following four dimensions of culture and ranked 37 countries based on the employee surveys according to each of these areas:

1. Individualism versus Collectivism - A measure of the amount of interdependence among a society's individuals.
2. Large versus Small Power Distance - A measure of the extent to which members in a given society accept that power is distributed unevenly within organizations and institutions.
3. Strong versus Weak Uncertainty Avoidance - Strong uncertainty avoidance would indicate that a society is uncomfortable with ambiguity and uncertainty.
4. Masculinity versus Femininity - Masculine societies tend to honor achievement, heroism, assertiveness and material success. Feminine societies tend to honor relationships, modesty, caring for the weak, and quality of life.

Gray furthered Hofstede's work by analyzing which systems of accounting were likely to arise given a combination of any of the four dimensions. Gray proposed four likely relationships outlined in Table 5.

Table 5

Relationships Leading to Business Behaviors

High Individualism Weak Uncertainty Avoidance Small Power Distance	Lead to Professionalism
Strong Uncertainty Avoidance Large Power Distance Low Individualism	Lead to Uniformity
Strong Uncertainty Avoidance Low Individualism Low Masculinity	Lead to Conservatism
Strong Uncertainty Avoidance Large Power Distance Low Individualism Low Masculinity	Lead to Secrecy

Source: Adapted from Gray (1980)

A tendency toward professionalism is an indication of a society's preference for and trust in independent professional judgment. This is the case in which an independent board of accountancy professionals, such as the IASC, would be relied on to create a set of standards and to oversee the accounting profession.

Uniformity of accounting standards is usually preferred by societies that are uncomfortable with uncertainty and require compliance with a legal framework. Codified systems of accounting rules and regulations are an example of how uniformity would manifest itself in accounting standards.

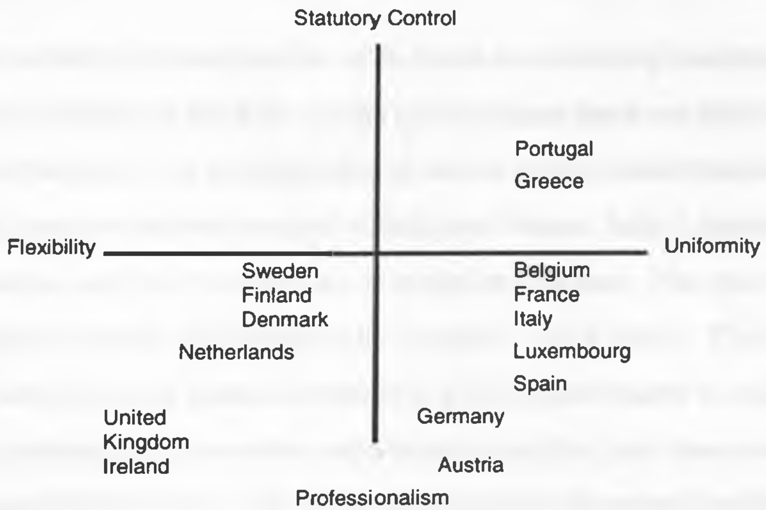
Conservatism, as it pertains to accounting, requires that companies use the accounting method that would have the least favorable impact on income. This policy is indicative of societies in which there exists strong uncertainty avoidance. Conservatism applied to standards on contingent liabilities and the methods used to estimate these liabilities would require that a company disclose any pending litigation in annual financial statements and attach a financial estimate of the settlement amount. The underlying assumption is that investors would rather have a company over-estimate these costs than be surprised when lower estimates failed to give an accurate representation of how large a settlement could be.

Secrecy is valued among cultures where collectivism is more important than individualism. Under these circumstances, less information is voluntarily disclosed by companies or required by law. In these cultures, individuals feel that they belong to a group or a firm and place a high value on protecting that organization.

Bindon and Gernon applied Hofstede's and Gray's work specifically to the EU and derived the following plots from their work:

Exhibit 1

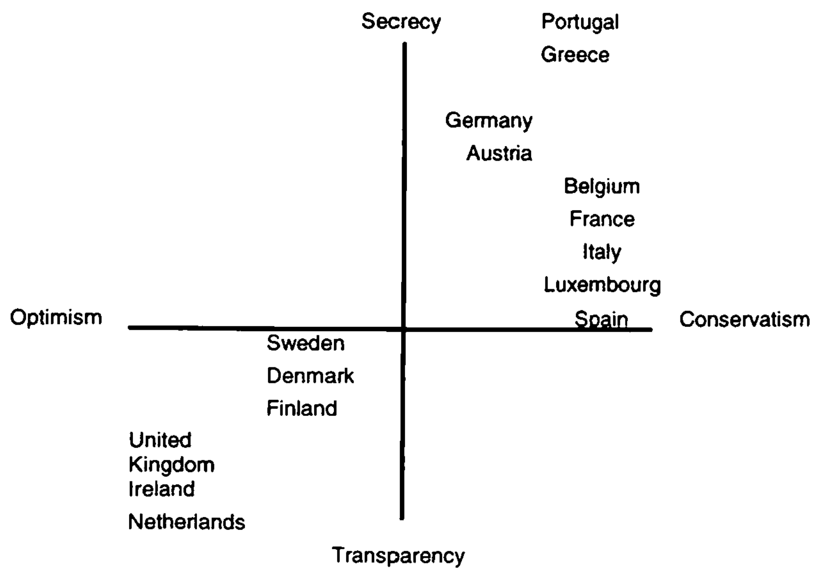
Measurement Plot for EU Countries



Source: Adapted from Bindon and Gernon (1995)

Exhibit 2

Disclosure Plot for EU Countries



Source: Adapted from Bindon and Gernon (1995)

These exhibits demonstrate the differences in accounting standards derived from the variances in cultures in the EU. As the plots indicate there are some major groupings of EU nations that allow for a comparison of sets of nations rather than individual nations. One group of nations consists of Belgium, France, Italy, Luxembourg, Spain, Germany, Austria, and for the most part, Portugal and Greece. The other consists of the United Kingdom, Ireland, the Netherlands, Denmark, and Finland. The first group relies on codified laws regarding financial reporting, professional boards to guide the accountancy profession, conservative accounting principles, and does not freely disclose large amounts of information. The second group allows for more flexibility, allows the profession to establish standards, value accuracy over conservatism, and requires that companies disclose a large amount of financial information.

Obviously, EU Directives are not going to be able to standardize the cultures of Europe. There is potential, however, for the Directives to lessen cultural influence on financial reporting.

Tax Systems

Historically in France and Germany, tax laws have been analogous to accounting laws. This is not the case in the United Kingdom however. One example of this is the treatment of depreciation, which, for tax purposes, is determined by a formalized scheme of allowances. For financial reporting, depreciation is allocated evenly among several accounting periods (Nobes & Parker, 1998). For instance, Company A may report the historical cost of a building at 100,000 Euros with a 20-year life. For financial statement purposes, depreciation expense for the building is reported evenly at 5,000 Euros annually. For tax purposes, the maximum depreciation allowed in the first year might be 7,500 Euros, while the second year may increase to 8,000 Euros etc. In a country like Germany where tax law was historically the same as accounting law, both the financial statements and the tax reports would indicate the same amount for depreciation.

Legal and Political Systems

Especially pertinent in the European Union has been the influence of legal and political systems on accounting standards. Prior to the issuance of the EU Directives, European nations were completely independent and drew from either a common law system of government such as the United Kingdom's, or a system of codified Roman law such as France. Table 6 provides a listing of the major EU nations and the legacy of their legal systems:

Table 6

Legal System Classifications

Common Law	Codified Roman Law	
United Kingdom	Austria	Italy
Ireland	Belgium	Luxembourg
	Denmark	Netherlands
	Finland	Portugal
	France	Spain
	Germany	Sweden
	Greece	

Source: Adapted from Nobes and Parker (1995)

The influence that a particular legal system has on an accounting system may be generalized along the same divisions as used in Table 6. A common law system will address a particular issue in reference to a specific case. The system will find a solution for the problem for that case and later, when solving similar problems, look to the solution used earlier. The codified systems will adopt a single set of rules to be applied uniformly for all cases.

Since the creation of the European Union however, much of an individual nation's autonomy has been given to the EU in order to allow the Directives to be legally binding on all member nations. The more Directives that are passed and take precedence over national laws, the more closely aligned legal systems within the EU will become.

What is the harmonization effort?

Harmonization is the efforts to minimize the differences between reported financial statements on an international level and eliminate the need for reconciling reports. It "is the process of bringing international accounting standards into some sort of agreement so that the financial statements from different countries are prepared according to a common set of principles of measurement and disclosure" (Haskins, Ferris, & Selling, 1996, p. 29).

This seemingly simple task has such influential ramifications that nearly 25 years after the serious contemplation of harmonization began, there remain vastly different accounting practices across nations.

The debate concerning accounting harmonization was initially opened as the internationalization of sales and capital markets became a reality. Prior to that time, investors in companies like Cadbury Schweppes would most likely reside in the same nation as the company they were investing in, rendering comparability of international financial statements unnecessary.

Harmonization would make investment and financing activities in international capital markets easier by making entities' financial reports from various nations more comparable and thereby increasing the ease with which an investor or analyst could evaluate a company's financial position. This is known as the transparency of financial statements: "Transparency, for Michel Camdessus, Chairman of the IMF Executive Board, is the Golden Rule. He argued that high-quality information and analysis are essential for sound policy formulation and for participation in the markets. Market participants must offer greater transparency, to ensure better functioning markets"(IASC, 1998, October, p. 1).

Investors are not the only group of financial statement users putting pressure on standard-setting groups to develop an international set of standards: "International pressures for improvement in the comparability of accounting and information disclosure arise from the diverse interests and concerns of a wide range of participant groups and organizations around the world" (Weetman, Jones, Adams, & Gray, 1998, p. 190). These groups include governments, businesses, analysts, professional organizations, stock exchanges, and of course, individual investors.

Harmonization is not to be confused with standardization. Harmonization allows for a limited number of variations among accounting standards whereas standardization requires uniformity. Bounded diversity is a smaller movement away from total diversity of standards than comparability represents. In a state of bounded diversity there are a limited number of acceptable treatments for accounting transactions. There is still room for variation and financial statements prepared under a system of bounded diversity are not necessarily comparable.

Exhibit 3

States of Harmony for Financial Reporting

Extreme State of Total Diversity	Harmony		Extreme State of Total Uniformity
	Bounded Diversity	Comparability	

Source: Adapted from Bindon and Gernon (1995)

What has been done so far?

The organizations that influence accounting harmonization in Europe are the International Accounting Standards Committee (IASC), International Organization of Securities Commissions and Similar Organizations (IOSCO), and the European Union (EU).

The IASC and IOSCO

The IASC was formed in 1973 as an independent, private-sector body, through an agreement made by the professional accounting bodies from Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the United Kingdom and Ireland, and the United States. Today there are 142 accounting organizations representing 103 countries in the IASC.

IOSCO, initially formed as the Inter-American Association of Securities Commissions in 1974, is currently comprised of representatives from securities commissions from around the world. The Presidents' Committee, which meets once a year during the Annual Conference, is made up of all the Presidents of member (regular and associate) agencies. The United States' Securities and Exchange Commission (SEC) is one of the most prominent members on IOSCO. IOSCO's objectives include:

- Cooperating to promote standards of regulation in order to maintain just, efficient, and sound securities markets
- Uniting efforts to establish standards and effective surveillance of international securities transactions; and
- Providing mutual assistance to promote the integrity of markets by rigorous application of the standards and effective enforcement against offenses.

Prior to the involvement of IOSCO, the IASC had met with more resistance than with success in its efforts to create accounting standards acceptable on an international level (Pakorn Malakul Na Ayudhya, Secretary-General, Thailand Securities and

Exchange Commission, 1998). IOSCO involved itself with the IASC in 1987. At that time IOSCO informed the standard-setting group that it would enforce a core set of standards developed by the IASC if a couple of criteria were met. The number of acceptable treatments in the existing standards had to be reduced and the IASC had to revise the standards to meet the needs of capital markets and the international business community (Haskins, Ferris, & Selling, 1996). IASC has endeavored to ensure the endorsement of their standards by involving IOSCO in all planning and development stages including Steering Committee and Board meetings. IOSCO is currently considering the endorsement of the IAS for use worldwide in cross-border listings and as alternatives to national accounting standards.

The standards being produced by the IASC are intended to serve as either an entire body of standards for those countries wishing to adopt it in full, or as a starting point for countries who need customized standards to address national concerns (IASC, 1998).

The European Union

The European Union (EU) has issued the 4th and 7th directives which are binding on all 15 member nations. The 4th Directive, which was adopted by the EU on July 25, 1978, coordinates company law among the fifteen EU member nations and establishes basic reporting requirements. A summary of the Directive's Articles is given in Appendix A1. The Seventh Directive, adopted in 1983, creates the basic rules for creating consolidated statements. A summary of the Articles in the Seventh Directive is given in Appendix A2.

These directives were an attempt toward greater comparability of financial statements within Europe. Rather than bringing statements into full comparability however, Bindon and Gernon assert that "a closer look at the 4th and 7th Directives allows us to see that they fell short of comparability. However, they do achieve the worthy goal of bounded diversity by reducing the extent of national financial reporting differences across member states" (Bindon & Gernon, 1995, p. 28). (See Exhibit 3).

Even under these Directives, a company would usually find that the standard to which they had been adhering in past periods was still a valid option under the new standards. This meant that the EU presented standards that were more easily accepted by a wide variety of nations. The unfortunate result was that only a small amount of harmonization occurred; companies were still producing vastly different financial statements.

The Movement Today

Investor pressure has required that the IASC, in their development of a set of standards, gradually eliminate many of the options previously available to companies. In 1995 the IOSCO and the IASC agreed on a list of core standards that would create the basis for the IAS. The core standards were completed by 1998 year-end. As a result, 35 International Accounting Standards were adopted by the IASC (see Appendix B). During 1998, Belgium, Italy, France and Germany allowed publicly traded companies to use International Accounting Standards (IAS) domestically.

The Obstacles

There is a great deal of pressure being exerted on standard-setting bodies in Europe to develop a single set of commonly accepted accounting principles. This pressure is coming from investors, practitioners, and the business communities alike. The question must then be asked why there is not faster movement in that direction.

The obstacles to financial reporting harmonization are of great significance. Peter Clark, a Senior Research Manager for the IASC lists four major obstacles to harmonization of accounting standards in Europe (letter, January 21, 1999):

- The difference in relative importance of different sources of finance among countries.
- The different institutional arrangements for national standard setting.
- The perception that harmonization is not important.

- The fear of a loss of sovereignty coupled with a resistance to change.

Each of these obstacles stands to be influenced by the movement to a single currency in Europe. The impact the Euro will have on these four obstacles is discussed in Section IV.

III. The Economic and Monetary Union

An analysis of how the single currency stands to affect financial reporting harmonization in Europe can be more easily achieved with an understanding of why the single currency is being adopted. This section outlines the history of the common currency in Europe. It also outlines the objectives that the leaders of the European community had in mind when making the decision to engage in such a costly and time-consuming task.

A Brief History

The European Union (formerly the European Economic Community) was established in 1958 for the purpose of creating a single European market. EU policy-makers attempted to achieve this goal through legislation that increased the "four freedoms" - the free flow of goods, capital, services and people. The movement toward a single market was largely completed in 1992 following the Single European Act of 1986 (SEA). The Act made it possible for nearly 300 internal market directives to be adopted including the abolishment of tariffs between nations. The SEA also called for standards of mutual recognition. Mutual recognition required that individual nations accept imports that met the minimum standards of quality, materials, and the like, of the country in which they were produced. Once the European Union countries adopted this legislation, the biggest remaining barrier to a single market was the different currencies and the need to convert from one currency to another.

The Economic Monetary Union (EMU) represents the agreement between eleven European nations to give up their national currencies in favor of the Euro - the common currency of the EMU. As decided on May 2, 1998 in Brussels, the eleven participating countries are Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain. The Euro zone is comparable both in size, and economic terms, to the United States and has a combined population of about 300 million people. The EMU will account for 20% of world trade and world GDP (EC, 1998).

The United Kingdom, Sweden, and Denmark have opted to wait to join the union until the success or failure of the currency can be tested. Greece, who would have liked to participate, failed to meet the minimum economic standards required of all participating nations.

Table 7

EMU Participation

European Country	Participating in the EMU	Reason
Austria	Yes	
Belgium	Yes	
Denmark	No	Chose to wait
Finland	Yes	
France	Yes	
Germany	Yes	
Greece	No	Failed to Qualify
Ireland	Yes	
Italy	Yes	
Luxembourg	Yes	
Netherlands	Yes	
Portugal	Yes	
Spain	Yes	
Sweden	No	Chose to wait
The United Kingdom	No	Chose to wait

All four of the non-participating nations will probably join the EMU at some point in the future although that date is as yet uncertain. For now, their monetary policies, including maximum inflation rates, maximum interest rates, budget deficit amounts, and currency fluctuation amounts, will maintain a close relationship with participating nations through the successor to the Exchange Rate Mechanism (ERM). The ERM was the system by which bilateral conversion rates between currencies and in relation to the European Currency Unit (ECU) were established (See Appendix C). The successor to this system is the ERM-II, which will continue to be in operation for the United Kingdom, Denmark, Greece, and Sweden so that they will be eligible for participation in the single currency at some point in the future.

In the original ERM central rates and fluctuation margins against other national currencies, had to be kept to 2 x 15%. This means that the British pound, for example, was not allowed to fluctuate more than 15% from the value of the Austrian schilling or more than 15% away from the bilateral central rate as represented by the value of the European Currency Unit (ECU). The ERM II centers on the Euro, which means that, as an example, the British pound may not fluctuate more than 15% in reference to the value of the Euro or more than 15% in reference to the central rate. The central rate, which was determined by the ECU for the purposes of the first ERM, is now determined by the value of the Euro. This means that non-EMU countries that are choosing to adhere to the ERM II are operating under a de facto margin of 30% between non-Euro currencies (ABN AMRO Bank, 1998).

Convergence Criteria

Historically, individual currencies in Europe were allowed to fluctuate against each other to reflect changes in economic conditions in their respective nations. This meant that when one nation was facing a tough time, the currency of that country was normally weaker compared to the currencies of the other European nations. Under a single currency, if one nation is facing economic difficulties, it will be reflected in the currency used by all member nations. For example, if Spain experiences hyperinflation, it will be reflected in the operating currency of France. For the economically stronger nations of Europe it became extremely important that the weaker nations maintain stable economies.

The convergence criteria were meant to ensure that countries demonstrate they were responsible and able to manage their fiscal and monetary policies within certain guidelines. The criteria, as set out in the Maastricht Treaty, required the following:

- ❖ The EMU member nation had to have previously participated in the European Exchange Rate Mechanism for two years.
- ❖ Inflation rates, observed over a period of one year, must not be more than 1.5% above the average of the three best-performing members.
- ❖ Long-term interest rates observed over a period of one year must not be above 2% of the average of the three best-performing member states in terms of price stability.
- ❖ Member states' budget deficits (including central, regional, and local governments) should not exceed 3% of gross domestic product (GDP), unless they are temporary and exceptional. Their public debt ratio should not exceed 60% of GDP. This criterion is also satisfied if it is approaching the reference value at a satisfactory speed.
- ❖ Currencies must have respected the normal fluctuation margins provided by the Exchange Rate Mechanism of the European Monetary System without severe tensions or unilateral devaluation's for at least the last two years.
- ❖ The national Central Banks must be granted full independence.

Countries had to not only have met these criteria to be considered for participation in the EMU, but must also maintain these standards while participating. The Stability and Growth Pact, agreed on by EU Heads of State and Government in July of 1997, allows for sanctions to be brought against member states that do not comply with strict guidelines for managing public finances after they have been approved for participation. The European System of Central Banks, which includes the Central Banks of the Euro countries and the independent European Central Bank, has responsibility for setting interest rates and overseeing Euro operations.

The Time-Line

On May 2, 1998 the European Council Heads of State and Government officially designated the initial members who would participate in the EMU on January 1, 1999. At the same time the European Central Bank was established.

The Euro was introduced on January 1, 1999 as an accounting currency. The conversion rates of the participating currencies were fixed irrevocably on this date. The conversion rates are summarized below:

Table 8

Conversion Rates

National Currency	*1 Euro equivalent*
Austria (Schilling)	13.76
Belgium (Franc)	40.34
Finland (Markka)	5.95
France (Franc)	6.55957
Germany (Mark)	1.95583
Ireland (Pound)	0.79
Italy (Lira)	1,936.27
Luxembourg (Franc)	40.34
Netherlands (Guilder)	2.20
Portugal (Escudo)	200.48
Spain (Peseta)	166.386

Also on January 1, 1999 all operations of the European Central Bank commenced in Euros. Wholesale financial and capital markets switched to the new currency and all public debts were re-denominated in Euros with the start of the new year. Private citizens now can choose to have Euro-denominated bank accounts and Euro-denominated credit cards are now available. In most participating nations, public administrations make it possible for companies to switch to the Euro for accounting purposes, tax payments, and in some cases, social security payments (EC, 1998). This is known as Phase B of the phase in for the Euro. This phase will continue until December 31, 2001.

Phase C begins on January 1, 2002 when the physical introduction of Euro notes and coins begins. All participants of the EMU are to have completed the changeover and all transactions and assets are to be converted into Euros. The withdrawal of the national currencies is to be completed no later than July 1, 2002.

Why a New Currency?

In November of 1991 at the European Union summit in Maastricht, the decision was made to adopt a single currency. The goal was to advance the cause of European unity and benefit Europe from the resulting economic effects. Yves-Thibault de Silguy, European Union monetary affairs commissioner, said: "Europe, the greatest trading power in the world, will have its own currency and be able to reshape the international monetary system with the aim of achieving greater stability and growth in the world" (McElroy, 1999, p. B2)

The Euro is hoped to rival the US dollar as the world's preferred reserve currency. Some experts believe the Euro could account for 25% or more of global foreign exchange reserves in the medium term (EC, 1998).

With a single currency, doing business across national borders becomes much less expensive as well as less risky. This means that the Euro zone will see more cross-national trade and investment: "In the financial sector, the Euro will create new opportunities. The combined volume of bonds, stocks, and bank assets in the Euro zone is already almost as high as in the United States, but stock market capitalization's in the Euro zone at the end of 1997 was only 44% of GDP, compared with 139% in the United States. There is also great potential in the market for venture capital, which in Europe in 1998 was still only 1% of that on the NASDAQ market" (EC, 1998). The increased flow of trade and investment instruments is expected to put increased pressure on governments to harmonize taxes, regulations, and accounting standards. The hope is that increased harmonization will lead to faster economic growth (MAC, 1998).

The Euro should result in a greater degree of price transparency, which will translate into lower prices across Europe. Past price discrepancies that were masked by varying international currencies will now become apparent and will force companies to rethink their pricing decisions.

A majority of Europeans are in favor of a single currency according to a European Commission poll in March and April of 1998 (EC, 1998). According to the poll, 67% of Europeans are for the EMU while only 33% are against such a union.

Functional Business Areas Potentially Affected by the Euro

Businesses and governments in Europe will have to acknowledge the range of activities that stand to be affected by the movement to a single currency. The Euro will affect functional business areas far beyond the systems and treasury functions. The following is a list compiled by the accounting firm PricewaterhouseCoopers of functional areas that could potentially be affected by the movement to the Euro (PwC, 1998):

- Marketing, Sales, and Distribution (e.g., price transparency)
- Human Resources (e.g., payment of wages)
- Accounting (e.g., conversion of historic data, rounding)
- Information Systems (e.g., parallel currencies during introduction phase)
- Legal (e.g., EMU/ non-EMU contract continuity)
- Tax (e.g., tax treatment for transition costs, filing taxes, payment of taxes)
- Treasury (e.g., elimination of currency risk between participating national currencies, opportunity to centralize EMU treasury function)

The transition to a single currency in Europe stands to not only unite European countries in a very real way, but also to have ramifications that go far beyond the usual banking and finance matters usually considered. Matters unrelated to banking and finance that warrant some attention include re-valuating current marketing plans and adjusting price differences previously masked by various exchange rates, retrofitting information systems with software capable of dealing in Euros, and re-structuring wage schedules to remain competitive in job markets.

Summary

Accounting harmonization is the movement toward a global set of financial reporting standards with the eventual goal of international comparability of financial statements. Differences among accounting standards exist due to environmental differences; financing systems, culture, taxation, and legal and political systems. There are four major obstacles to financial reporting harmonization in Europe:

1. The difference in the relative importance of different sources of finance
2. The different institutional arrangements for national standard setting
3. The perception that harmonization is not important
4. The fear of loss of sovereignty and the resistance to change on behalf of individual nations.

The single currency in the EMU is expected to facilitate the free flow of capital, a freer flow of goods among EU nations, and a host of other economic changes. Either directly or indirectly, the Euro stands to impact the obstacles to harmonization and may in fact prove to be the catalyst to bring harmonization to fruition.

IV. The Impact of the Euro on Accounting Harmonization in Europe

The information presented in Sections II and III of this paper serves as a background for the following section which analyzes the impact the Euro will have on accounting harmonization in Europe. Four obstacles to financial reporting harmonization, as identified earlier, are evaluated and conclusions drawn about their potential impact on harmonization efforts.

The Difference in Relative Importance of Different Sources of Finance

One of the obstacles to financial reporting harmonization in Europe is the relative importance of different sources of financing for companies in European Union nations. The Euro stands to increase the free flow of capital among participating nations, which will lead to more open and less expensive listings on capital markets. This change, according to analysts such as Kevin Mellyn, Vice President of Mercer Management Consulting in New York, will encourage companies who have historically relied on bank and private lender financing to look for opportunities in capital markets.

Corporate financing systems among European Union countries are generally classifiable as either creditor or equity market based. These classifications are summarized in Section II. Specific European countries' financing systems are listed in Table 9.

Table 9
Financing Systems in the European Union

Creditor Based		Equity Market Based
Austria	Greece	United Kingdom
Belgium	Italy	Ireland
Denmark	Luxembourg	Netherlands
Finland	Portugal	
France	Spain	
Germany	Sweden	
Greece		

The predominance of bank financing in Europe has remained true even over the past three decades while the United Kingdom has replaced bank financing with capital market financing. This move toward a market-based system is a means of rewarding innovative and start-up companies. Markets will provide inexpensive financing to those companies from whom they expect high rates of return. The same is true in reverse. Investors will expect high prices for capital provided to outmoded and failing companies. For the most part, Europe has shied away from this change asserting that "the interests of consumers and shareholders should be subordinate to those of managers and workers" (Mellyn, 1999). The Euro should aid the change from creditor to equity financing in Europe.

One of the most touted benefits of moving to a single currency in Europe is the ease with which capital will flow from one EMU nation to another:

> The arrival of a single European currency, by creating a single, enormous capital market, represents a powerful catalyst for change in the strategic landscape. Eleven sub-scale capital markets will be consolidated into a market that rivals that of the US dollar. This change in scale alone will accelerate the movement of European finance from a bank-centered model to a market-centered one (Mellyn, 1999).

Without a single currency, the volatility of currency values with respect to one another required that companies find some way to insure themselves against losses. This process, known as hedging, is costly and time-consuming. Investors, too, would be interested in insuring themselves against currency fluctuations and would therefore require risk premiums, or higher rates of return, to provide capital to companies. The single market will result in the elimination of the high transaction costs associated with converting national currencies, the elimination of the need for these hedging and associated costs, as well as an elimination of risk premiums.

Already several stock and derivatives markets have planned and executed link-ups that would serve as one-stop-shops for European stocks and derivatives. The German, Swiss, and French derivatives markets are one such link-up (EIU, 1998) that should further the development of a single capital market throughout Europe.

In aggregate, this means that capital markets will suddenly be open to companies that did not have access previously. For example, German companies, who have traditionally operated under the German system of bank financing, will now have easy and cheap access to a wide array of European investors with almost infinite investing capabilities.

Innovative companies in Europe will increasingly demand access to capital markets where they are able to locate inexpensive financing. Investors too will demand access to companies in whom they see earning potential and analysts will demand that they be able to compare and evaluate European companies effectively. Pressure on capital exchange markets in Europe to standardize the requirements for a market listing will therefore increase. Included with the requirements for listing, pressure to adopt a single set of financial reporting standards will increase as well.

Institutional Arrangements for National Standard Setting

The institutions responsible for financial reporting standards vary by nation throughout Europe. Standards can be derived from corporation law, tax law, or written by independent professional boards. Table 10 below lists European Union nations and the traditional basis for their accounting standards.

Table 10

Accounting Standard Setting Basis by Country

Country	*Standard Setting Basis*
Austria	Standards are law-based.
Belgium	The King has authority to set financial standards through the Commission for Accounting Principles.
Denmark	Standards in the Annual Accounts Act, also have standards of the Institute of State-Authorized Public Accountants.
Finland	The Finnish Accounting Board, a government agency, sets standards. The Association of Authorized Public Accountants advises the Board.
France	Standards are set by the CNC and are strongly influenced by tax and legal requirements.
Germany	Standards are the responsibility of legislators. Emphasis is on commercial law but influenced by tax law.
Greece	Accounting principles are outlined in Company Law 2190/192.
Ireland	Accounting standards issued by the ASB of the UK and modified by the Institute of Chartered Accountants in Ireland.
Italy	Standards are established in part by Italian law and in part by the principles of the CNDC.
Luxembourg	National standards are not established.
Netherlands	Standards established by law but are strongly influenced by the profession and accounting theory.
Portugal	Standards developed by the Ministry of Finance and the Commission for Accounting Normalisation.
Spain	Standards established by Code of Commerce. ICAC develops standards under the authority of the Minister of Finance.
Sweden	Companies must follow the Annual Accounts Act.
United Kingdom	Principles established by the Accounting Standards Board, a wholly owned subsidiary of FRC Ltd. The standards produced by the ASB are prescribed by the Secretary of State for Trade and Industry and are legally binding.

Tax Driven Standards

European Union leaders have set about to create a single European market. With this objective in mind, they have created a single currency and taken steps to harmonize accounting standards throughout Europe. Some leaders, especially those in France and Germany, view these steps as preliminary and are working toward a single European economy. In this context, the issue of the harmonization of tax has been broached: "With the January 1 launch of Europe's single currency less than a month away they (Jacques Chirac and Gerhard Schroder) raised the controversial specter of tax harmonization throughout the European Union" (Time Inc., 1998, p. 16(1)).

The United Kingdom is, at least for the time being, opposed to such a harmonization effort: "Britons were worried by German Finance Minister Oskar Lafontaine's suggestion that the European Council adopt majority voting on tax issues. That would end Britain's ability to veto higher levies from Brussels. Behind the shrill British action was the fear that France and Germany were leading a coalition of left-wing governments bent on bringing back high taxes, excessive government regulation and, ultimately, 'a single European state'" (Time Inc., 1998, p. 16(1)).

The Euro has opened the door for these discussions to take place and as with the introduction of the idea of a single currency, the idea of harmonized taxes is being met with the traditional European skepticism. The single currency overcame the skeptics and is now a reality. If the same can be expected of harmonized taxes, it would mean that accounting standards in Europe that are based on taxation issues will inadvertently be more comparable as well.

Law Driven Standards

European accounting standards that are based on individual nations' legal systems have experienced the most harmonization to date. With the implementation of the 4th and 7th EU Directives, the legal bases for standards began to look very similar across Europe.

As the Euro opens capital markets and produces a free flow of capital, there will be pressure from the investing community for countries to encourage easy access to capital markets by making provisions for the use of international standards. The similarities in legal requirements for financial reporting will increase as these provisions are adopted. Once the legal systems start requiring similar financial reporting, harmonization will indirectly result.

Independent Boards As Standard-Setters

A few nations in Europe still maintain influential independent boards of accounting professionals who are responsible for standard setting. The most notable of these is the United Kingdom's Accounting Standards Board (ASB). With the increased use of the IASC's IAS however, boards are focusing their attention on how to maximize their input on IAS rather than writing their own standards. The ASB for instance has increased its influence in the IASC in hopes that the committee can create a set of standards that are more closely related to the standards already in use in the United Kingdom.

The Euro, as demonstrated previously, should encourage the use of international accounting standards. As countries start looking toward fully adopting a common standard set, they look to independent boards to help in the evaluation of said standards.

It would be foolish at this point for individual boards of accountants to spend the incredible amounts of time and money to develop new accounting standards independently of each other. For instance, with the dramatic increase in the options available to companies in the derivatives markets, new standards are being called for that deal specifically with this issue. The European Union alone could potentially have fifteen different committees working on solving the same problems. The end result would most likely be fifteen variations of the same basic concepts.

Especially in light of the emphasis on harmonization, this strategy makes no sense. The effective and less costly alternative is for independent boards to work together with the IASC to create mutually acceptable standards and thereby increase financial reporting harmonization.

Perceptions Regarding the Importance of Harmonization

The movement toward financial reporting harmonization has been hindered in part by the lack of importance that some nations' leaders are attributing to it.

An indication of the amount of importance that a particular country attributes to this issue is whether or not they have passed laws to allow the use of the IASC's International Accounting Standards as introduced in Section II.

The list of countries that have accepted IAS for use in preparing annual financial statements is the best indicator available to estimate the receptiveness of individual countries to a single set of international accounting standards. The countries represented in Table 11 under Class A have taken definitive action toward adopting international standards. It would be unfair to disqualify countries that are in Class B from the group of countries working toward international standards. Rather, the countries that are listed have agreed to accept, at least to some extent, the beginnings of a common standard set. The countries in Class B have simply not yet agreed to this particular set of standards.

Table 11

Countries Allowing the Use of IAS

Countries in Which IAS are Allowed Class A		Countries in Which IAS are Not Yet Allowed Class B
Austria	Italy	Finland
Belgium	Luxembourg	Greece
Denmark	Netherlands	Ireland
France	Sweden	Portugal
Germany	United Kingdom	Spain

By virtue of having accepted an international set of accounting standards for use in their countries, Class A nations have given indication that this subject is of importance to them.

Class B countries have been hesitant to allow companies to use IAS for a number of reasons. Spain for instance has a highly detailed and inflexible set of domestic accounting standards. Spain, Greece, and Portugal are all identified in Section II as having a high level of uncertainty avoidance, which means that they want to be assured of the quality of these standards before they give up domestically produced standards. For these reasons, it is impossible to determine from this listing alone that these countries place a lower level of importance on this issue. It can be assumed however that if the issue were extremely important to these nations, that concession would be made in order to achieve comparability.

Fears Regarding the Loss of Sovereignty and the Associated Resistance to Change

The last of four obstacles to harmonization in Europe is the loss of additional sovereignty and the consequent resistance to change on behalf of some national leaders. Financial reporting standards, as discussed in Section II, are influenced substantially by the culture in which the standards are set. Because of this, some nations fear the loss of additional sovereignty and have a corresponding resistance to the adoption of *international* standards, which may not be the best fit for their particular situation. Nationalism, according to Nobes and Parker: "...may show itself in an unwillingness to accept compromises which involve changing accounting practices towards those of other countries. This unwillingness may exist on the part of accountants and companies or on the part of states who may not wish to lose their sovereignty" (Nobes & Parker, 1998, p. 69).

The list of countries that allow the use of IAS for financial reporting purposes gives a good indication of the willingness of nations to participate in international standards. In addition to this indicator however, there are at least two other, less definitive, indications of how receptive individual countries are to a common set of standards. These indicators are the speed with which accounting legislation is adopted, and the amount of preparation countries had completed for the introduction of the Euro by December of 1998.

Since the onset of the European Union, individual nations have been asked to give an ever-increasing amount of control to the central government in order to achieve the objectives of the Union. EU law already accounts for 70 percent of legislation pertaining to business in the United Kingdom (New Statesman, 1998). The speed with which nations implemented the EU Directives and their state of preparedness for the Euro gives some indication of the willingness a nation has to change current operating systems as well as their enthusiasm to hasten the onset of EU objectives. One such EU objective is the adoption of a set of international accounting standards. There is no objective way to evaluate a country's willingness to change national standards, but by evaluating how quickly nations have complied with prior changes as directed by EU government, an estimate of their willingness to comply with this objective can be formed.

The speed with which the adoption of the EU Directives occurred in each country may be indicative of their willingness to change domestic systems for greater comparability throughout Europe, the speed of the government in passing legislation, and country-specific obstacles to implementation. The speed at which legislation moves through government should serve as some indication of the importance of the issue to members of government. Legislation that is deemed important normally receives a higher priority listing. To better predict the specific issues related to accounting that might affect a country's willingness to change, the Fourth and Seventh Directives are examined. These two Directives dealt specifically with accounting issues and are used to approximate the issues faced by moving to an international set of accounting standards.

On July 25, 1978, the Fourth Directive (See Appendix A1) was agreed on by European Union member states. Individual member nations were legally bound to incorporate the requirements of the Directive in domestic legal systems by July of 1980. Not a single nation was able to meet this deadline. Denmark and the United Kingdom complied in 1981 when they passed the Companies Act. The Netherlands did not follow until 1983. Italy was the last to comply in 1991 although Finland, Sweden, and Norway adopted it as they joined the EU after 1991 (See Table 12).

The European Commission and the Board of Ministers agreed on the Seventh Directive (See Appendix A2) in 1983. By 1987 member nations were supposed to have incorporated the Directive into national law that would be effective no later than 1990 (See Table 12). Three countries were unable to meet this deadline but followed within two years. The Seventh Directive required countries like Greece, Luxembourg, Italy, and Portugal that did not have consolidation requirements to implement them entirely. Belgium, France, and Germany were required to significantly change their previous consolidation standards.

Table 12

Implementation of Accounting Directives as Laws

Country	Fourth Directive	Seventh Directive
Denmark	1981	1990
United Kingdom	1981	1989
France	1983	1985
Netherlands	1983	1988
Luxembourg	1984	1988
Belgium	1985	1990
Germany	1985	1985
Ireland	1986	1992
Greece	1986	1987
Spain	1989	1989
Portugal	1989	1991
Austria	1990	1990
Italy	1991	1991
Finland	1992	1992
Sweden	1995	1995
Norway	1997	1997

Source: Adapted from Nobes and Parker (1998)

Another indication of the willingness of countries to accept international accounting standards is the state of preparedness for the Euro. Generally, countries that are a major proponent of the Euro or that are in strong favor of a single market have taken steps to prepare for the use of the Euro. These countries have shown a willingness to do the necessary work to make the single market a reality. A set of international accounting standards, as discussed in Section II, is recognized to be instrumental to the creation of a single market. The author has therefore made the assumption that countries active in the creation of a single market will be in favor of international accounting standards.

Table 13 lists the percentage of companies in various countries involved in a 1998/9 FEE survey that had taken steps to prepare for the implementation of the Euro.

Table 13

Percent of Companies Prepared for the Euro

Country	*Taken Steps to Prepare*
Austria	95.1%
Germany	91.1%
Netherlands	88.7%
Luxembourg	88.2%
Belgium	88.0%
Ireland	87.8%
France	81.8%
Finland	81.7%
Spain	81.7%
Italy	79.3%
Greece	75.0%
Portugal	73.6%
United Kingdom	71.4%
Sweden	54.7%
Denmark	47.1%

Source: Adapted from FEE Preparing for the Introduction of the Euro (FEE, 1998/9)

This ranking of countries may be relied on to give some information about the likelihood that international accounting standards are a priority within a particular nation but must not be used definitively. The problem with using this indicator is that the countries that have opted out of the Euro are lower on the ranking. This is a false assessment of the likely adoption of international accounting standards at least in the case of the United Kingdom that has been a major proponent of international standards, largely in part because the London-based IASC.

The Euro has the potential to negate much of the resistance to harmonization simply by making financial statements similarly denominated. If harmonization does not occur, financial statements that are denominated in the same currency can be highly misleading for investors and analysts.

Previously, investors were comparing statements prepared under Italian regulations and denominated in Italian Lira, to statements prepared under German regulations and denominated in German Marks. Comparing them was nearly impossible. Under a single currency however, the statements *look* very similar and investors will be tempted to compare companies Euro for Euro without making allowances for varying accounting standards. It will be in a country's best interest to allow companies to use international standards to harmonize measurement and disclosure methods, thereby allowing them to report comparable figures in annual financial statements.

V. European Countries Outside the EMU

For the purposes of this paper, Denmark, Greece, Sweden, and the United Kingdom have been included in an effort to evaluate accounting harmonization in the European Union. These four countries are not currently participating in the common currency however. It is therefore necessary to evaluate what benefits and drawbacks for harmonization will be unique to this group.

The United Kingdom supports the monetary union and intends to involve itself once the success of the currency can be determined. The British Labour government does not expect that involvement to take place prior to the end of the current parliament, which will occur in May 2002 at the latest (ABN AMRO Bank, 1998). In the meantime, the United Kingdom has had no trouble in keeping within the restrictions of the ERM II and would be eligible for participation at any time.

Denmark opted out of the EMU due largely in part to negative public sentiment regarding a common currency. Denmark has less definite plans than the United Kingdom regarding a timeline for joining but has not had a problem maintaining eligibility according to the ERM II and the Maastricht criteria.

Sweden does not currently meet the exchange rate convergence criteria (See Section III) but has met all other criteria necessary for participation in the EMU. Public opinion is not entirely in favor of participation and played a large role in the decision to wait about joining. Sweden did not negotiate an opt-out clause when it agreed to the Maastricht Treaty. Therefore, as soon as it met the criteria, it would be required to join the EMU. For now, Sweden does not participate in the ERM II, a necessary requirement for participation, and is thereby provided an escape clause (ABN AMRO Bank, 1998).

Greece, the only nation in the European Union that failed to meet the convergence criteria, is also included with this group and plans on joining as soon as it has maintained stable economic conditions.

This group of countries, given their geographic positions and political influence, are an integral part of European politics. Their status as member nations in the European Union will remain unchanged, although it seems apparent that their contributions to EU discussions of tax harmonization, unemployment, inflation rates, and the like, will be less influential than had they participated in the single currency.

The Impact of the Euro for Non-Participating Nations

Even before some participating nations were taking steps to prepare, the British government was encouraging businesses to prepare to transact in the new currency. The benefits of the new currency for those nations that are not initially participating will include many of the same benefits EMU nations will see. The effects will likely not be as drastic however: "The impact on entities which are based within Euro-zone countries is likely to be greater than that on entities which are based in member states which remain outside the Euro-zone. However, the exact nature and extent of the impact will depend upon the scope of the particular business" (FEE, 1998/9).

For instance, British companies such as Giorgio are taking advantage of the ability to pay their European suppliers in the Euro, which will reduce the number of currencies they will have to transact in. Additionally, non-participating countries will also enjoy better access to increasingly competitive markets throughout Europe (Leeman, 1999).

The downside for these countries is two-fold. If computer systems, including billing, financing, accounting, and others, are not updated to handle Euro transactions, companies could lose out to others who are willing to transact in the new currency.

Even if companies take the initiative to prepare for the Euro, domestic prices will still require conversion and will continue to be subject to price fluctuations. Customers in participating nations will have the option of dealing with companies who share their currency and therefore do not experience such fluctuations.

Harmonization in Non-Euro Countries

The good news for the countries outside the Euro-zone is that although they are not participating, they will most likely reap the rewards of financial reporting harmonization in the same manner as their participating counterparts.

The movement in Europe is toward using IAS standards as the international standard. The United Kingdom, Denmark, and Sweden have all adopted IAS for use in their respective countries and, in that way, are just as much involved in harmonization as any EMU-participating nation.

The new currency promises to change legal, tax, and standard-setting systems for participating nations. If these four countries remain as involved in the economic activities of the EU as they have been, there is no reason to suggest that they might not see the same changes occurring within their own borders. The only limit on the scope of harmonization that will take place in these countries is that annual financial statements will still require translation to the Euro which will, in some cases, affect the net income figures according to currency fluctuations. These statements are costly to produce and work to impede the free flow of capital.

VII. Summary and Conclusions

As of January 1, 1999, eleven European Union nations adopted a single currency, appropriately named the Euro, to replace the ten national currencies previously used by the participating nations. This change in the European marketplace stands to have significant implications for the financial statement harmonization movement, begun over twenty years ago, which is aimed at increasing the comparability of annual financial statements through a reduction of the number of alternative treatments that nations allow for various accounting issues.

The single currency in Europe will impact the accounting harmonization effort by moving financial statements toward comparability. Through increasing the free flow of capital among European nations, the Euro will exert pressure on standard-setters to adopt international accounting standards for a number of reasons. The impact the Euro will ultimately have on the harmonization effort will occur in the following areas:

- The Euro, through a freer flow of capital, will encourage countries to harmonize measurement and disclosure standards, which in turn will make capital markets more accessible.
- The Euro, by encouraging the adoption of international accounting standards, will work to harmonize legal, tax, and standard-setting systems as well, which consequently produces increasingly harmonized accounting standards.
- By producing similarly denominated financial statements, countries that do not engage in harmonization efforts will be endangering the comparability of their domestic companies in the international markets.

All of these factors will lead to greater levels of financial reporting harmonization throughout Europe and will allow the movement to take on a greater degree of importance and priority in the coming years.

Four months after the introduction of the Euro there has yet to be an increased rush toward financial statement harmonization. Undoubtedly, it will take time for the continent to settle in to their new currency, but the potential for increased accounting harmonization looms larger every day. Financial statement harmonization is not a subject that will go away any time soon. Rather, the need for harmonization is self-evident. The introduction of a single currency has enhanced the importance of the topic for all of Europe and will likely prove to be the catalyst needed for accounting harmonization to become a reality.

APPENDIX A1

A SUMMARY OF THE CONTENTS OF THE FOURTH EU DIRECTIVE

- Article 1 states that the directive relates to public and private companies throughout the European Union, except that member states need not apply the provisions to banks, insurance companies, and other financial institutions.
- Article 2 defines the annual accounts to which it refers as the balance sheet, profit and loss account, and notes.
- Articles 3-7 contain general provisions about the consistency and detail of formats for financial statements; there is a specified order of items, items cannot be omitted, and corresponding figures for the previous year must be shown.
- Articles 8-10 detail two formats for balance sheets: horizontal or vertical; one or both may be allowed by member states.
- Articles 11 and 12 allow member states to permit small companies to publish considerably abridged balance sheets.
- Articles 13 and 14 concern details of disclosure, particularly to contingent liabilities, which were shown in the United Kingdom but not in some other countries.
- Articles 15-21 concern the definition and disclosure of assets and liabilities.
- Articles 22-26 specify four formats for profit and loss accounts that member states may choose between.
- Article 27 allows member states' medium-sized companies to avoid disclosure of the items making up gross profit.
- Articles 28-30 contain definitions relating to the profit and loss accounts.
- Articles 31 and 32 provide general rules of valuation.
- Article 33 is a lengthy explanation of the directive's stance toward accounting for inflation or for specific price changes.
- Articles 34-42 relate to detailed valuation and disclosure requirements for various balance sheet items.
- Articles 43-46 concern the disclosures that are obligatory in the annual report.
- Articles 47-51 relate to the audit and publication of accounts. Member states may exempt "small companies" from publishing profit and loss statements; "medium-sized companies" can abridge their balance sheet and notes.

- Articles 52-62 deal with the implementation of the directive and with transition problems, particularly those relating to consolidation, which await the seventh directive.

Source: Adapted from Haskins, Ferris, and Selling (1996)

APPENDIX A2
A SUMMARY OF THE CONTENTS OF THE SEVENTH EU DIRECTIVE

- Articles 1-4 require undertakings (which member states may restrict to mean limited companies) to draw up consolidated accounts that included subsidiaries and subsubsidiaries, and so on, irrespective of their location.
- Article 5 allows member states to exempt financial holding companies that neither manage their subsidiaries nor take part in board appointments.
- Article 6 allows member states to exempt medium-sized and small groups, using the criteria of the Fourth Directive and assuming that no listed company is included.
- Articles 7-11 exempt a company from the requirement to consolidate its own subsidiaries if it is itself a wholly owned subsidiary of an EU company.
- Article 12 allows member states to require consolidation when companies are managed by the same persons.
- Articles 13-15 allow various subsidiaries to be excluded from the consolidation if they are immaterial.
- Article 16 requires that consolidated accounts shall be clear and shall give a true and fair view.
- Article 17 requires the Fourth Directive's formats to be used, suitably amended.
- Article 18 requires consolidation to be 100 percent.
- Article 19 requires that there to be a once-and-for-all calculation of goodwill based on fair values at the date of first consolidation or at the date of purchase.
- Article 20 allows merger accounting when any cash payment represents less that 10 percent of the nominal value of shares issued.
- Articles 21-23 require minority interest to be shown separately, and 100 percent of income of consolidated companies to be included.
- Articles 24-28 require consistency, elimination of intra-group items, use of the parent's year-end as the group's year-end, and disclosure of information to enable meaningful temporal comparisons when the composition of the group has changed.
- Article 29 requires the valuation rules of the Fourth Directive to be used and uniform rules to be used for the consolidation of all subsidiaries.
- Articles 30 and 31 require positive goodwill on consolidation to be depreciated or to be immediately written off against reserves and that negative goodwill only be

taken to profit if it is realized or when it was due to the expectation of future costs or losses.

- Article 32 allows member states to require or permit proportional consolidation for joint ventures.
- Article 33 requires associated companies to be recorded as a single item, initially valued at cost or at the proportion of net assets.
- Articles 34-36 specify the number of disclosures relating to group companies and consolidation methods.
- Articles 37 and 38 deal with publication and audit.
- Articles 39-51 deal with transitional and enabling provisions.

Source: Adapted from Haskins, Ferris, and Selling (1996)

APPENDIX B
LIST OF CURRENT IASC STANDARDS

IAS Number	Subject of IAS
IAS 1	Presentation of Financial Statements
IAS 2	Inventories
IAS 4	Depreciation Accounting
IAS 7	Cash Flow Statements
IAS 8	Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies
IAS 10	Contingencies and Events Occurring After the Balance Sheet Date
IAS 11	Construction Contracts
IAS 12	Income Taxes
IAS 14	Segment Reporting
IAS 15	Information Reflecting the Effects of Changing Prices
IAS 16	Property, Plant, and Equipment
IAS 17	Leases
IAS 18	Revenue
IAS 19	Employee Benefits
IAS 20	Accounting for Government Grants and Disclosure of Government Assistance
IAS 21	The Effects of Changes in Foreign Exchange Rates
IAS 22	Business Combinations
IAS 23	Borrowing Costs
IAS 24	Related Party Disclosures
IAS 25	Accounting for Investments
IAS 26	Accounting and Reporting by Retirement Benefit Plans
IAS 27	Consolidated Financial Statements and Accounting for Investments in Subsidiaries
IAS 28	Accounting for Investments in Associates
IAS 29	Financial Reporting in Hyperinflationary Economies
IAS 30	Disclosures in the Financial Statements of Banks and Similar Financial Institutions
IAS 31	Financial Reporting of Interests in Joint Ventures
IAS 32	Financial Instruments: Disclosures and Presentation
IAS 33	Earnings Per Share

IAS 34	Interim Financial Reporting
IAS 35	Discontinuing Operations
IAS 36	Impairment of Assets
IAS 37	Provisions, Contingent Liabilities, and Contingent Assets
IAS 38	Intangible Assets
IAS 39	Financial Instruments: Recognition and Measurement

Source: Adapted from the IASC web page www.iasc.org.uk

APPENDIX C
EXCHANGE RATE MECHANISM
BILATERAL CENTRAL RATES, INTERVENTION LIMITS, AND ECU CENTRAL RATES FROM MARCH 16, 1998

		BEF/LUF 100 =	DKK 100 =	FRF 100 =	DEM 100 =	IEP 100 =	NLG 100 =	PTE 100 =	ESP 100 =	ATS 100 =	FIM 100 =	ITL 1000 =	GRD 100 =
BELGIUM/LUXEMBOURG	S	-	627 88	714 030	2395 20	59 4775	2125 60	23 3645	28 1525	340 420	787 830	24 1920	13 2655
BEF/LUF	C	-	540 723	614 977	2062 55	51 2210	1830 55	20.1214	24 2447	293 162	678 468	20 8338	11 4242
	B	-	465 665	529 660	1776 20	44 1100	1576 45	17.3285	20 8795	252 470	584 290	17 9417	9 83835
DENMARK	S	21 4747	-	132 066	442 968	10 9995	393 105	4 32100	5 20640	62 9561	145 699	4 47400	2 45331
DKK	C	18 4938	-	113.732	381 443	9 47269	338 537	3 72120	4 48375	542167	125 474	3 85295	2 11276
	B	15 9266	-	97 9430	328 461	8.15774	291 544	3 20460	3 86140	46 6910	108 057	3 31810	1 81948
FRANCE	S	18 8800	102.100	-	389 480	9 67145	345 650	3.79920	4 55780	55 3545	128 107	393379	2.15709
FRF	C	16 2608	87 9257	-	335 386	8 32893	297 661	3 27189	3 94237	47 6704	110 324	3 38773	1 85766
	B	14 0050	75 7200	-	288 810	7.17277	256 350	2 81770	3 39510	410533	95.010	2 91750	1 59979
GERMANY	S	5 63000	30 4450	34 6250	-	2 88370	(103 058)*	1.13280	1.36500	16 5050	38 1970	1.1729	
DEM	C	4 84837	26 2163	29 8164	-	2 48338	88 7517	0 975559	1 17547	14 2136	32 8947	1 0101	
	B	4 17500	22 5750	25 6750	-	2.13860	(76 4326)*	0 840140	1.01230	12 2410	28 3280	0 8699	
IRELAND	S	2 26706	12 2583	13 9416	46 7595	-	41 4989	0 456154	0 549632	6 64602	15 3810	0 472304	
IEP	C	1.95232	10 5567	12 0063	40 2676	-	35 7382	0 392834	0 473335	5 72347	13 2459	0 406743	
	B	1 68131	9 09132	10 3397	34 6776	-	30.7774	0 338304	0 407631	4 92900	11.4072	0 350281	
NETHERLANDS	S	6 34340	34 3002	39 0091	(130 834)*	3 24910	-	1 27637	1.53793	18 5963	43 0378	1 32156	
NLG	C	5 46285	29 5389	33 5953	112 674	2 79812	-	1.09920	1.32445	16 0150	37 0637	1.13812	
	B	4 70454	25 4385	28 9381	(97.0325)*	2 40970	-	0 946611	1.14060	13 7918	31.9187	0 980132	
PORTUGAL	S	577 090	3120 50	3549 00	11903 30	285 592	10564.0	-	139 920	1691 80	3915 40	120 240	65 9280
PTE	C	496 984	2687.31	3056 34	10250 50	254 560	9097 53	-	120 492	1456 97	3371.88	103 541	56 7765
	B	428 000	1920 70	2632 10	8827 70	219 224	7834.70	-	103 770	1254.70	2903 80	89.170	48 8950
SPAIN	S	478 944	2589 80	2945 40	9878 50	245 320	8767 30	96 3670	-	1404 10	3249 50	99.7800	54.7156
ESP	C	412 462	2230 27	2536 54	8507 22	211 267	7550 30	82 9929	-	1209 18	2798 42	85 9313	47.1204
	B	355 206	1920.70	2184 40	7326 00	181 940	6502 20	71 4690	-	1041.30	2410 00	74 0000	40 5795
AUSTRIA	S	39 6809	214.174	243 586	816 927	20 2881	725 065	7 97000	9 60338	-	268 735	8 2522	4 52500
ATS	C	34 1108	184 445	209 774	703 552	17 4719	624 415	6 86357	8 27006	-	231.431	7 1066	3 89689
	B	29 3757	158 841	180 654	605 877	15 0466	537 740	5.91086	7 12200	-	199 305	6.1203	3 35595
FINLAND	S	17 1148	92 5438	105 253	353 008	8 76639	313 295	3 44376	4 14938	50 1744	-	3 56570	1 95523
FIM	C	14 7391	79 6976	90 6420	304 001	7 54951	269 806	2 96571	3 57345	43 2094	-	3 07071	1 68382
	B	12 6931	68 6347	78 0597	261 801	6 50154	232 353	2 55402	3 07740	37 2114	-	2 64438	1 45008
ITALY	S	5573 60	30138 0	34276 0	114956 0	2854 85	102027 0	1121 500	1351 30	16339 0	37816 0	-	636 700
ITL	C	4799 90	25954 2	29518 3	99000 2	2458 56	87864 4	965 805	1163 72	14071 5	32565 8	-	548 350
	B	4133 60	22351 0	25421 0	85259 0	2117 28	75668 0	831 700	1002 30	12118 0	28045 0	-	472 200
GREECE	S	1016 43	5496 05	6250 80	20964 3	520 624	18606 2	204 520	246 429	2979 78	6896 13	211 770	-
GRD	C	875 34	4733 13	5383 11	18054 2	448 355	16023 4	176 129	212 222	2566 15	5938 86	182 365	-
	B	753 83	4076 11	4635 86	15547 2	386 117	13799 1	151 681	182 763	2209 94	5114 47	157 060	-

S = Exchange rate at which the central bank of the country in the left hand column will sell the currency identified in the top row
C = Bilateral central rate and ECU 1 = ECU central rate
B = Exchange rate at which the central bank of the country in the left hand column will buy the currency identified in the top row.
* These buying and selling rates are not operational. Reflecting a bilateral agreement between the German and Dutch monetary authorities, the following rates apply Netherlands (100 DEM selling 115 2350, buying 110 1675), Germany (100 NLG selling 90 7700, buying 86 78)

Source: Adapted from http://www.bankofengland.co.uk/pr98034.htm

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