EUROPEAN CENTRAL BANK

12 September 2003
ST/STC/BP/03-34.DOC

IMPACT OF INTERNATIONAL ACCOUNTING STANDARDS ON EXTERNAL STATISTICS

This paper is a working document.

EXECUTIVE SUMMARY

Background[1]

1. The Regulation on the application of International Accounting Standards (IAS) will require all EU companies listed in a regulated market as well as companies preparing for such a listing to prepare their consolidated published accounts in accordance with those IAS that are adopted for application within the EU from 2005 onwards.

2. The aim is to increase transparency for existing/potential shareholders. The protection of investors and the confidence in financial markets is an important aspect of the completion of the internal market. It also creates a single set of high-quality, enforceable global accounting rules for use by the EU capital markets thereby improving the international comparability of consolidated statements for listed companies. The IAS Regulation reinforces the freedom of movement of capital in the internal market and helps EU companies to compete for financial resources available in capital markets on an equal footing.

3. Only for consolidated accounts of EU listed companies the new IAS will become compulsory by 2005 yet, it also provides an option for Member States to go further than the EU Regulation, by permitting or requiring the application of adopted IAS in preparing annual individual accounts and by permitting or requiring the application of adopted IAS by unlisted companies. Member States may thus require an

1 The Eurostat's note "International accounting standards – impact on the financial accounts" presented to the meeting of the Financial Accounts Working Party at its meeting on 14-15 November 2002 and the ECB S/MBS note "Impact of IAS on money & banking statistics" have provided useful background for this report.

uniform application of adopted IAS to important sectors such as banking or insurance, regardless of whether companies are listed or not. In addition, certain companies may prepare dual accounts (e.g. multinationals may also prepare financial statements in accordance with US Generally Accepted Accounting Principles (GAAP) if their shares are also listed overseas).

4. In fact, **the extent to which Member States decide to apply the IAS to the individual accounts of listed companies, and even extend their application to unlisted companies, will be crucial in determining the benefits of IAS for the statistical systems**: if there would not be a homogeneous approach for requiring/permitting the adoption of IAS to the **individual accounts** of listed and unlisted companies and/or the timetable for this adoption would vary from Member State to Member State, inconsistencies and asymmetries may arise in the statistical data compiled from companies' data recorded following different accounting practices. This could be a more important problem for compiling euro area statistical aggregate than the one associated to the compilation of statistical data from accounting rules departing from statistical standards but applied consistently in all Member States.

5. Therefore, statisticians may consider the convenience of bringing this issue to the attention of the bodies governing the application of IAS both at the EU and the national level. The state-of-play as at June 2003 regarding the possible extension of IAS to the individual accounts of listed companies and to consolidated and individual accounts of unlisted companies is summarised below (no timetable available for the time being).

Expected scope of application of the IAS (as at June 2003)

		Consolidated accounts	***Individual accounts***	**Undecided**
Listed	***required***	***All EU MS***	***GR, PT, IT, IS***	***LU***
	permitted	***n.a.***	***DE, DK*** *(2005)*, ***CZ*** *(2004)*, ***NL, FI, BE, SE, UK***	
	not allowed	***n.a.***	***ES, AT, NO***	
Unlisted	***required***	***BE*** *(2007)*	***BE*** *(2007)*	
	permitted	***DE, GR, ES, FR*** *(2005)*, ***IT, PT, FI, DK*** *(2005)*, ***AT, NL, CZ*** *(2004)*, ***SE, NO, IS, UK***	***DE, GR, ES, FR*** *(2005)*, ***IT, PT, FI, DK*** *(2005)*, ***AT, NL, CZ*** *(2004)*, ***SE, NO, IS, UK***	

Source: Eurostat's report entitled "Latest developments on accounting and statistics." This Table is largely based on informal contacts with Member States.

The issue

6. The aim to improve the comparability of financial statements of listed companies is achieved by introducing **fair valuation** as the standard and the rejection of historical cost valuation methods. In IAS 39,

the fair value is referred to as a *market value*, for those financial instruments for which a reliable market value can be readily identified, or a value resulting from generally accepted valuation models and techniques, for those instruments for which a reliable market value cannot be readily identified.

7. The introduction of "fair" (market) valuation as the standard and the rejection of historical cost valuation methods is of special importance towards increasing the consistency between accounting and external statistics, in particular balance of payments (b.o.p.) and international investment position (i.i.p.). The possible review of the current version of IAS 39 towards the adoption of "full" fair value accounting (i.e. also for assets and liabilities in the banking book such as loans and deposits) would also be a step forward in moving accounting standards closer to BPM5 (and SNA 93) recommendations and, thus, would be seen as an asset for b.o.p./i.i.p. compilers and statistics from a theoretical/conceptual viewpoint. It may, however, increase the gap with the business accounting of companies not applying IAS (for a transitional period or permanently).

8. In the context of a general move of b.o.p./i.i.p. reporting from bank settlements to surveys , it is expected that balance sheet and profit and loss accounts from major financial and non-financial companies will grow in importance as a source for b.o.p./i.i.p. statistics. Therefore, the closer the **link between accounting and statistical standards** the better the quality of the statistics and the lesser the statistical burden, as the reporting requirements are then more directly related to the accounting ledgers/software of the companies.

9. In this connection, it is worth noting that **IAS broadly complies with concepts, classifications and valuation rules of BPM5 and SNA93**. Therefore, the introduction of IAS may contribute to a further harmonisation of the data collection and may yield additional information that helps compilers to overcome some problems using company accounts, e.g. the identification of realised/unrealised holding gains and/or the disclosure of items recorded off-balance sheet.

Way forward

10. As a way forward, there are a number of areas where the introduction of IAS may affect b.o.p./i.i.p. collection methods and statistics and which therefore should guide the work of b.o.p./i.i.p. statisticians in the coming months:

(1) The project on harmonised b.o.p./i.i.p. reporting for multinationals

(a) **Harmonised b.o.p./i.i.p. reporting model for multinationals with a close link-up with the enterprises' accounting systems**. A statistical reporting functionality based on the so-called Enterprise Resource Planning (ERP) software would be advisable in order to retrieve information needed for b.o.p./i.i.p. reporting from the enterprise accounting system (e.g. the ledgers such as on fixed/financial assets). In this respect, the development and implementation of IAS[2] may act as a **catalyst** of this process, as it will at once (i) promote EU-wide harmonised accounting rules (at least for major international companies) and (ii) further enhance the consistency between the accounting rules and the b.o.p./i.i.p. statistical standards.

(b) **new data transmission technologies developed for both accounting and statistical data transmission, such as XML and more specifically, XBRL**. XBRL offers a means of codifying business data (accounting, statistics or any other) in a precise and standardised way. To the extent that standard statistical classifications are integrated within XBRL, the accounting and statistical records downloaded from the ERP software will be directly reported by the company via Internet to the relevant authorities and statistical compilers, respectively, using these internationally accepted transmission formats. This may, however, call for an increasing awareness of the relevant software providers with statistical requirements.

(2) Foreign Direct Investment

(a) The compilation of FDI stocks will in the future be based on information collected via FDI surveys, which largely rely on balance sheet information. Thus, a closer consistency between accounting and the i.i.p. methodology will definitely be **an important asset** for FDI statistics.

(b) The principles for the treatment of extraordinary items and of changes to profits arising from new standards or from the correction of errors, may facilitate the application of the Current Operating Performance Concept (COPC)[3] for calculating reinvested earnings. This COPC, in contrast to the ‘all-inclusive concept’, can only be applied in practice if **separate information on operating and extraordinary profits/losses is presented** in the profit and loss statement, as set up in IAS 8.

(c) FDI stock statistics may much benefit from the new mandatory “statement of changes in equity” under IAS 1, i.e. changes in own funds, as it will facilitate a more harmonised application of the so-called **Own Funds at Book Value (OFBV)** agreed by the STC for the valuation of listed and non-listed companies.

(d) The **accounting concept of goodwill** as defined in IAS 22, i.e. the difference between the acquisition cost and the net assets at fair (market) value, is consistent with the statistical concept included in the definition of Own Funds at Book Value (OFBV) agreed by the STC for the valuation of FDI stock of listed and non-listed companies statistics;

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[2] The US GAAP is already used by some EU-based multinationals.

[3] The COPC represents income from normal operations of the enterprise (net of depreciation allowances and of other transfers) and does not include realised or unrealised holding gains or losses arising from valuation changes and write-offs.

(e) The new requirements for the notes accompanying the consolidated accounts may assist b.o.p./i.i.p. compilers in **identifying FDI relationships**: (i) IAS 24 requires disclosure of related parties that are able to control or exercise significant influence over the company *–FDI in reporting economy–*; and (ii) IAS 27 and 28 require including a list of the most significant subsidiaries and associates *–FDI abroad–*;

(f) According to IAS 27 and 28 the consolidated statements of the parent company should include all domestic and foreign subsidiaries and associates except when the control is lost or is only intended to be temporary. The **geographical detail is not foreseen in the IAS requirements for consolidated statements** and should separately be required to permit the use of the accounting data as a direct input in FDI statistics;

(g) According to IAS 27 and 28 consolidated accounts encompass those entities where the stake of the parent company is 20% or above ('associates' –between 20% and 50%- and 'subsidiaries' –more than 50%). However, the current statistical rules as set out in the OECD Benchmark for FDI define FDI relationships according to the so-called '10% criterion', i.e. FDI relationships exist if there is an ownership of more than 10% of the capital). Therefore, international fora (IMF B.o.p. Committee, OECD Working Party on Financial Statistics) may in due course wish to **revisit the 10% criterion** set out in the BPM5 for assessing the "lasting interest", as an alignment of the international statistical standard to the "20% criterion" in place in accounting rules may much ease the data collection and help in reducing asymmetries;

(h) Lastly, it may be worth noting that, according to existing information, a majority of Member States will permit the application of the new IAS accounting standards to consolidated and **individual (unconsolidated) accounts of unlisted companies**. In these countries, it is considered that the largest firms will likely do so in the short-term. In the longer-term, competitive pressures may also lead smaller firms to switch to IAS. In this scenario where both listed and non-listed companies would compile their accounts on the basis of IAS, the ratio market values/book values may still be a valid method for estimating the market value of FDI stocks for non-listed companies.

(3) Accruals recording

If the proposed amendments to IAS39 are endorsed, the extension of fair valuation to the "banking book" **may imply a move towards the 'creditor' approach for accruals recording**.

(4) Insurance corporations

Bearing in mind the increasing role of direct reporters in b.o.p./i.i.p. collection systems, the valuation methods applied in the accounting statements of insurance corporations, as potential direct reporters, will most likely be of utmost importance in the near future. Particularly relevant may be those activities of insurance corporations in which cross-border business has a significant impact such as reinsurance deals[4] or insurance technical reserves (especially for the compilation of the international investment position). In the latter case, the extent to which some valuation methods promoted in the new IAS will be applicable to insurance corporations deserves further attention in areas such as life insurance.

(5) Other Investment

As data for the other investment account of the MFI sector in the b.o.p./i.i.p. are largely derived from money & banking statistics, a practical problem may arise for these data if the amended IAS 39 is adopted. In this case, if money & banking statistics still required a nominal valuation for loans and deposits, an inconsistency would appear in the b.o.p./i.i.p. other investment account. The valuation for the 'other sectors' would mainly be fair value as derived from companies' accounting records, while for the MFI sector, mainly nominal value would be obtained from money & banking statistics. Therefore, if IAS 39 were amended towards "full" fair value accounting, the adoption of this valuation rules in MFI balance sheet statistics would be highly welcome by b.o.p./i.i.p. compilers.

In a nutshell, the introduction of the new IAS may contribute to the use of more harmonised accounting standards across enterprises, broadly in line with international statistical standards.

However, the practical implementation may still vary across Member States and the gap may increase between companies applying the IAS (and reporting along these lines) and other companies. The extent to which compilation of statistics may benefit from the closer link of the new IAS to international statistical standards will crucially depend on if, and where, the new IAS will be applied to individual accounts of both listed and unlisted companies. Difference in the timing of the implementation in various Member States, as well as the way b.o.p./i.i.p. compilers will adapt their reporting requirements may also cause disruptions at the euro area level.

A further exchange of views and experience is indispensable, in particular (i) in the framework of the Task Force on FDI, (ii) in the context of the Steering Group on Multinationals, and (iii) in any follow-up to the report of the Technical Group Direct Reporting. The discussion (on 9 May 2003) of the Steering Group on Multinationals with representatives of some multinationals and software houses has shown that reporting rules, both harmonised and consistent with accounting standards, may foster more timely and higher quality data, while creating a case for Enterprise Resource Planning software packages to include new modules/facilities to automate the data processing, thereby reducing the costs for enterprises.

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4 It was noted in the IMF B.o.p. Committee in October 2002 that while insurance is largely a domestic activity, reinsurance is mostly cross-border owing to the important concentration of the business and, thus, of relevance for b.o.p./i.i.p. compilers.

***Initiatives to foster a more harmonised pace of implementation across Member States and a broader and more homogeneous coverage for individual accounts of both listed and unlisted companies will have to be pursued and supported by all institutional players*.**

THE IAS FRAMEWORK

Background

1. The 23-24 March 2000 Lisbon Council Conclusions emphasised the need to advance the completion of the internal market for financial services and urged that measures be taken to enhance the comparability of financial statements prepared by listed companies. On 13 June 2000, the Commission adopted a Communication[5] in which the Commission proposed that all EU companies listed on a regulated market stock are required to prepare their consolidated accounts in accordance with a single set of accounting standards, namely the International Accounting Standards (IAS), from 2005 at the latest. As a result, the Council adopted "The Regulation on the application of International Accounting Standards"[6] ('the IAS Regulation') on 19 July 2002.

2. The IAS Regulation fills in a gap in the previous legislation, as the requirements set out in the original EU Accounting Directives[7] could not ensure a high level of transparency and comparability of financial reporting by all publicly traded Community companies.

Aim

3. IAS are developed by the International Accounting Standards Board (IASB), a world-wide private sector institution established in 1973 by the leading professional organisations and with the official backing of national governments of major developed countries. The IASB's mandate is to create a single set of high-quality, enforceable global accounting rules for use by the world's capital markets. The aim is thereby to improve the international comparability of consolidated statements for listed companies.

4. In addition, the protection of investors and the maintenance of confidence in financial markets is also an important aspect of the completion of the internal market. The IAS Regulation reinforces the freedom of movement of capital in the internal market and helps EU companies to compete for financial resources available in capital markets on an equal footing.

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5 "The EU's Financial Reporting Strategy: The Way Forward"; COM (2000) 359, 13 June 2000.

6 Cf. EC (2002) 1606, 19 July 2002.

7 Cf. Council Directive 78/660/EEC of 25 July 1978 on the annual accounts of certain types of companies, Council Directive 83/349/EEC of 13 June 1983 on consolidated accounts, Council Directive 86/635/EEC of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions and Council Directive 91/674/EEC of 19 December 1991 on the annual accounts and consolidated accounts of insurance companies.

APPLICATION OF IAS

Consolidated accounts of listed companies

5. As part of the Commission's Financial Services Action Plan, which is due to be implemented by 2005, the introduction of IAS for listed companies represents an important step to enhance the comparability of financial statements prepared by publicly traded companies.

6. The new IAS Regulation requires all EU companies listed in a regulated market as well as companies preparing for such a listing to prepare their consolidated published accounts in accordance with those IAS that are adopted for application within the EU from 1 January 2005 onwards at the latest. Indeed, the timing is even tighter as comparable information is required for the year 2004, so that the conversion of accounting systems must be completed by end-2003. As a transitional provision, Member States may grant derogations to make the new accounting requirements applicable from 1 January 2007 for those companies whose securities are admitted for trading or whose securities are listed in a non-Member State and which, for that purpose, already comply with other internationally accepted standards.

Extension to individual accounts of listed companies and consolidated and individual accounts of unlisted companies

7. Only for consolidated accounts of EU listed companies the new IAS will become compulsory by 2005 yet, it also provides an option for Member States to go further than the EU Regulation, by permitting or requiring the application of adopted IAS in preparing annual individual accounts and by permitting or requiring the application of adopted IAS by unlisted companies. Member States may thus require an uniform application of adopted IAS to important sectors such as banking or insurance, regardless of whether companies are listed or not. In addition, certain companies may prepare dual accounts (e.g. multinationals may also prepare financial statements in accordance with US Generally Accepted Accounting Principles (GAAP) if their shares are also listed overseas).

8. In fact, **the extent to which Member States decide to apply the IAS to the individual accounts of listed companies, and even extend their application to unlisted companies, will be crucial in determining the benefits of IAS for the statistical systems**: should the approach for requiring/permitting the adoption of IAS to the **individual accounts** of listed and unlisted companies be heterogeneous and/or the timetable for this adoption vary from Member State to Member State, inconsistencies and asymmetries may arise in the statistical data compiled from companies' data recorded following different accounting practices. This could be a more important problem for compiling euro area statistical aggregate than the one associated to the compilation of statistical data from accounting rules departing from statistical standards but applied consistently in all Member States. Therefore, statisticians may consider the convenience of

bringing this issue to the attention of the bodies governing the application of IAS both at the EU and the national level.

9. According to information available on June 2003, in three countries (ES, NL and FI) the extension to cover the individual accounts maybe made compulsory such that individual and consolidated accounts would have to comply with the IAS. However, ES has indicated that if the option to permit FVA is introduced in the latest revision of IAS39 as currently proposed, then this will be not be permitted for the non-consolidated accounts. Four Member States (DE, IT, PT and DK) indicate that they may permit (but not require) the new rules to be applied to individual accounts of listed financial institutions. In two member states (BE and FR), the extension to the individual accounts will not be applied, and instead listed financial institutions must continue to apply domestic GAAP. FR has indicated that it is planned gradually to converge towards IAS in a process that may take 5 to 10 years. The remaining four countries (IE, LU, AT and SE) could not forecast at this stage the likely decisions to be taken by their national authorities.

10. Concerning the application of the new accounting standards to consolidated and unconsolidated accounts of unlisted companies, information based on non-official communications indicates that eight countries (DE, ES, GR, FR[8], IT, PT, FI and DK) will probably permit this, while application is expected to become a compulsory extension in one country (NL). In another country (BE), the national authorities intend to impose IAS to the consolidated accounts of all companies, regardless whether they are listed or not. Four countries (IE, LU, AT, SE) could not forecast yet the likely decision to be taken by its domestic authorities.

Expected scope of application of the IAS (as at June 2003)

		Consolidated accounts	*Individual accounts*	**Undecided**
Listed	***required***	***All EU MS***	***GR, PT, IT, IS***	***LU***
	permitted	***n.a.***	***DE, DK** (2005)**, CZ** (2004)**, NL, FI, BE, SE, UK***	
	not allowed	***n.a.***	***ES, AT, NO***	
Unlisted	***required***	***BE** (2007)*	***BE** (2007)*	
	permitted	***DE, GR, ES, FR** (2005)**, IT, PT, FI, DK** (2005)**, AT, NL, CZ** (2004)**, SE, NO, IS, UK***	***DE, GR, ES, FR** (2005)**, IT, PT, FI, DK** (2005)**, AT, NL, CZ** (2004)**, SE, NO, IS, UK***	

Source: Eurostat's report entitled "Latest developments on accounting and statistics." This Table is largely based on informal contacts with Member States).

[8] Only to consolidated accounts. Unlisted companies will have to compile their individual accounts on the basis of domestic GAAP, which will gradually converge towards IAS.

Content: compulsory standards under IAS Regulation

11. These new reporting requirements of the IAS Regulation for listed companies will be additional to the requirements of the existing Accounting Directives. The detailed provisions of the 4th and 7th Accounting Directives[9] will continue to act as a basis of EU accounting legislation for entities that do not prepare their annual or consolidated accounts in accordance with the IAS. In many respects, the Accounting Directives remain in line with modern accounting theory and practice.

12. However, in certain areas, such as the valuation principles, the accounting rules for Special Purpose Vehicles (SPVs) and the disclosure of risks and uncertainties, these Directives are incompatible with IAS and were amended by Directive 2001/65/EC, which introduced the concept of fair value and other rules taken from IAS standards.

13. The IAS currently comprises 41 individual standards[10] and 25 interpretations covering some 1,300 pages. The Regulation EC/1606/2002 confers on the Commission the powers to implement IAS in accordance with the Council Decision 1999-468-EC of 28 June 1999[11]. In deciding on the compulsory standards under the IAS Regulation, the Commission is assisted by a technical committee called the Accounting Regulatory Committee (ARC), in which the ECB is represented with an observer status.

14. On 16 July 2003, the ARC agreed with the Commission regarding the importance of an immediate adoption of all existing IAS, with IAS 32 and 39 as soon as possible thereafter. The adoption of future standards must respect the quality criteria set out in the IAS Regulation and be conducive to the European public good.

THE ACCOUNTING PRINCIPLES IN IAS

Valuation principles (IAS 39)

15. The aim to improve the comparability of financial statements of listed companies, as a decision-making tool for investors, is achieved by introducing **fair valuation** as the standard and the rejection of historical cost valuation methods. In IAS 39, the fair value is referred to as:

(i) a market value, for those financial instruments for which a reliable market value can readily be identified. Where a market value is not readily identifiable for an instrument but can be identified

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9 Cf. Council Directive 78/660/EEC of 25 July 1978 on the annual accounts of certain types of companies, Council Directive 83/349/EEC of 13 June 1983 on consolidated accounts, Council Directive 86/635/EEC of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions.

10 See annex 1.

11 Council Decision of 28 June 1999 lays down the procedure for the exercise of implementing powers conferred on the Commission OJ L 184, 17.7.99, page 23.

for its components or for a similar instrument, the market value may be derived from that of its components or of the similar instrument; or

(ii) a value resulting from generally accepted valuation models and techniques, for those instruments for which a reliable market value cannot be readily identified. Such valuation models and techniques shall ensure a reasonable approximation of the market value.

16. **On the assets side**, fair valuation should be applied to all tradable financial instruments:

(i) traded securities and securities available for sale (*"trading book"*);

(ii) traded loans and deposits; and

(iii) financial derivatives.

17. Accordingly, the only exceptions to the principle of fair valuation under IAS are:

(a) non-negotiable securities and securities held to maturity *("banking book"*) are to be valued at the *amortised cost price*;

(b) non-traded loans and deposits are to be valued at *amortised cost*.

18. However, proposed amendments to IAS39 would considerably broaden the application of fair values. These amendments foresee the introduction of the option for applying fair valuation also to the (a) "banking book" and (b) the non-traded loans and deposits categories currently exempted.

19. **On the liabilities side**, financial liabilities are measured at the *original recorded amount less principal repayments and amortisation*. Only exceptions are derivatives and liabilities held for trading (such as securities borrowed by a short-seller) for which fair valuation should be applied.

Recognition of gains and losses of financial assets and liabilities in the profit and loss account (IAS 39)

20. The rules guiding the recognition of gains and losses of financial assets and liabilities in the profit and loss account are also regulated in IAS 39.

21. As a general principle, all financial assets and liabilities are to be recognised on the balance sheet, including all financial derivatives.

22. Moreover, for those financial assets and liabilities measured at fair value, the company will have the option to:

(i) recognise the entire adjustment in net profit or loss for the period;

(ii) recognise in net profit or loss for the period only those changes in fair value relating to financial assets and liabilities held for trading ("*trading book*"), with the non-trading value changes ("*banking book*") reported as own funds in the balance sheet until the financial assets is sold, at which time the realised gain or loss is reported as a net profit or loss. For this purpose, derivatives are always deemed 'held for trading' unless they are designated as hedging instruments.

23. In this respect, one of the proposed amendment to IAS 39 foresees the application of an "impairment test" to all loans (even those held to maturity and those originated by the company) at each balance sheet date. If there is objective evidence of impairment that the company will not be able to collect all amounts due, an impairment or bad debt loss needs to be recorded in the profit and loss account, using the original effective interest rate to discount the expected cash flows[12]. This impairment test can also be carried out for a group of loans sharing the same risk features (e.g. consumer credit loans). Expected cash flow in a group of loans that are collectively evaluated for impairment is estimated on the basis of the contractual cash flow and the historical loss experience.

24. Finally, the removal of assets from the balance sheet is subject to strict requirements ensuring that the control over the assets is actually transferred. Combined with guidance on the consolidation of SPVs, the ability to conduct activities through vehicles that transfer assets off the balance sheet is severely restricted.

Disclosure and presentation of financial instruments in the balance sheet (IAS 32)

25. IAS 32 establishes the rules for the disclosure and presentation of on-balance sheet and off-balance sheet financial instruments in respect of a company's financial position and performance. This clarifies (a) the classification of a financial instrument issued by an enterprise as equity or as a financial liability; (b) the conditions under which assets and liabilities may be offset and (c) the disclosure rules for financial instruments.

26. In addition, IAS 1 on presentation and structure of financial statements requires the publication of a new "statement of changes in equity", i.e. changes in own funds. This new statement should show recognised gains and losses including all gains and losses recognised directly in equity such as revaluation gains and losses, foreign currency translation gains and losses, and changes in fair values of financial instruments.

27. Finally, the treatment of goodwill is contained in IAS 22 which presents the different business combinations giving raise to consolidation. The recognition of goodwill is only connected to acquisition of companies, not to processes of uniting of interests such as joint ventures. When one company acquires another one, the goodwill will be the difference between the acquisition cost and the net assets at fair (market) value. This difference may either be positive or negative: (i) positive goodwill should be recorded

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[12] Otherwise, using the current market rate would be equivalent to use fair value for financial assets that IAS39 requires to be measured at amortised cost.

in the balance sheet of the acquiring company at cost price less amortisation (maximum 20 years) and depreciation; (ii) negative goodwill (i.e. "badwill") should be deducted from assets and be written off.

Methods of consolidation (IAS 27 and 28)

28. IAS 27 and 28 deal with the consolidation methods for companies: (i) IAS 27 presents the consolidation methods for **subsidiaries**, entities which are controlled by the parent company; (ii) IAS 28 contains the rules and methods applicable to the consolidation of investments in **associates**, entities in which the parent company exerts significant influence.

29. The presentation of investments in subsidiaries on the balance sheet of the parent company is described in IAS 27. Subsidiaries are defined as those entities which are fully under control of the parent company, i.e. *ownership of more than 50% of the capital*. The consolidated statements of the parent company should include all domestic and foreign subsidiaries except when the control is lost or is only intended to be temporary. If the latter would happen, either the rules for consolidating associates or the standard rules for valuing financial instruments (in case some assets/liabilities would still be owned by the parent company) would be applied.

30. The consolidation method is based on full consolidation carried at cost according to either the "equity[13]" or the "as available-for-sale" methods, with the minority interests presented separately and after elimination of intra-group transactions and balances. In the notes accompanying the consolidated accounts (balance sheet, income and cash-flow statements), a list of the most significant subsidiaries and the effect of the acquisition/disposals of subsidiaries has to be included.

31. Likewise, the presentation of investments in associates on the balance sheet of the parent company is described in IAS 27. Associates are defined as those entities where the parent company exerts a *significant influence, though has not full control: in practice ownership of at least 20% or more of the capital (but less than 50%, of course) is required in order to consider the related company as an associate*. The consolidated statements of the parent company should include all domestic and foreign associates except when the control is lost or is only intended to be temporary. As for subsidiaries, the consolidation method is based on full consolidation carried at cost according to either the "equity" or the "as available-for-sale" methods, with the minority interests presented separately and after elimination of intra-group transactions and balances. In the notes accompanying the consolidated accounts (balance sheet, income and cash-flow statements), a list of the most significant associates has to be included.

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[13] The 'equity' method consists in valuing the investment in related companies at cost plus retained profits or losses.

CONSISTENCY BETWEEN IAS AND B.O.P./I.I.P. STANDARDS

More homogeneous accounting rules should yield benefits for b.o.p./i.i.p. statistics

32. A special concern of IAS from the point of view of compiling b.o.p./i.i.p. statistics is the fact that company accounts constitute an important statistical source. Company accounts are usually collected by means of sample surveys. Central business registers are usually used as sample frameworks for branch classifications which are then adjusted to cover the entire business sector.

33. Moreover, in the context of a general move from (bank) settlement-based to (company) survey-based collection systems, it is expected that balance sheets and profit and loss accounts will grow in importance as raw data for b.o.p./i.i.p. statistics.

34. In this connection, national b.o.p./i.i.p. compilers have to first convert the items of business accounting to the statistical categories compliant with the BPM5 and SNA93 standards. The more divergent statistical and accounting standards are, the more difficult this conversion becomes. Therefore, it is worth noting that IAS broadly complies with concepts, classifications and valuation rules of BPM5 and SNA93. Therefore, the introduction of IAS may harmonise the data collection and yield additional information that may help compilers to overcome some problems using company accounts, e.g. the identification of realised/unrealised holding gains and/or the disclosure of items recorded off-balance sheet.

Closer correspondence in valuation principles

35. International standards for b.o.p./i.i.p. statistics determine that "market price be used as the basis of valuation for both transactions and stocks. Thus, transactions are generally valued at the actual prices agreed upon by transactors; stocks of assets and liabilities are valued at market prices in effect at the time to which the balance sheet relates. These principles are in accordance with those presented in the SNA"[14]. Exceptions/deviations to/from this general principle are only admitted by the BPM5 when this ‘market price concept’ may be impractical or difficult to apply. In these cases, other values considered as an acceptable proxy for market values are accepted.

36. In this context, the introduction of “fair” (market) valuation as the standard and the rejection of historical cost valuation methods is of special importance towards increasing the consistency between accounting and b.o.p./i.i.p. statistics. Along the same line, the review of the current version of IAS 39 towards the adoption of “full” fair value accounting (i.e. also for assets and liabilities in the banking book such as loans and deposits) would also be a step forward in moving accounting standards to BPM5

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14 Please refer to BPM5 paragraph 91.

recommendations and thus would not pose major difficulties for b.o.p./i.i.p. compilers and statistics from a theoretical/conceptual viewpoint.

37. Many balance sheet items are still not valued at market prices. Cost valuation, hidden reserves, off-balance sheet items are familiar terms that all reveal that valuation at market prices is not fully used in accounting standards. Two arguments have often been used to defend this practice. One, market prices may be temporarily out of equilibrium. Two, it is good to be conservative. The counter argument to the first point is that prices at any given moment include the best collective estimate of future developments. To the second point, whereas a prudent/conservative approach to financial management makes sense, this should not be in conflict with being transparent.

Closer correspondence in distinguishing income and valuation changes and application of accruals

38. According to the international standards for b.o.p./i.i.p. statistics, capital gains and losses are not to be classified as income on investments (revenue) but as part of the value of the investments. Moreover, realised gains and losses arising from transactions should be included in the financial account, whereas unrealised valuation changes are not to be included. Finally, income on investments (revenue) is to be recorded as accruing over the life of the investment, i.e. the principle of accruals should be applied.

39. In this respect, the IAS Regulation brings accounting rules closer to these statistical standards. According to IAS 39, whereas gains and losses relating to financial assets and liabilities held for trading ("*trading book*") will be reported in net profit or loss for the period even if unrealised, gains and losses reflected in changes in fair value with the non-trading instruments ("*banking book*") will be reported as own funds in the balance sheet until the financial assets is sold (i.e. until a 'transaction' in statistical terms occurs), at which time the realised gain or loss is reported in net profit or loss. In both cases, though, gains and losses will be separately recognised from revenue (interest, dividends). Finally, IAS 1, which defines overall principles to be applied in the financial statements, establishes the accruals basis of accounting under IAS.

Closer correspondence in presenting financial instruments in the balance sheet

40. As mentioned in the previous section, IAS 32 establishes new rules for the disclosure and presentation of on-balance sheet and off-balance sheet financial instruments in respect of a company's financial position and performance. In particular, it requires all derivatives to be recognised on-balance sheet at their fair values, with the exception of those derivatives that are to be held to maturity which should be recorded at cost. This requirement contributes to bring closer accounting standards to b.o.p./i.i.p. statistical rules, as all financial derivatives that are recognised on-balance sheet should be recorded at fair or market value.

41. Finally, the concept of goodwill as defined in IAS 22 has also been a further step in converging accounting and statistical standards. When refining the definition of 'own funds' for compiling euro area Foreign Direct Investment stocks on a book value basis, it was agreed that this definition should include the following components: (i) nominal capital; (ii) all types of reserves, including those resulting from goodwill; and (iii) non-distributed profits net of losses (including results for the current year). Therefore, it was concluded that goodwill should be included in the valuation of DI enterprises based on own funds.

42. Moreover, following ESA95. Annex 7.1, *the value of goodwill includes anything of long-term benefit to the business that has not been separately identified as an asset*. This implies that the concept of goodwill to be included in FDI stocks does not solely refer to "purchased goodwill" (or goodwill made evident in the price of acquisition of a DI company, at the time FDI transactions occur) but to the accounting concept of goodwill as defined in IAS 22, i.e. any entry in the liabilities side of the balance sheet of an enterprise, which is part of its total reserves, and whose origin is the difference between the total value of its assets net of any liabilities.

WAY FORWARD: CONSEQUENCES OF IAS ON B.O.P./I.I.P. STATISTICS

43. Though it may be too early to draw definite conclusions on the precise impact of the introduction of IAS, there are a number of areas where the introduction of IAS may affect b.o.p./i.i.p. collection methods and statistics and which therefore should guide the work of b.o.p./i.i.p. statisticians in the coming months. However, it should be mentioned that the extent to which compilation of external statistics may benefit from the closer link of the new IAS to international statistical standards will crucially depend on if, and where, the new IAS will be applied to individual accounts of both listed and unlisted companies. If they are only applicable to consolidated accounts of listed companies, these benefits may be blurred to a large extent:

(1) The project on harmonised b.o.p./i.i.p. reporting for multinationals

44. Following a request in mid-2000 by the European Round Table of Industrialists (ERT) to the President of the European Central Bank, Mr. Duisenberg, to consider the possibility of harmonising balance of payments (b.o.p.) reporting across the European Union, the ECB and the European Commission (Eurostat) commissioned the Steering Group on Multinationals (SGM) to run a feasibility study and testing with multinational companies to assess the costs and benefits of such a harmonised reporting.

45. At the moment, Europe is marked by a diversity of national b.o.p./i.i.p. reporting formats. For enterprises with affiliates in other European countries, this may not be optimal as reporting for these enterprises requires a specific data processing for each EU Member State. Standardisation of b.o.p./i.i.p. reporting rules for multinationals would result in one common reporting procedure for affiliates in the various European countries and is expected to yield cost savings. Standardisation of b.o.p./i.i.p. reporting

rules would also benefit the quality of the information as a result of the streamlining of the reporting process for all enterprises concerned.

46. The current investigations focus on a harmonised b.o.p./i.i.p. reporting model for multinationals with a close link to the enterprises' accounting system. A statistical reporting functionality based on the so-called Enterprise Resource Planning (ERP) software would be advisable in order to retrieve information needed for b.o.p./i.i.p. reporting from the enterprise accounting system (e.g. the ledgers such as on fixed/financial assets). For this purpose, specifications of the level of detail and aggregation have been laid down in a harmonised reporting model that was established on the basis of requirements of international institutions such as the ECB and Commission (Eurostat).

47. This ERP software should enable the company to derive the information needed for both the enterprise accounting system and b.o.p./i.i.p. reporting from its basic entries. Of course, the success of such a system will crucially rely on two elements:

(i) the degree of harmonisation at the EU level of the accounting rules for companies in general and for multinational groups in particular;

(ii) the degree of consistency and compatibility between such harmonised accounting standards and the b.o.p./i.i.p. statistical standards.

48. In this respect, the development and implementation of IAS[15] may act as a catalyst of this process, as it will at once (i) promote EU-wide harmonised accounting rules (at least for major international companies) and (ii) further enhance the consistency between the accounting rules and the b.o.p./i.i.p. statistical standards. This will also facilitate contacts with representatives of the main international ERP software companies that will be held[16] to discuss these reporting functionalities on the basis of current market standards.

49. The system could also benefit from new data transmission technologies which are currently developed for both accounting and statistical data transmission, such as XML and more specifically, XBRL. XBRL is one of a family of XML (extensible mark-up languages) that is becoming widely recognised and used and which is expected to be applied as a world standard for data transmission. XBRL offers a means of codifying business data (accounting, statistics or any other) in a precise and standardised way. The accounting and statistical records downloaded from the ERP software will be directly reported by the company to the relevant authorities and the statistical compiler, respectively, using these internationally accepted transmission formats via Internet.

(2) Foreign Direct Investment

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15 The US GAAP is already used by some EU-based multinationals.

16 The Steering Group on Multinationals will meet ERP software providers on 9 May 2003 at the ECB facilities.

50. In the field of FDI, several aspects may be influenced by the implementation of IAS:

(a) Firstly, the provision of annual FDI stocks based on an accumulation of b.o.p. flows will not be recognised any more as an acceptable practice and will therefore be discontinued as soon as possible. The compilation of FDI stocks will in the future be based on information collected via FDI surveys, which largely rely on balance sheet information. Thus, a closer consistency between accounting and the i.i.p. methodology will definitely be **an important asset for FDI statistics**.

(b) Secondly, the principles for the treatment of extraordinary items and of changes to profits arising from new standards or from the correction of errors may facilitate the application of the Current Operating Performance Concept (COPC)[17] for calculating reinvested earnings. This COPC, in contrast to the 'all-inclusive concept', can only be applied in practice if separate information on operating and extraordinary profits/losses is presented in the gains and losses statement, as set up in IAS 8;

(c) Thirdly, FDI stock statistics may much benefit from the new mandatory "statement of changes in equity" under IAS 1, i.e. changes in own funds, as it will facilitate a more harmonised application of the so-called Own Funds at Book Value (OFBV) agreed by the STC for the valuation of listed and non-listed companies.

(d) Fourthly, the accounting concept of goodwill as defined in IAS 22, i.e. the difference between the acquisition cost and the net assets at fair (market) value, is consistent with the statistical concept included in the definition of Own Funds at Book Value (OFBV) agreed by the STC for the valuation of FDI stock of listed and non-listed companies statistics;

(e) Fifthly, the new requirements for the notes accompanying the consolidated accounts may assist b.o.p./i.i.p. compilers in identifying FDI relationships: (i) IAS 24 requires disclosure of related parties that are able to control or exercise significant influence over the company – *FDI in reporting economy* -; and (ii) IAS 27 and 28 require including a list of the most significant subsidiaries and associates – *FDI abroad* -;

(f) Sixthly, according to IAS 27 and 28 the consolidated statements of the parent company should include all domestic and foreign subsidiaries and associates except when the control is lost or is only intended to be temporary. The lack of a mandatory geographical detail in the IAS requirements for consolidated statements may hamper the use of the accounting data as a direct input in FDI statistics;

[17] The COPC represents income from normal operations of the enterprise (net of depreciation allowances and of other transfers) and does not include realised or unrealised holding gains or losses arising from valuation changes and write-offs.

(g) Seventhly, according to IAS 27 and 28 the consolidation perimeter for compiling consolidated accounts consists of those entities where the stake of the parent company is 20% or above (‘associates’ – between 20% and 50% - and ‘subsidiaries’ – more than 50% -). However, the current statistical rules as set out in the OECD Benchmark for FDI define FDI relationships according to the so-called ‘10% criterion’, i.e. FDI relationships exist if there is an ownership of more than 10% of the capital). Therefore, it may be considered in due course revisiting the 10% criterion set out in the BPM5 for assessing the “lasting interest”. An alignment of the international statistical standard to the “20% criterion” in place in accounting rules may much ease the data collection and help in reducing asymmetries;

(h) Lastly, it may be worth noting that according to existing information a majority of Member States will permit the application of the new IAS accounting standards to consolidated and individual (unconsolidated) accounts of unlisted companies. In these countries, it is considered likely that the largest firms will do so in the short-term. In the longer-term, competitive pressures may also force small firms to switch to IAS. In this scenario where both listed and non-listed companies would complie their accounts on the basis of IAS, the ratio market values/book values may still be a valid method for estimating the market value of FDI stocks for non-listed companies.

(3) Accruals recording

51. Regarding the debate among statisticians on whether accruals recording of income should be based on the debtor or creditor approach, the implementation of IAS 39 may have an important practical effect. So far, current accounting standards were recording income on negotiable securities on the basis of the so-called ‘acquisition’ approach on the assets side and following the ‘debtor’ approach on the assets side.

52. However, if the proposed amendments to IAS39 were adopted, the extension of fair valuation also to the “banking book” would imply a move to the ‘creditor’ approach on the assets side.

(4) Insurance corporations

53. Bearing in mind the increasing role of direct reporters in b.o.p./i.i.p. collection systems, the valuation methods applied in the accounting statements of insurance corporations, as potential direct reporters, will most likely be of utmost importance in the near future. Particularly relevant may be those activities of insurance corporations in which cross-border business has a significant impact such as reinsurance deals[18] or insurance technical reserves (especially for the compilation of the international investment position). In the latter case, the extent to which some valuation methods promoted in the new IAS will be applicable to insurance corporations deserves further attention in areas such as life insurance.

(5) Other Investment

54. As stated in the BPM5, "Other investment items, …, are recorded in the investment position at nominal or face value (as is the case for currency). In general, that value is an acceptable proxy for market value. […]. In principle, values recorded in the position [for bad loans] should be based on secondary market quotations."[19] In short, this implies that both current and amended IAS 39 will be consistent with these b.o.p./i.i.p. statistical valuation criteria.

55. As data for the other investment account of the MFI sector in the b.o.p./i.i.p. are largely derived from money & banking statistics, a practical problem may arise for these data of the amended IAS 39 is adopted. In this case, if money & banking statistics still required a nominal valuation for loans and deposits, an inconsistency would appear in the b.o.p./i.i.p. other investment account. The valuation for the 'other sectors' would mainly fair value as derived from companies' accounting records, while for the MFI sector, mainly nominal value would be obtained from money & banking statistics. Therefore, if IAS 39 would be amended towards "full" fair value accounting, the adoption of this valuation rules in MFI balance sheet statistics would be highly welcome by b.o.p./i.i.p. compilers.

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18 It was noted in the IMF B.o.p. Committee in October 2002 that while insurance is largely a domestic activity, reinsurance is mostly cross-border owing to the important concentration of the business and, thus, of relevance for b.o.p./i.i.p. compilers.

19 See BPM5 paragraph 471.