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The International Accounting Standards and the Sources of Law.

**An analysis of the IAS/IFRS's impact on the legal system and on the legal
rules governing Accounting**

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ABSTRACT

As of January 2005, a number of Italian companies prepare their consolidated and individual balance sheets according to the International Accounting Standards as approved by the IASB (*International Accounting Standard Board*)⁽¹⁾ and adopted by EU legislation.

This paper aims primarily at analysing how the endorsement of the IAS/IFRS in the EU legislation affects the Italian law system, with specific reference to the Italian civil and accounting law.

It is assumed that a dogmatically correct understanding of the nature of the IAS/IFRS and of the position within the system of sources of law admitted by the Italian legal system is preliminary to any further analysis aimed at understanding the actual functioning of the IAS/IFRS, or at assessing the choices of the Italian lawmakers in the implementation of the EU IAS/IFRS legislation.

To this end, this paper analyses the characteristics of the acts and facts recognised as sources of law, both in the Italian and in the Community system. The two systems are analysed first separately, and then in their interaction.

As already stated, in order to assess the position of the IAS/IFRS within the Italian legal system it is important to have a thorough knowledge of the mechanisms governing legal and accounting systems: the EU endorsed IAS/IFRS, in fact, show a number of peculiarities that must be correctly understood and qualified under a dogmatic point of view (e.g., they are drafted by a private body of standard setter, endorsed by the EU through a special procedure, not perfectly coincident with the ordinary EU legislative procedures, embodied and recalled in legislative acts of different nature, revised by *ad hoc* bodies through a special mechanism, implemented by national laws). The same deep knowledge of the ultimate legal nature of the IAS/IFRS is required to solve any interpretation issues linked with their

⁽¹⁾ The international accounting standards issued until the end March 2001 are known as IASs (*International Accounting Standards*), whereas the IFRSs (*International Financial Reporting Standards*) are the standards issued as of April 2001.

Those standards that were issued before April 2001, but were updated or modified after this date continue to be identified as IAS (this is the case, for example, of IAS 16, 36 and 38); if the standards have been not simply revised or updated but radically changed and substituted they become IFRS (IFRS 3, for example, replaced IAS 22).

In the Paper, the term IAS/IFRS is used to identify broadly all the standards issued by the IASC first, and the IASB then.

The different name of the standard is a consequence of substantial changes in the structure of the standard setting entities: as of April 2001, in fact, the IASC (*International Accounting Standards Committee*), which was the entity entitled to draft and approve the international accounting standard, has been replaced by the IASB (*International Accounting Standards Board*).

These structural changes also affected the denomination of the official interpretations to the international accounting standards: the interpretation of the IASs are called SICs (from the name of the body issuing them, the *Standing Interpretations Committee*), whereas the interpretations of the IFRS are known as IFRICs, since they are now issued by the *International Financial Reporting Interpretations Committee*.

application and to fill in the possible “gaps” of the system (the so called “*lacunae iuris*”).

The evaluation of the correct position of the IAS/IFRS also enables us to assess the change brought in the legal system by the formal adoption of IAS/IFRS by EU Legislation

If these are the theoretical premises of this research, we need to briefly summarise the topics analysed in the Paper and the findings achieved.

Chapter 1 gives an overview of the Italian system’s sources of law, with specific references to the peculiarities of the sources of the tax law (such references are due to the specific impact that accounting has in Italy on direct taxation).

The focus is on the “crisis” of the legal systems (especially those based on the tradition of civil law), when confronted with endogenous and exogenous factors, which hamper its theoretical structure by questioning State sovereignty and the pre-eminence of the politicians’ will on the technicians’.

The concept of sovereignty (and, as a consequence, the claim that State legislation be a system “exclusive” and “closed” with respect to other systems) is hindered, on the internal side, by the growing relevance achieved by a number of non-State entities bearing public interests, and, on the external side, by the massive globalization of economics and society. It flows from this that the principle of the “pre-eminence” of statutes –and, more generally, of State-originated law, that can be ascribed to the people’s will, or, more realistically, to the political will of its democratically elected representatives – is nowadays less more than a fetish. Statutes, regulations and other forms of State-originated law maintain their formal validity, but are almost completely deprived of their substantial value; this is to say that the State and the politicians loose their role of “law-makers” and become “rule-endorsers”, since they do no more than approving decisions taken by others.

In all areas of law, laws (“norms”) are based on concepts and ideas belonging to the dominion of specialised subjects, and might be properly understood only by those who have specific technical skills. The increasing “technicalisation” of the law runs parallel to the growing role played by technology in society and social relations, in addition to the increase of the facts that become regulated by the law.

What happens then is that “hard” law is overcome by “soft” law and the “primacy of law” is thus pushed aside by the increasing “primacy of praxis”, as shown by the affirmation of the new “*lex mercatoria*” in the field of international and financial contracts.

Chapter II focuses on the sources of Community law and on the relationship between Community law and EU Member States’ national laws.

The analysis is based on the assumption that Community law is “unique”, both under a structural and a theoretical perspective.

The EU legal system is in fact essentially different from other legal systems originated by an international Treaty and from national legal systems, both of federal and of a confederal type.

The “exceptionalism” of Community law can be better understood, when considering, for example, the “direct effect” that many provisions of Community law have on all subjects of the EU, including private citizens and companies or the almost unconditioned “primacy” of Community law on national law.

Moreover, it is not unusual to find in Community law concepts or doctrines which are a mix of concepts and doctrines belonging to different legal families: many of the legal “inventions” which characterise Community law cannot be fully understood if analysed solely with the tools of the civil lawyer or of the common lawyer. A good example of this mixture of legal traditions are the judgments the European Court of Justice, which, though not formally binding, assumed *de facto* the value of “binding precedents” not only with respect to national judges, but to all subjects of the EU.

Another peculiarity of EU law is the large number of technical regulations and, more generally, of legal provisions having a technical origin. This is partly due to the fact that the EU can enact legislation only insofar it has been attributed the competence to do so by a specific provision of the EU Treaties; it cannot adopt binding legal instruments in areas where it has no specific competence (aside from the cases covered by Art. 308 of the EC Treaty). Since the basic objectives of Community law are economic (the internal market), their achievement often requires technical legislation.

The abundance of technical rules in EU legislation is also due to the distinctive balance existing among EU institutions endowed with legislative power. In the EU, the primacy of the “technicians” on the “politicians” is structural, as confirmed by the long-running criticisms to the “*democratic deficit*” of the EU law-making process. As opposed to ordinary national law-making procedures, the EU legislative process is complex and highly bureaucratised; many variations are possible, and it is common that substantially “political” choices are made by committee of experts or bureaucrats.

Once the analysis of the national and community law system has been completed, and the main evolution trends of the two systems have been identified, this paper provides a comprehensive look at the structure, origin, purpose and evolution of the accounting standards.

Charter III analyses Italian accounting standards under a historical, structural and functional point of view.

First of all, it investigates the general function and the origin of accounting and, more generally, of bookkeeping within enterprises. The main aim is to understand how balance sheets developed from general accounting books and to which extent they assume relevance in different areas of law.

The research carried on in the development of national legislation and case-law regarding accounting books and balance sheets showed that the original idea of accounting as a purely “internal” tool designed to solve management issues gradually evolved due to the recognition of the essential “external” role of accounting, seen as a powerful source of information for a

large number of stakeholders (creditors, controllers, auditors, but also investors and competitors). Such a development in the legislation and in the case-law is not surprising, since it reflects the parallel evolution of commercial practice.

More specifically, the multiple purposes served by balance sheets and financial statements runs parallel with the growth of financial markets and the request for an independent external audit of listed companies' accounts.

The Italian case reflects these assumptions. In Italy the issue of the identification of the "correct" accounting principles follows the adoption of legislation requiring listed companies to have their accounts audited and certified by independent professionals (see law no. 214/1974).

It is undisputable that, under a structural point of view, accounting standards are purely technical standards (they are principles recognised by accountants as a best practice) used by accountants to prepare balance sheets and financial statements and by auditors to audit them.

law no. 214/1974 introduced also as a public level of control on accounting, carried on by the CONSOB, the Italian Securities Exchange Commission.

It is easy to understand that the public relevance of accounting standards entails some form of formal "codification" of the "correct" principles to be used by preparers and controllers.

This explains why immediately after law no. 214/1974 went into effect, academics and businesses raised the issue of the identification and recognition of the "correct" accounting standards.

The same issues were raised at Community level, and explain why Community law adopted accounting Directive that embodied, under the same extent, technical rules taken from the dominion of accounting.

Since the 1970's, the gradual absorption of the accounting technical rules by legal texts provoked tensions among specialists. An example is the debates on the hierarchy of the legal provisions regulating financial statements or on the limits incurred by judges in assessing the application of legal provisions regulating accounting. The "juridification" of accounting rules had an impact also on the legal value of the accounting standards, even though they had not been directly taken in by the legislation.

This is reflected by the different theories aimed at recognising some sort of legal value to the accounting standards, by qualifying them as examples of customary law, or by interpreting the legal provision regulating accounting as containing an (implicit) reference to accounting standards.

Setting aside the specifics of each theory (many of which were not very rigorous under a purely legalistic perspective), nowadays it is widely accepted that Italian accounting standards are not, strictly speaking, sources of law. This implies that they are not binding rules, and may only be used by the interpreters of legal texts (especially by judges) as a means to better interpret the meaning of binding legislation, and only insofar they do not conflict with it.

The purely "supportive" value traditionally recognised as accounting standards by Italian legislation differs from the quasi-legislative value they have in other States, and even in other civil law European countries.

French accounting standards, for example, attain legal status by being approved by an *ad hoc* Agency, to which French primary legislation recognises

law-making powers (approved French accounting standards can be found in the so-called “*plan comptable*”).

The conclusions reached in Chapter III are confirmed by the analysis carried on in Chapter IV, based on the development of the EU strategy in the field of accounting harmonisation. The EU-driven process of harmonisation of accounting rules started in the late ‘70s with the Accounting Directives and did not change until the second half of the ‘90s, when the EU decided to request at least listed companies to prepare their consolidated financial statements according to the IAS/IFRS.

As far as the details of the harmonisation process, the 4th Accounting Directive was passed in 1978 and represents the outcome of a difficult compromise between Community request for a more complete harmonization of the internal market and Member States’ will to maintain, as much as possible, their national accounting practices.

The 4th Directive was the first important step towards complete harmonisation of accounting rules within the EU; however, it did not achieve the objective of the full comparability of balance sheets within the EU.

The partial failure of the objectives that were behind the Accounting Directives is due, to some extent, to the highly differentiated implementation the same Directives received in the Member States.

In the ‘90s, however, the stunning growth of financial markets – tied, as already recalled, to the globalization of the economies and to the boom of IT – raised the need for a real harmonisation accounting rules used across Europe. In brief, as of the second half of ‘90s, the EU quest for harmonization has been pushed forward by the boom of the international markets and the growth of “multilisting” companies.

The decision of the European institutions to “back up” the IAS principles was formally announced in the European Council held in 2000 in Lisbon.

It is relatively easy to understand why the EU institutions decided to use a “ready-made” set of standards, drafted by a private entity, instead of drafting a brand new set of truly “European” accounting standards.

First of all, IASs were already diffused amongst EU companies and widely accepted at an international level. Secondly, the drafting of a new set of rules was likely to be an extremely time-consuming exercise and could have resulted in a further complication of the system.

The strategy developed by the Commission was two-fold.

In the short term, the focus was meant to be on the rapid harmonization of the accounting rules used by listed companies in the preparation of their consolidated statements. Consolidated statements of listed companies were effectively the most exposed to the development of the financial markets. This objective could be better achieved by a Regulation (Council Regulation 1606/2002, so-called “IAS Regulation”).

In the medium-long term, though, the objective was a thorough modernisation of the old accounting rules, in order to align them with the more efficient rules contained in the IAS principles and reduce the gap between companies adopting IAS/IFRS for accounting purposes (essentially large companies) and companies adopting national accounting standards (essentially

SMEs). Since this objective had to be achieved gradually, the EU decided to use a set of “Directives” (Council Directive 65/2001, so-called “Fair value Directive”, and Council Directive 53/2001).

In order to better understand the scope of the IAS project developed by the EU institutions, and to assess the impact of the IAS/IFRS on the national legal systems, the Paper tries to answer a number of questions: firstly, what are the IAS/IFRS principles and where do they come from; secondly, how can they be “adopted” by EU legislation and which is the legal nature of the “endorsement” procedure provided for by Reg. 1606/2002; thirdly, how did the IAS/IFRS principles penetrate in the Italian legislation, and which was the role, if any, played by the Italian law-makers.

As far as their origin, the IAS/IFRS are drafted by a private body (the International Accounting Standards Boards, IASB), controlled by a private Foundation. The IASB stems from the anglo-saxon accounting tradition, but is currently open to highly qualified accountants coming from all over the world.

In the years the IAS/IFRS gained acceptance and recognition at the international level and became a valid alternative to the US GAAP.

In fact, the choice of the IAS/IFRS made by the European institutions may be seen also as a way to counteract the dominance of the US GAAP within listed companies and to have some hold on the drafting of the accounting principles.

The need to maintain some control on the actual drafting of the accounting principles to be used by EU companies, together with the emphasis put on the need for a flexible set of rules, also explains why the mechanism envisioned for the endorsement of the IAS/IFRS is so complex.

Community Law does not contain any specific (“fixed” or “substantial”) reference to the actual IAS/IFRS that currently exists of the IAS Regulation’s entry into force, on the grounds that such a reference would have “frozen” the system, thus hampering change and quick adaptation to new standards. Community Law, however, does not contain either any “flexible” reference to the “source” of the IAS/IFRS, i.e., to all principles, present and future, issued by the IASB. An automatic adoption of all IAS/IFRS approved by the IASB would have resulted in devolving permanently the drafting and approval of the accounting principles to a private body, waiving any possibility to control whether or not these principles were “fit for Europe”.

The mechanism set out by Article 6 of the IAS Regulation is a hybrid which requires that each IAS/IFRS to be embodied in a formal legislative act (Commission Regulation) in order to be binding in the EU as well as a simplified and permanent endorsement mechanism that might be used to assess and possibly absorb any future standards issued by the IASB.

More specifically, the “adoption” of each IAS/IFRS by Community Law requires to successfully meet a double check. The first check is to assess whether each IAS/IFRS is consistent with the pursuing of the “European public interest” (whether it is politically desirable). The second check is aimed at verifying whether or not each IAS/IFRS is consistent with the basic principles of EU accounting law, i.e., with the basic principles underlying the Accounting Directives, as amended by the “IAS” Directives (whether the IAS/IFRS is technically coherent with the existing rules).

The political check is performed by a quasi-legislative entity, the Accounting Regulatory Committee (ARC), composed by representatives of the Member States. The ARC is an example of the “comitology committees”, committees of bureaucrats set on the basis of Article 202 EC Treaty in order to assist the EC Commission in the implementation of Community Law.

The technical check of the endorsement mechanism is performed by a private technical committee, formally independent from the EU, the EFRAG (European Financial Reporting Advisory Group). This group can be seen as an example of the “committee of experts” that might assist the Commission in the implementation of highly complex technical legislation. As customary for this kind of bodies, the opinions delivered by the EFRAG are not binding on the EC Commission or on the EC Council; the rules governing the relationship between the Commission and the EFRAG are set out in a Working Agreement signed in March 2006. In practice, however, the strict cooperation between ARC and EFRAG makes a formal contrast between the two bodies quite unrealistic.

The European Parliament also plays a role in the endorsement mechanism, but, for the time being, its role is limited to the possibility to issue opinions to assess whether or not each entity acted pursuant to the competences attributed by Art. 6 of the IAS Regulation.

After the endorsement process has been completed, each IAS/IFRS is approved with a Commission Regulation, thus becoming Community law under all respects.

In the end, the endorsed IAS/IFRS might be described as a flexible ad multi-level set of rules.

They maintain their original structure, which is reason why they seem to be closer to a handbook than to a legal text. This circumstance, however, does not undermine the binding legal force that must be recognised to each paragraph of the endorsed IAS/IFRS.

After having thoroughly analysed the legal value of IAS/IFRS under Community Law, the Paper focuses on their relevance in internal law. Special attention has been paid to the relationship between the binding force of the endorsed IAS/IFRS and of the national accounting standards (Italian GAAP), that continue to be used by a large number of Italian companies.

In this context, emphasis has been put on the underlying contradiction of the Italian lawmakers, who allowed an extensive implementation of the IAS Regulation and restricted the implementation of the IAS Directive.

The Italian legislation implementing the IAS Regulation used the options granted by the Regulation with regards to the identification of companies required or permitted to use endorsed IAS/IFRS in the preparation of their separate and consolidated accounts (see Legislative Decree no. 348/2005).

On the contrary, the implementation of the Fair value Directive was very strict: the use of fair value was limited to the notes on the accounts (see Legislative Decree no. 394/2003). The same happened with the implementation of Directive 51/2003, that resulted in the mere adjustment of two provisions of the Civil Code, regarding the management’s and the auditors’ report (see, respectively, Art. 2428 and Art. 2409-ter Civil Code).

We cannot help criticise the schizophrenic attitude of the Italian lawmakers, who, misunderstand (or, possibly disregard) the fact that both the IAS Regulation and the IAS Directives were part of a single project, and share the same final objective and therefore introduces a strong and somewhat arbitrary distinction between IAS compliant and non-IAS compliant companies.

The distinction raises several issues, also due to the different binding force of the endorsed IAS/IFRS and of the Italian GAAP: while the endorsed IAS/IFRS are Community law and, as such, prevail on national law; national law continues to prevail on Italian GAAP.

After having analysed the Italian and EU law systems, the nature of the Italian GAAP and of the endorsed IAS/IFRS, and the role they play both at Community and at national level, it is feasible to provide an answer to the basic issue raised by this study: what is the actual impact of the endorsed IAS/IFRS under a purely juridical point of view?

Before answering to this question, it must be noted that many authors qualified the adoption of the endorsed IAS/IFRS as a “revolution” for the sources of law.

Chapter 5 tests this assumption by ascertaining whether, under a purely juridical perspective, the endorsed IAS/IFRS can be considered “systematic” sources of law, e.g., inherently coherent with the Italian and Community law system.

Once again, it must be stressed that the so-called accounting “revolution” brought by the endorsement of the IAS/IFRS has been analysed only with reference to the impact of these principles on the law system, but not with reference to their actual content. This means that this Paper does not provide the difference between the accounting rules to be used under the endorsed IAS/IFRS and under Italian GAAP.

On the basis of the research carried on in this Paper, we may conclude that, though the difference between the structure of IAS/IFRS and the traditional structure of legal texts cannot be denied, the endorsement of IAS/IFRS does not determine – under any respect – a “breach” in the law system, but a mere evolution of it. In other words, the endorsed IAS/IFRS are not a revolution, they are only a step forward.

More specifically, the “adoption” of IAS/IFRS is in line with the trends that dominate the historical, international and juridical evolution of accounting rules.

To offer a historical point of view, the adoption of IAS/IFRS by EU legislation is not a revolution of the sources of law, since it fits perfectly within the evolution of accounting legislation, case-law and legal doctrine. This assumption has been extensively demonstrated in Chapter III.

The analysis of the evolution of the accounting rules confirms that accounting standards have been gradually transformed in (somewhat) legally relevant concepts. Full “juridification” of accounting standards (*rectius*, of some accounting standards) is only the last chapter of a process of gradual juridification of accounting rules. The process started in Italy as early as 1882, when the former Code of Commerce was approved.

Under an international point of view, the adoption of IAS/IFRS by EU legislation is not a revolution of the sources of law, since, as references in Chapter IV, the strategy agreed by the EU at the end of the 1990's to achieve a better harmonisation of accounting rules used by European companies fits well into the international trend pushing towards the standardisation of accounting rules, which grew parallel to the integration and development of financial markets.

Lastly, under a purely juridical point of view, the adoption of IAS/IFRS by EU legislation is not a revolution of the sources of law, since the juridification of technical rules (and, on the other hand, the increasing number of binding legal rules pretending to govern purely technical issues) applies increasingly to all areas of law. Moreover, the prevalence of techniques over politics is commonly regarded as a distinctive feature of Community law.

The endorsed IAS/IFRS are essentially a good example of "global law", whose binding force developed primarily outside legal instruments. The affirmation of "global law" also confirms the increasing gap between law and politics and the convergence of legal systems imposed by globalisation.

Even under a purely legalistic point of view, the adoption of IAS/IFRS cannot be seen as revolutionary: the endorsement mechanism is in fact not more than one of the many variants of the comitology procedures, ordinarily used to implement and update Community law.

The conclusions reached with regards to the ordinary – and not revolutionary – nature of the endorsement of IAS/IFRS, have an influence also on the way the new accounting rules might be interpreted and applied.

First of all, it must be emphasised that, as a general rule, interpretation of the endorsed IAS/IFRS must follow the rules used to interpret legal texts. These general rules may be disregarded only insofar there is a specific provision in the endorsed IAS/IFRS that provides for a different interpretation rule.

Secondly, it must be recognised that the legal nature of the endorsed IAS/IFRS implies that not every sentence of these principles corresponds to a legally binding rule (a "norm"): laws are made of norms and principles, and IAS/IFRS are no exception to this.

This helps solving the question of a possible hierarchy between the paragraphs of the endorsed IAS/IFRS, according to their real binding value: every single sentence of the endorsed IAS/IFRS is legally binding, but legally binding provisions and rules ("norms") do not always coincide. A norm might result from the combination of a number of provisions whereas a single provision might express more than one norm. A few norms – the so called "legal principles" – cannot be read in any specific provisions, but are embedded in the law system.

These conclusions might also help solve the debate on actual legal value of the Framework, which might be considered as the "constitution" of the IAS/IFRS but has not been adopted by EU legislation.

Under a legalistic approach, the reference to the Framework made in IAS 8 should be seen a substantial (indirect) juridification of its content.

However, even if the reference made in IAS 8 to the Framework is not seen as an indirect juridification of its actual content, it should nonetheless be

recognised as stating the underlying assumptions of the IAS/IFRS system. In other words, the Framework outlines what each IAS/IFRS alludes to.

Moreover, the endorsed IAS/IFRS have an impact on the interpretation of general accounting rules: the main assumption underlying the IAS/IFRS system are, in fact, embodied within the new Accounting Directives, whose primacy on national law requires consideration of interpretations of all the Italian accounting laws.

Finally, the adoption of the IAS/IFRS by EU legislation implies that the European Court of Justice is ultimately competent to assess the correct interpretation of the endorsed IAS/IFRS and the validity of the Commission Regulations adopting the accounting standards.

The juridification of IAS/IFRS implies, under Art. 101, paragraph 1, of the Italian Constitution, that the competence of national judges to interpret and apply the endorsed IAS/IFRS when assessing the validity of a company's assembly decision approving the individual and consolidated accounts.

However, the power of the judges to assess the correctness of company accounts, as recalled in Chapter III, was already admitted, even though the limits of such a power have been disputed and gradually reduced by case-law.