The evolution of accounting standards for credit institutions

Accounting practices in Germany are undergoing a major change. A new regulation adopted by the European Commission requires that from 2005 all listed companies in the EU file at least their consolidated financial statements using International Accounting Standards (IAS). The adoption and implementation of this EU regulation are taking place at a time when events such as the collapse of US energy trader Enron have cast doubt on the reliability of accounting practices. All parties involved have come under fire: accountants, auditors, rating agencies and financial analysts. Even investors have drawn criticism for blithely accepting published corporate profit figures at face value. Against this background, it is important to carefully weigh the benefits and disadvantages of changing over from the tried and tested accounting rules of the German Commercial Code, with its emphasis on creditor protection and capital preservation, to IAS rules, which are oriented more towards investors and capital markets. It is necessary to develop solutions that contribute to financial market stability and ensure that reliable prudential risk limitation standards are applied in a manner that ensures a level playing field. At present, it would appear inappropriate to move too hastily towards abandoning the compilation of single-entity financial statements according to German accounting standards or abandoning the instrument of undisclosed reserves.

Change in the legislative framework

Accounting rules for credit institutions last changed in 1993

The last time the legislative framework for credit institutions' accounting practices changed in Germany was when the Bank Accounts Directive[1] was translated into German law by means of the 1991 Bank Accounts Directive Act (*Bankbilanzrichtlinie-Gesetz*) and the 1992 Accounting Regulation for Banks (*Verordnung über die Rechnungslegung der Kreditinstitute*). At that time, uniform accounting rules for all credit institutions were incorporated into the Commercial Code and a matching statutory ordinance, although this did not fundamentally change accounting practices. In particular, the formation of undisclosed reserves through the corresponding exercising of national options, even if in limited form, remained a key aspect in banks' accounting practices.[2] However, the fact that the Bank Accounts Directive permits numerous national options has thus far hampered the harmonisation of accounting rules in the European Union.

Annual accounts are an element of prudential supervision

To banking supervisors, the supervised institutions' annual accounts, drawn up in line with external accounting requirements, are a key foundation for assessing the institutions' economic situation. For that reason, they are also required by law to be audited. The reports on the audits of the annual accounts by external auditors or audit associations are an important instrument of prudential supervision in Germany.

Concepts of capital

Banks' capital plays a major role in supervision. The concept of regulatory capital defines how much capital is needed to back a bank's counterparty risk and market price risk. The definition of capital under commercial law, or "balance sheet capital", is close to that of regulatory capital. However, while the prudential definition of "own funds" is based on the commercial-law concept of capital, it goes beyond the definition of the capital to be reported on the balance sheet. Balance sheet capital always constitutes "core capital" in prudential terms. Changes in the balance sheet which alter the balance sheet capital therefore also simultaneously affect the capital recognised for prudential purposes. Moreover, changes in core capital also have an impact on the maximum permissible level of "additional capital", as the latter may not exceed 100 % of core capital.[3]

Key importance of accurately valuing assets

"Balance sheet capital" is a residual concept arrived at after valuing and matching assets, liabilities and off-balance sheet business. Values shown in the balance sheet are also the starting point for defining the "risk assets" in the prudential sense which need to be backed by capital. That being the case, it is clear that an accurate valuation of assets is a key precondition for prudential risk limitation standards to function properly.

1 Council Directive 86/635/EEC of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions.
2 See Deutsche Bundesbank, The new accounting legislation for credit institutions applicable from 1993, and its implications for the monthly balance sheet statistics, *Monthly Report,* May 1992, p 37–46.
3 The impact of the internationalisation of accounting practices on credit institutions' capital was described in detail in the January 2002 issue of the Monthly Report. See Deutsche Bundesbank, Credit institutions' capital viewed from a business and a regulatory perspective, *Monthly Report,* January 2002, p 39–57.

Consolidated financial statements drawn up according to German GAAP have limited international relevance...

The principal information instrument of German enterprises is the consolidated financial statement based on the Commercial Code, ie German generally accepted accounting principles. However, the fact that German companies, too, are resorting increasingly to the international capital markets has caused more and more companies active in foreign capital markets to switch to disclosing information in their consolidated financial statements on the basis of international accounting standards, which are more familiar to international investors than German GAAP based on the rules of the Commercial Code.

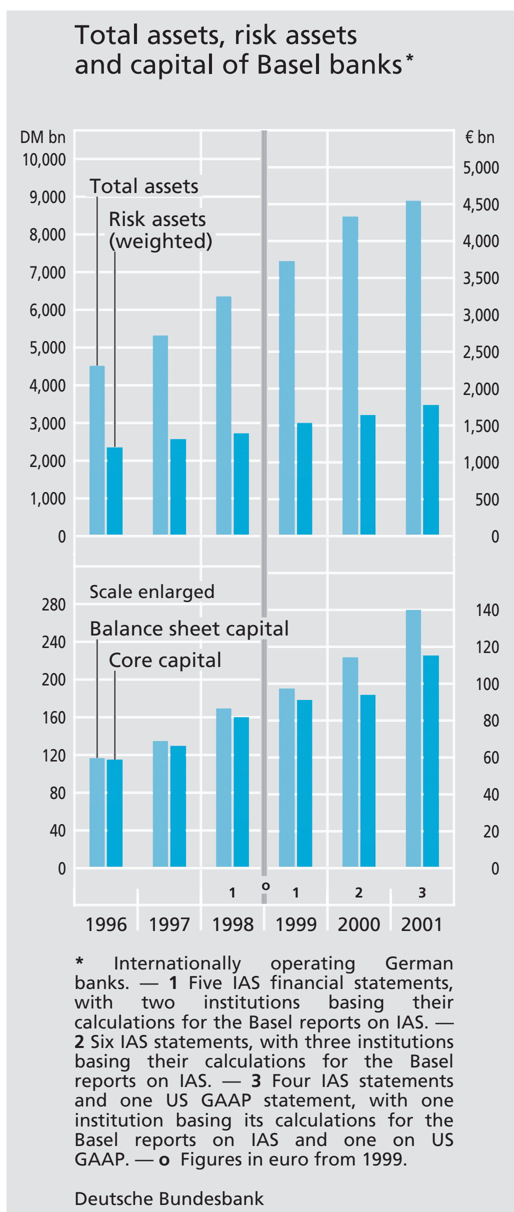
... hence exemption option for consolidated financial statements pursuant to new section 292a of the Commercial Code

The German parliament reacted to this development in 1998 by adopting the Act to Facilitate International Equity Financing (*Kapitalaufnahmeerleichterungsgesetz*)[4] and a supplemental provision in the Corporation Directive Act (*Kapitalgesellschaften- und Co-Richtlinien-Gesetz*). Listed parent companies now have the option, in compliance with the EU accounting directives, of compiling their consolidated financial statements pursuant to section 292a of the Commercial Code in line with internationally recognised accounting principles.[5] Internationally recognised accounting principles are the International Accounting Standards (IAS) elaborated by the International Accounting Standards Board (IASB), as well as, on account of their widespread international use, the US Generally Accepted Accounting Principles (US GAAP) developed by the Financial Accounting Standards Board (FASB) in the United States; their application is mandatory for companies wishing to be listed on a US stock exchange. For internationally operating credit institutions which have undertaken to comply with the Basel Committee's capital adequacy standards, consolidated financial statements drawn up according to IAS or US GAAP pursuant to the exemption option of section 292a of the Commercial Code may also be used as the basis for calculating regulatory capital. At present two of the 15 internationally operating German credit institutions are making use of this option.

Development of international accounting in Germany after 2004

The exemption option granted by section 292a of the Commercial Code is only an interim solution, however, and is due to expire at the end of 2004. After that, it is likely that a regulation of the European Parliament and the Council regarding the use of international accounting standards will enter into force, requiring listed companies in the EU to draw up and publish their consolidated financial statements according to IAS from 2005. This EU regulation, the draft version of which met with broad support, was recently adopted. To

4 *Gesetz zur Verbesserung der Wettbewerbsfähigkeit deutscher Konzerne an internationalen Kapitalmärkten und zur Erleichterung der Aufnahme von Gesellschafterdarlehen,* 20 April 1998, Federal Law Gazette I, p 707, supplemented by the *Kapitalgesellschaften und Co-Richtlinien-Gesetz,* 24 February 2000, Federal Law Gazette I, p 154. Concurrently with the Act to Facilitate International Equity Financing, the German parliament passed the Act on Corporate Governance and Transparency *(Gesetz zur Kontrolle und Transparenz im Unternehmensbereich),* 27 April 1998, Federal Law Gazette I, p 786. It was on this legal basis that the German Accounting Standards Committee was established; it is a publicly recognised private German accounting committee whose job it is to develop generally accepted accounting principles for consolidated financial statements, to advise the Federal Ministry of Justice in drafting bills relating to accounting, and to increase Germany's influence on the process of international standardisation, particularly in the context of the IASB.
5 This arrangement is explicitly restricted to consolidated financial statements and does not include single-entity financial statements, for which application of the Commercial Code is still mandatory.



Total assets, risk assets and capital of Basel banks*

* Internationally operating German banks. — 1 Five IAS financial statements, with two institutions basing their calculations for the Basel reports on IAS. — 2 Six IAS statements, with three institutions basing their calculations for the Basel reports on IAS. — 3 Four IAS statements and one US GAAP statement, with one institution basing its calculations for the Basel reports on IAS and one on US GAAP. — o Figures in euro from 1999.

Deutsche Bundesbank

avoid hardship cases, a grandfather clause is envisaged until the end of 2006 for companies which only trade in debt securities on regulated capital markets or which already use other internationally accepted standards because they are listed in a country outside the EU. Basically, that relates solely to companies which are listed in the United States and therefore use US GAAP. Moreover, the draft regulation gives member states an option of allowing or requiring non-listed parent companies to compile consolidated financial statements in accordance with IAS or of allowing or requiring all companies to draw up single-entity financial statements, too, in line with IAS. The German Commercial Code, IAS and US GAAP are compared in the box on page 43.

International Accounting Standards (IAS)

IAS – an initiative to internationalise accounting practices

The use of internationally uniform and appropriate accounting standards is intended to enhance transparency in the enterprise sector and promote the stability of the financial system. IAS is regarded as a crucial instrument for harmonising accounting practices worldwide. In October 1998 the G7 finance ministers and central bank governors called on the International Accounting Standards Committee (IASC)[6] to make further improvements to the IAS. In return, they promised to promote the national use of IAS.

Basel Committee and IOSCO in favour of IAS

Both the Basel Committee on Banking Supervision (BCBS) and the International Organisation of Securities Commissions (IOSCO) have assessed IAS, each from its own particular perspective. The BCBS thinks that IAS is generally suitable for prudential supervisory purposes, although it felt that two standards (IAS 39 and IAS 30) required further comment. IOSCO accepted the IAS and recommended in May 2000 that its member organisations generally allow the use of IAS as a cri-

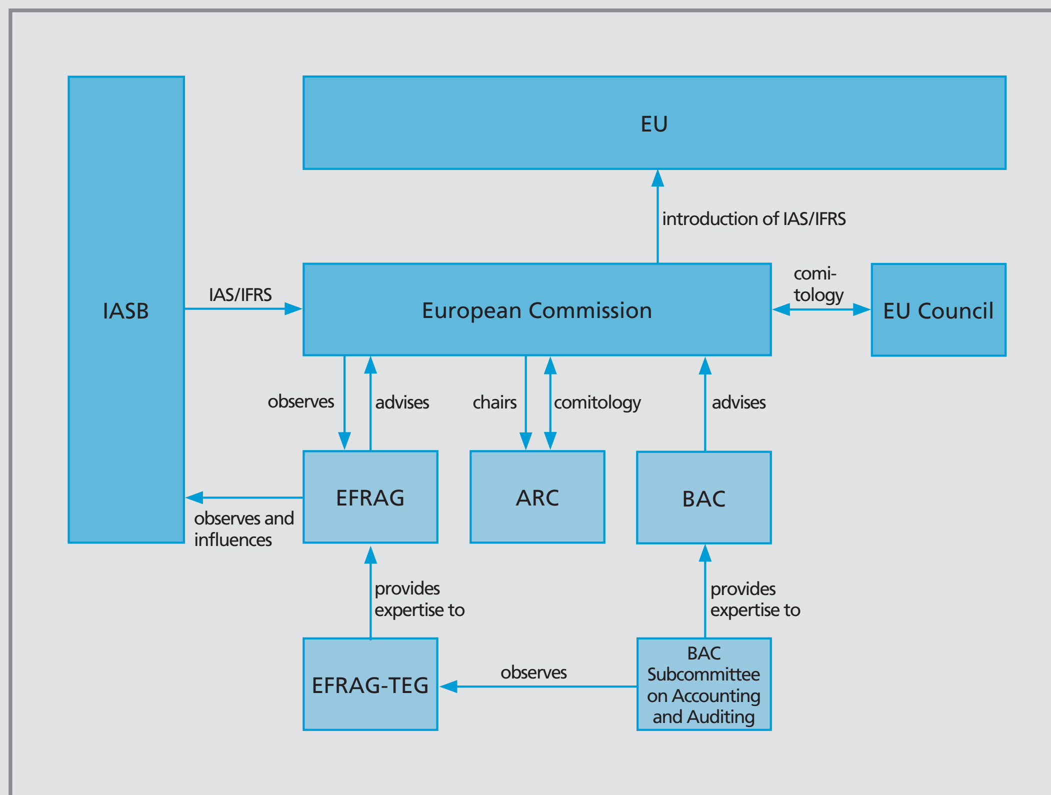
6 Now the International Accounting Standards Board (IASB).

A comparison of accounting standards

Selected criteria	German Commercial Code/ German GAAP	International Accounting Standards (IAS)	US Generally Accepted Accounting Principles (US GAAP)
Purpose	Creditor protection	Investor protection	Investor protection
Target group	Mainly external lenders	Mainly shareholders	Mainly shareholders
Parties responsible for developing regulations	Government (Federal Ministry of Justice); German Accounting Standards Committee with the German Standardisation Board: publicly recognised private bodies	International Accounting Standards Board (IASB): an international, non-governmental and independent organisation	US Financial Accounting Standards Board (FASB), a private, independent organisation
Function of standard setters	Justice Ministry: regulates commercial law; German Standardisation Board: develops standards for consolidated financial statements; advises Justice Ministry; represents Germany in international standardisation process (especially IASB)	Formulates and publishes accounting standards in the public interest with the goal of achieving worldwide usage and acceptance	Develops principles for listed companies in the United States
Legal relevance	Codified accounting legislation; also generally accepted accounting principles (GAAP); German Standardisation Board: develops standards for consolidated financial statements	Not universally applicable, legally protected accounting rules; to be applied to all consolidated financial statements of capital market-oriented companies in the EU from 2005; further-reaching options for member states and enterprises are envisaged	Not universally applicable, legally protected accounting rules; however, use by listed companies in the United States is mandatory; monitored by the Securities and Exchange Commission (SEC)
Type of system	General commercial accounting and bookkeeping principles (code law system)	General accounting principles (case law system)	Detailed accounting principles applied to individual cases (case law system)
Scope of application	Differentiated according to legal form and size of firm; special rules apply, *inter alia,* to credit institutions	Applied regardless of legal form or size of firm	Listed firms in the United States; no distinction between single-entity and consolidated financial statements
Commercial/ tax accounts	Commercial accounts form the basis for tax reporting	Strict separation between commercial accounts and tax accounts	Strict separation between commercial accounts and tax accounts
General norm	To give a true and fair view of the net worth, financial position and results in accordance with GAAP	To give a fair presentation of the firm's financial situation	To give a fair presentation of the firm's financial situation
Function of accounting	To determine profit which is distributable while protecting creditors and preserving capital	To present a true and fair view of the result for the period; no determination of distributable income	To present a true and fair view of the result for the period; no determination of distributable income
Principles	Accrual principle as defined in the Commercial Code	Accrual principle	Accrual principle
Single-entity/ consolidated financial statements	Assessment basis is the parent company financial statement; consolidated financial statements provide information	General concept for annual accounts including consolidated financial statements	Consolidated financial statements, as the extended financial statement of the parent company, replace single-entity financial statement
Options	Options under commercial law	Options tightly limited	No explicit options
Form and structure	Detailed rules	Only minimum requirements	Detailed rules for listed companies only
Presentation of items			
Assets	Individual realisation	Future economic benefit	Future economic benefit
Debts	Economic burden	Future depletion of benefit	Future depletion of benefit
Valuation			
Initial	Historical cost	Historical cost	Historical cost
Subsequent	Strict and diluted principles of lower of cost or market with the requirement to reinstate original values and historical cost as the maximum value	Fair value, amortised cost	Fair value, amortised cost

Deutsche Bundesbank

The endorsement mechanism for IAS in the EU



The planned endorsement mechanism for the International Accounting Standards **(IAS)** which are developed by the International Accounting Standards Board **(IASB)**, later to become International Financial Reporting Standards **(IFRS)**, for the European Union **(EU)** is intended to address the ongoing evolution of these standards. The IAS/IFRS are to be endorsed EU-wide by means of a special EU legislative procedure known as comitology. A basic legal act authorises the **European Commission** to adopt implementing legislation in a simplified procedure. The Commission presents its proposal to endorse (or reject) an IAS/IFRS to the Accounting Regulatory Committee **(ARC)**, a body consisting of representatives of the member states and chaired by the Commission. If the ARC accepts the Commission's endorsement proposal, the Commission prepares to apply the accounting principle in the EU. If the ARC rejects the Commission's proposal, the comitology procedure requires that the Commission take its proposal to the **EU Council**. The Council can then either approve the Commission's proposal or reject it by qualified majority. The European Financial Reporting Advisory Group **(EFRAG)**, a technical committee consisting of experts from the member states, is to advise the Commission on the introduction of the IAS/IFRS in the EU with its Technical Expert Group **(EFRAG-TEG)**. The European Commission has observer status in EFRAG. EFRAG is to maintain contact with the IASB; that way, even at the stage in which a new IAS/IFRS is being developed or an existing standard is being amended, EFRAG will be able to assert the EU's interests. To permit bank-related and prudential supervisory aspects to be taken into account, the **Subcommittee on Accounting and Auditing** of the EU's Banking Advisory Committee **(BAC)**, which advises the Commission in all issues regarding banking and banking supervision, has been given observer status in the EFRAG-TEG.

Deutsche Bundesbank

Valuation according to IAS 39

Item	Financial assets				Financial liabilities
	Held for trading	Available for sale	Held-to-maturity	Loans and receivables originated by the enterprise	Financial liabilities
Initial measurement	Historical cost				
Remeasurement	Fair value		Amortised cost		
Treatment of value changes	Inclusion in net profit or loss	Options: (a) inclusion in net profit or loss or (b) recognition in equity	Inclusion in net profit or loss		
Lower of cost or market test	No (already included in measurement)	For (a): no (already included in measurement) For (b): yes (to include in net profit or loss a need for write-downs or reinstatement of original value necessitated by credit rating)	Yes (to include in net profit or loss a need for write-downs or reinstatement of original value necessitated by credit rating)		N/A

Deutsche Bundesbank

terion for gaining access to their national stock exchanges.

Approval and application of IAS in the European Union

The creation of a single European financial market means that accounting practices will need to be harmonised more extensively than has been achieved thus far by the accounting directives. IAS is an appropriate instrument for achieving that goal, particularly because it has been designed for worldwide acceptability. The European Union's strategy in accounting practices follows along these lines. With the Fair Value Directive,[7] which is scheduled to be translated into German law in the next legislative period, the EU is seeking to enable IAS to be applied in conformity with the directive as early as the 2001 financial year. Since the mandatory introduction of IAS from 2005 will abolish existing accounting policy options, additional companion regulations will be necessary. Given the probable ongoing development of IAS by the IASB, the EU will need to put in place a continuous endorsement mechanism. In addition, EU interests are to be asserted in the IASB already at the drafting stage for new standards.

Philosophy of IAS

Whereas the defining features of German GAAP as enshrined in the Commercial Code are creditor protection and, by association, the

7 The Fair Value Directive (Council Directive 2001/65/EC) of 27 September 2001 allows more extensive fair value accounting for certain financial instruments to enable, in particular, the more comprehensive fair value accounting provisions of IAS 39, which have been applicable since 2001, to be applied in a manner complying with the directive. As part of its advisory function to the Justice Ministry, the German Accounting Standards Committee has submitted a proposal for translating the Fair Value Directive into German law.

Hedge accounting under IAS 39

IAS 39 provides two key methods of hedge accounting:

Fair value hedge

Fair value hedges aim at hedging exposures to changes in the fair value of a recognised asset or liability.

Cash flow hedge

Cash flow hedges aim at hedging exposures to variability in future cash flows from the hedged item.

For both methods, IAS 39 requires a high degree of effectiveness and comprehensive formal documentation of the hedging relationship. In addition, fair value hedging is permitted only for micro-hedges. For cash flow hedges, evidence must be furnished of a sufficient volume of variable future cash flows for the hedging relationship.

Deutsche Bundesbank

principle of prudence,[8] IAS (like US GAAP) is geared towards informing investors, for whom the balance sheet is primarily intended. Consequently, IAS contains more comprehensive balance sheet formatting provisions than the Commercial Code, and valuation is extensively geared towards the concept of fair value, expressed either as actual market value or estimated market value regardless of realisation.

IAS 39

Interest is currently focused on IAS 39, “Financial Instruments: Recognition and Measurement”, a standard which is of primary importance to banks, and which has been applicable since 2001. The vast majority of items in a bank’s balance sheet can be subsumed under “Financial Instruments”. Pursuant to IAS 39, the relevant financial assets and financial liabilities are assignable to one of four categories which are distinctly different in terms of recognition and measurement. In addition, IAS 39 generally requires on-balance recognition of all derivatives, with special rules applying to structured products with embedded derivatives. IAS 39 also defines hedge accounting principles.

Hedge accounting pursuant to IAS 39

The implementation of IAS 39 is fraught with considerable difficulty for users of IAS. In the area of hedge accounting, IAS 39 does not permit strategies based on hedging entire portfolios (macro-hedges). Additional difficulties are created by the fact that under IAS 39 only hedging transactions with third parties are eligible for recognition, and not those within a company or group (internal contracts).

Approaches to reforming IAS 39

The BCBS has worked hard towards having the issues relating to the application of IAS 39 addressed in an IASB committee attended by banks. The committee’s work on introducing that standard produced comprehensive annotations in the form of a list of questions and answers. This, however, did not resolve all problems deriving from the parallel use of fair value and historical cost. The IASB will soon publish a draft amendment to IAS 39 for consultation. The most significant changes it proposes concern, firstly, available-for-sale instruments, changes in the value of which can no longer be

8 The annual accounts of credit institutions and financial service institutions should provide a fair and accurate picture of the assets, financial position and profitability of the enterprise in line with German generally accepted accounting principles (section 340a of the Commercial Code read in conjunction with section 264 (2) of the Commercial Code). The specific regulations to be followed here concern the itemisation, valuation and disclosure of the annual accounts positions, which in Germany have traditionally been defined by the principles of prudence and creditor protection. The main objective is to ascertain profit available for distribution to shareholders.

posted to the profit and loss account but instead must be exclusively posted directly to equity. Secondly, an extensive option to designate any financial instrument as held for trading and therefore to be measured at fair value is being proposed. This presumably also represents an attempt to find a solution to the hedge accounting problem. This is achieved if not only the hedging instrument but also the hedged item are valued at fair value and the countervailing changes in value – in an ideal case – cancel each other out in terms of amount. It will depend greatly on the comments put forward in the consultation procedure whether and how these proposals are implemented.

Full fair value accounting

IAS 39 ultimately represents the first concrete reflection of the efforts undertaken by the IASB to advance the use of fair value accounting for financial instruments. The original all-embracing concept of full fair value accounting had encountered open criticism and reservations. The more specific provisions in IAS 39 were then developed as an interim solution, albeit without any set expiry date.

IAS 30

A further regulation with considerable relevance for banks is IAS 30, "Disclosure in the Financial Statements of Banks and Similar Financial Institutions". This bank-specific standard governing the information to be disclosed in credit institutions' and similar institutions' financial statements is intended to help standardise and improve the disclosure, and thereby the transparency, of financial institutions' financial situation. IAS 30 is being revised at present, with the IASB having acted on a proposal by the BCBS. In particular, a future version of IAS 30 may contain an extension of the risk disclosure requirement. The German Accounting Standards Committee has already taken account of this development by adopting a standard for the risk disclosure of credit and financial services institutions (DRS 5-10) which applies to financial years beginning after 31 December 1999.

US GAAP

Growing interest in US GAAP

US Generally Accepted Accounting Principles (US GAAP) have been gaining increasing significance for major German enterprises for two reasons. One is that the US Securities and Exchange Commission (SEC) has made the application of these principles mandatory for listing on a US stock exchange. The other is that the pool of potentially worldwide investors has been expanding continuously in the wake of globalisation. Important investors come from the Anglo-American countries and therefore prefer dealing with familiar accounting and disclosure methods when making investment decisions.

Chief characteristic of US GAAP

The chief characteristic of US GAAP is its dense mass of specific regulations. One could say US GAAP is a case-based system rather than a code-based system, reflecting the fact that US law is based on case law. Another feature of US GAAP is its fluidity, for its rules are constantly being amended or supplemented.

Generally no options in US GAAP

US GAAP generally lacks explicit options owing to its plurality of individual provisions. That is intended to minimise the scope for interpretation. In practice, however, there is the growing danger of tailoring business transactions to a preferred rule or intentionally cir-

cumventing an existing rule in order either to engineer the desired balance sheet result or to avoid an undesired reporting method. This can undermine the effect actually intended by a rule.

Fair presentation

US GAAP is often described as embodying the principle of fair presentation, whose overriding aim is to prevent the circumvention of case-by-case rules and thus to serve the interests of those for whom the rules are intended. Such a general clause is not expressly codified in the official sources of US GAAP. However, fair presentation is a principle of auditing US financial statements, compliance with which must be confirmed by the auditor.

Mounting criticism of US GAAP

US GAAP has achieved high esteem worldwide, particularly because of the size and importance of the US economy. In the wake of the increasing efforts towards achieving internationally accepted and applicable rules as embodied by the IAS, however, US GAAP is facing serious competition which seeks to eliminate some of the shortcomings of GAAP. Recent events surrounding the collapse of the US energy trader Enron have exposed such weaknesses, leading to criticism which has also aroused international attention. The Appendix at the end of this article will discuss important aspects of the Enron case.

Prudential consequences of the internationalisation of accounting practices

Uniform accounting practices relevant for competition

The prudential regulations in the German Banking Act are based on the accounting rules contained in the Commercial Code which apply equally to all credit institutions and which are to that extent competition-neutral. They are based on banks' single-entity financial statements and the underlying accounting and valuation decisions. The consolidated supervision of banking groups is based on the supervisors' own consolidation rules as contained in section 10a of the Banking Act. Consolidated financial statements based on the Commercial Code serve only informational purposes with regard to banking supervisors, too, with the exception of internationally operating German institutions, which additionally calculate an own-funds ratio pursuant to the Basel Capital Accord based on their consolidated financial statements. The application of different accounting standards for consolidated financial statements (IAS or US GAAP) does not create a competition-related problem since these institutions are likewise required to comply with the business and risk reduction standards of the Banking Act.

Questions prior to the implementation of the planned IAS accounting practices in Germany

How the national options for applying IAS as proposed by the European Commission will be translated into German law is an issue that will be debated intensively. Before IAS can be applied to the consolidated financial statements of non-listed enterprises or even to the single-entity financial statements of either listed or non-listed enterprises, too, it will first be necessary to answer key questions relating, above all, to the implications for the uniformity of national accounting practices, creditor protection, or the requirement of capital preservation. However, the introduction of the optional application of inter-

national accounting standards by companies to their single-entity financial statements must be rejected unless it is assured, in compliance with the tried and tested commercial-law principles of creditor protection, that the comparability of single-entity financial statements is preserved, for they form the basis for profit distribution, tax payments and prudential capital adequacy requirements.

Conceptual differences between German GAAP and IAS have implications for commercial law and tax law

The traditional German financial statement based on the Commercial Code, by stressing the prudent calculation of profit, is used to determine both the distributable profit and, owing to the primacy of the commercial accounts, the amount of tax to be paid.[9] Owing to this methodological link between the commercial balance sheet and the tax balance sheet, all further considerations regarding future requirements for drawing up single-entity financial statements have implications not only for commercial law but also for tax law. For Germany, therefore, the question will arise as to the calculation of profit for tax purposes and the consequences for the tax balance sheet and whether dual accounting may be tolerated for single-entity financial statements and consolidated financial statements.

Different accounting philosophies make congruence more difficult

In contrast to the German commercial balance sheet, a financial statement drawn up according to IAS or US GAAP does not serve to measure distributable profit, let alone to prudently measure distributable profit. The tried and tested system of German GAAP based on the Commercial Code prevents income from being reported before gains have actually been realised or the risk of losses has been permanently averted. Financial statements drawn up according to international accounting standards are geared solely towards providing information considered relevant for investors' decisions, in particular, and are designed to give a true and fair view of a company's assets, financial situation and profitability. Although this, too, can be seen as serving creditor protection interests, it is not focused on recognition and measurement rules for purposes other than transparency. A true and fair view of the actual financial situation requires a more extensive application of market valuation and abandoning the historical cost as the value ceiling as well as the unilateral recognition of only negative changes in value (unless the reinstatement of original value is required). The principle of market valuation is not contained in German law. The different recognition and measurement rules under German GAAP and IAS thus give rise to at times major differences in the calculation and disclosure of net profit or loss, which also affects the amount of balance sheet capital relevant for prudential purposes.

Prudential recognition of the capital effects of unrealised value changes through IAS 39

A key prudential problem with accounting under IAS 39 is created by the recognition of fair value in categories such as "available-for-

9 For fixed assets and current assets the initial measurement is at historical cost, and this historical cost is at the same time the value ceiling for remeasurements. Current assets have to be written down on the reporting date if a lower value (stock exchange price, market price, fair value) is determined (strict principle of lower of cost or market). Fixed assets must be written down only if a lasting value impairment is likely (diluted principle of lower of cost or market). According to the commercial-law principles of German GAAP, only realised gains can be included in the net profit or loss, whereas expenditure has to be included in the net profit or loss even if it has not yet been realised. The Commercial Code requires the most objective valuation possible; discretionary scope exists mostly regarding the valuation of assets for which no stock exchange or market prices are available and for transfers to provisions.

Key implications for credit institutions' balance sheet capital of the changeover from German GAAP to IAS for consolidated financial statements

Item	German GAAP	Implications for IAS financial statements
Hidden reserves pursuant to section 340f of the Commercial Code	Claims and securities held as a liquidity reserve may be undervalued by up to 4%	IAS does not permit undisclosed reserves; equity increase
Goodwill	Capitalisation option only for purchased goodwill; may be offset against reserves immediately or may be amortised over four years or over the estimated useful life	Capitalisation requirement, amortisation at the expense of the profit and loss account; amortised over the estimated useful life, generally not more than 20 years; adaptation to US GAAP being discussed (capitalisation requirement, impairment test for remeasurement, no scheduled amortisation); change in equity dependent on previous procedure under German GAAP; tendency towards equity increase
Securities		
Fixed assets	Valued at historical cost less depreciation (diluted principle of lower of cost or market)	Write-downs only for permanent impairment; tendency towards equity increase
Current assets	Valued at cost or at the lower stock exchange or market price (strict principle of lower of cost or market)	Held to maturity: amortised cost, reduced if necessary by write-downs; trading securities: fair value, with unrealised gains recorded in the profit and loss account; available for sale: fair value, either recording unrealised gains as net profit or loss or recognising them in equity; tendency towards equity increase
Provisions for pensions	Accrual requirement for new commitments as from 1 January 1987	Accrual requirement; market interest rate, salary trends and pension adjustments are taken into account; equity is reduced
Leasing	Contractual arrangements determine accounting method; leased object shown under "other assets", if appropriate; various methods of depreciation	Contractual arrangements determine accounting method; if appropriate, financial lease can be classified as a receivable and declining-balance depreciation can be adjusted; tendency towards equity increase
Taxes	Special tax depreciation and transfers to special reserves; capitalisation option for deferred taxes	Special tax depreciation not allowed; comprehensive tax accrual and deferral requirement; tendency towards equity increase

Deutsche Bundesbank

sale" financial assets. The corresponding changes in the value of balance sheet assets are posted directly to a separate equity item which, as a revaluation reserve, can be equated to unrealised reserves and therefore is classified as additional capital for prudential purposes. If, by contrast, the alternative accounting option is taken of posting such changes to the profit and loss account, the change in the value of the asset flows directly into retained profits, which in prudential terms are considered core capital. Supervisors need to find appropriate methods of treating the different outcomes of such valuations, also in comparison to other components of the various categories of regulatory capital. The same applies to the prudential treatment of deferred taxes resulting from valuation pursuant to IAS.

Full fair value accounting

The international standard setters have a preference for full fair value accounting so as to make it impossible to put a positive gloss on the annual accounts by reclassifying assets to asset categories valued according to other principles. The banking industry and banking supervisors, as well as the European Commission and the European Central Bank, however, all oppose the use of full fair value accounting for all financial instruments. Unlike fair value accounting for marketable financial instruments, there are considerable problems involved in calculating the fair value of instruments such as loans, for which no active and liquid market exists at present in Germany and many other countries. The fair value would, in this case, have to be estimated, but there is no recognised and reliable procedure for doing so. The individual modelling of such

methods (mark-to-model), as well as the assumptions that would have to be made for the estimate, would offer a considerable amount of discretionary scope for valuation which would seriously impair the reliability of the accounting items calculated in this manner. Moreover, full fair value accounting may be expected to lead to a greater volatility of results, which could affect the stability of the financial system and also trigger a change in banks' behaviour. To control the volatility of their results, banks might be prompted to shorten the length of time during which interest rates and capital are locked in, thus causing the terms of long-term finance to deteriorate. At the same time, the incentive to transform maturities will depend much more than in the past on short-term capital-market conditions.

Value adjustments

In fair value accounting, individual value adjustments and general value adjustments have no accounting importance whatsoever. They are automatically taken into account if expected future payment streams are discounted to their present value. In the "mixed model" of IAS 39, however, there are – as mentioned earlier – financial instruments which are valued at amortised cost. They are subjected to an impairment test and, if necessary, written down to the lower fair value. In this case the value adjustments are deducted from capital. Whereas this accounting approach focuses more on the reporting date and disregards potential value impairments related to future events, regulators have a greater propensity to take account of expected negative future events. This is not contradicted by the calculation of general value adjustments in practice, in the view of banking supervisors. Aspects of the internationally widely discussed process of "dynamic provisioning", in which provision is made for expected losses based on solid past experience, can and should subsequently be taken into account when calculating general value adjustments. Such a practice of risk provisioning should also be recognised for tax purposes since that would offer an incentive for adequate risk provisioning, give an accurate impression of taxability and contribute to reinforcing the stability of the financial system.

The future of undisclosed reserves

German banks will face a major change when they switch to using international accounting standards in that they will no longer be allowed to include undisclosed contingency reserves in their consolidated financial statements or, for all practical purposes, in their single-entity financial statements, either.[10] A

---

10 The Commercial Code contains industry-specific regulations for the accounting practices of credit institutions and financial services institutions; these regulations supplement and sometimes amend the generally applicable principles. That is the background against which, in particular, the legal option of forming and releasing items which make provision for general banking risks and which constitute a special form of the principle of prudence is to be seen (sections 340f and 340g of the Commercial Code). These instruments may be used to set up balance sheet reserves which, if necessary, can be subsequently mobilised to enhance disclosed profits. Transfers to and the release of such reserves, which show up in net profit or loss, and the existence of a reserve item under section 340f of the Commercial Code, are generally not apparent in the accounts since they are offset by other items in the balance sheet or profit and loss account. "Undisclosed contingency reserves" provide scope for discreetly smoothing the result so as to avert a threat to the company's ability to continue as a going concern caused by excessive market reactions such as a run by depositors to deteriorating profitability and in order to buy time for corrective countermeasures. To that extent, this instrument runs counter to the transparency espoused in international accounting standards. Transfers to, the release of and the amount of the special item for general banking risks pursuant to section 340g of the Commercial Code are transparently listed in separate items of the balance sheet or profit and loss account and so are easily traceable for the observer.

number of institutions which are already applying international accounting standards have voluntarily abandoned this instrument. However, German banking supervisors continue to regard undisclosed contingency reserves pursuant to section 340f of the Commercial Code as being important for the stability of the financial system. The Bundesbank, for its part, advocates the continued use of the undisclosed reserves instrument for all commercial single-entity financial statements. To that extent, it will be necessary to tolerate a conflict of interest with the aim of greater transparency and market discipline (Pillar 3 of the new Basel Capital Accord).

Need to harmonise Pillar 3 and IAS 30

Pillar 3 (market discipline) of the new Basel Capital Accord (Basel II) is aimed at subjecting banks to market discipline as a complement to banking supervision. Banks are required to inform current and potential investors, counterparties and customers as well as the general public of their capital base and their risk profile. These extended transparency standards for the supervised institutions are consonant with current accounting trends. By expanding the disclosure of information and banking risks, as is envisaged by the IAS, market mechanisms and markets' risk analyses can be used as an adjunct to prudential banking supervision in order to reinforce the stability of the financial markets. To avoid placing undue strain on institutions and also to avoid confusing analysts and observers with differing data, it must be ensured that information according to a revised IAS 30 and the requirements of Pillar 3 are harmonised as far as possible.[11]

Appendix: The international debate on the consequences of the insolvency of the US energy trader Enron

The Enron case

The collapse of the US energy trader Enron in late 2001 attracted international attention. The Enron case had consequences not only for the company itself, its investors and its employees, but also for its auditing firm, which now is even on trial for its role in concealing Enron's shady business practices.

International debate on avoiding market disruptions

The Enron case has triggered an international debate on the causes and the necessary consequences in order to avoid future market disruptions like those which ensued as a consequence of a general loss of confidence in published company financial statements. Fraudulent business activities and the wilful violation of rules may have been partly to blame for Enron's collapse. However, some fundamental flaws and gaps in the accounting, auditing and corporate governance practices were brought to light, too.

Enron case reveals flaws in US GAAP and its application

US GAAP, being a large compendium of specific rules, created incentives for Enron to either circumvent or abuse them. Enron conducted many types of business for the sole purpose of being able to present a favourable financial statement according to US GAAP. It established non-consolidated "special-pur-

11 IAS 30 envisages only a very small number of items for the balance sheet and the profit and loss account and comprehensive notes with a non-standardised format. Since the single-entity and consolidated financial statements also provide information to banking supervisors, it will be necessary to come up with solutions which ensure that supervisors receive the information they need at a sufficient level of disaggregation and that breaks in the time series of annual accounts data are kept to a minimum.

pose entities" to this end in order, for instance, to remove debt from the balance sheet and to create financial turnover which netted to zero but conveyed to the markets a false impression of growth and liquidity. Basically, Enron was following the letter of US GAAP – yet violating the spirit.

The debate on Enron has also given rise to critical questions regarding the increasing practice of publishing "pro forma results"[12] which are often quite different from the audited figures published in the certified financial statements. It is clear that pro forma results are no substitute for a more precise analysis of a company's financial situation.

Enforcement of accounting rules

Accounting rules which produce reliable financial statements are by themselves insufficient if there is no credible institutional procedure for enforcing them. The SEC was given this role in the United States. To that extent, the USA now has a mechanism in place for enforcing accounting standards, even though criticism has grown that the SEC is understaffed and underfunded. In Germany, only the activity of the court of registration (*Registergericht*), if anything, can be seen as performing a similar sovereign function of enforcing rules. It may well make sense to examine whether Germany, too, could use an explicit enforcement mechanism. One idea in this respect might be for the court of registration and the German Accounting Standards Committee to join forces.

Improving the quality of audits

Moreover, in the Enron case – as well as similar problem cases in Germany (Balsam AG, Flowtex or Philipp Holzmann) – the auditing of corporate financial statements by individual external auditing firms has proved inadequate. In the Enron case the auditors not only tacitly approved dubious accounting practices but seemingly even made it more difficult to unearth them by destroying evidence. A general question in the field of auditing is just how independent auditors really are, especially since often auditing firms simultaneously provide auditing and consultancy services to the same client. It is true that there are already international standards such as the International Standards on Auditing (ISA) or the Code of Ethics of the International Auditing Practices Committee (IAPC). However, the use of these standards is not binding, nor are auditing firms explicitly supervised by government agencies. However, the auditing industry, as a consequence of past shortcomings, has been conducting mutual peer reviews. At the end of such reviews, the examining firm can present recommendations for implementation. Whether such peer reviews will suffice to restore the lost confidence is a matter for study. The industry is also conducting international discussions on further quality assurance measures in auditing financial statements.

Corporate governance

In the Enron case, as in many other problem cases, deficits in corporate governance were uncovered. Transparency in this area should be increased across the board. The voluntary corporate governance code for companies introduced in Germany at the end of

12 In addition to the officially audited results in the annual accounts, companies sometimes publish so-called "pro forma results" adjusted for special factors. They constitute what the company believes to be the sustainable projected profit but are subjective and not audited.

February 2002 and comprising 50 national and international standards can be considered a step in the right direction. Although compliance with these standards is voluntary, enterprises will be required to submit a written comment once a year in which any non-compliance with individual standards will have to be explicitly stated. The controversy surrounding this code, particularly its demand for the disclosure of individual board members' salaries, including stock options, shows that there is still no consensus surrounding the right level of corporate transparency.

Role of rating agencies

Last but not least, Enron also triggered a renewed debate on the role of rating agencies. Not only the markets but also banking supervisors, who will need to rely on external ratings for enforcing the new Basel II rules, are particularly interested in seeing the quality of ratings improve. In the Enron case, rating agencies came under fire for having given the enterprise an investment-grade rating just before its collapse. Wherever possible, the markets should be able to obtain more up-to-date ratings. This does not necessarily have to lead to greater volatility since changes in ratings, and therefore also market swings, will probably be fairly small. An improvement in rating quality by means of an explicit supervision of rating agencies by a government agency is also conceivable – although supervisors would have to confine themselves to monitoring working procedures and compliance with generally accepted standards. However, this is something the industry could do itself at potentially lower cost.

Process of reform under way in the USA as well as the EU

There are already some initiatives both in the United States and in the responsible EU institutions to address the above-mentioned problems as well as other issues. At present the FASB is revising some of the US GAAP rules so as, for instance, to reinforce the consolidation requirement for special-purpose entities. The SEC has presented a plan to monitor the independence of auditors at the major auditing firms. The European Commission has also been active in that area, recently publishing a recommendation containing criteria to ensure auditors' statutory independence. Moreover, there are comprehensive plans at the EU level to improve accounting and corporate governance practices as well. Additional EU initiatives aim at improving transparency in the international financial system, avoiding conflicts of interest among financial analysts and also the possibility of regulating the activities of rating agencies. These efforts on both sides of the Atlantic should be welcomed and should therefore be given continued political support.